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HEARING

before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

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Prepared by DARRYL C. EVANS,
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CONTENTS

OPENING STATEMENTS

WITNESSES

SUBMISSIONS FOR THE RECORD

THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL POLICY

Tuesday, February, 24, 1998

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 9:36 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Ewing, Thornberry, McCrery and Stark; Senators Sessions and Bingaman.

Also Present: Representative Ganske.

Staff Present: Christopher Frenze, Mary Hewitt, Robert Keleher, Dan Lara, Juanita Morgan, Howard Rosen, Joseph Cwiklinski, and Caroline Buerkle.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. The hearing of the Joint Economic Committee (JEC) to deal with the International Monetary Fund (IMF) and the issues surrounding it will come to order.

I am pleased to welcome the distinguished economic experts testifying before the Committee this morning. This hearing has been called to review the Administration's request for almost $18 billion for the International Monetary Fund. During the past several weeks there have been a number of hearings on the Asian crisis and the International Monetary Fund. Much of the focus has been on Asia instead of the fundamental issues regarding the IMF itself.

This is understandable given the circumstances, but more facts concerning the IMF are needed before Congress can make an informed decision about the IMF appropriation. For example, in presenting the case for increased resources for the IMF, little Administration testimony to date has presented basic financial information, such as the current quotas, amount of outstanding loans, the interest rate paid on quotas, and cost of overhead, and related expenses. Furthermore, the Administration case relies heavily on the Asian crisis, even though the IMF has sufficient funds to complete the announced Asian bailouts.

This hearing was called to focus on the IMF, its financing procedures, administration, and economic impact. This is entirely appropriate in light of the Government Performance and Results Act. Under the bipartisan legislation, which was supported by Members of both parties, Congress is to review programs based on measurable and objective performance criteria. This act fundamentally changes the way Congress and the Administration evaluate programs. Even if it is argued that the act does not technically apply to IMF, the IMF appropriation should be evaluated in the same spirit. This will require more trans-parency and responsiveness to Congress from the IMF in the future.

Sabastian Edwards, a former chief economist of the World Bank, has said the pervasive secrecy of the IMF makes evaluating its performance extremely difficult, if not impossible. I can attest to that, during the last couple of weeks in trying to figure out for myself, with the help of my able staff, many of the issues surrounding this subject.

The key question before Congress is whether the IMF should be significantly expanded into the future. Again, the IMF appears to have sufficient funds to cover its current obligations. We are now talking about whether the IMF should be significantly expanded and given more reach.

The current quota increase before Congress is somewhat smaller than that favored by the IMF. The IMF has signaled that the United States should be prepared for an additional quota increase fairly soon, apparently even after this appropriation. This indicates that the IMF expects rapid growth in its operation in coming years. The desirability of such permanent structural increase in the size and reach of the IMF is the key issue before Congress.

However, a convincing case for such IMF expansion is not clear to all and, in fact, has not been made. The IMF budget projections are not available because apparently the IMF does not produce such projections, even for their own internal use. Thus, a case for future IMF growth cannot be sustained by quantitative estimates of future IMF activities. Measurable and objective criteria for IMF functions are not available. Presumably the growth of the international capital flows in recent years might be used to justify an expansion of the IMF, but an alternative expansion might be a growing moral hazard problem, which we will get into later in the question and answer period, that is associated with the bailouts of recent years.

Aside from the specifics of the budget request, there are several major problems with existing IMF lending policies and practices. These include moral hazard, the lack of IMF transparency, excessive taxpayer exposure in the sending and the receiving countries, subsidized interest rates, and counterproductive conditions attached to the IMF loans. These are issues that reasonable people may disagree with, but they cannot be ignored. Meaningful structural reform of the IMF is needed whether an IMF expansion is financed in 1998.

[The prepared statement of Representative Saxton appears in the Submissions for the Record.]

At this time, I will ask the Ranking Member, Senator Bingaman, for any comments he may have.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. Thank you, Mr. Chairman. I do not have an opening statement. Let me welcome Assistant Secretary Geithner and the other witnesses. I look forward to your testimonies. This is an extremely important issue and we are going to live with its consequences for the foreseeable future. I commend you, Mr. Chairman, for having the hearing.

Representative Saxton. Thank you very much, Senator Bingaman. Do other Members have short opening statements, or shall we just move right ahead to the first witness if that is all right?

Mr. Geithner, thank you very much for being with us this morning to represent the position of the Treasury. We are anxious to hear your testimony. We have set aside 15 minutes for your opening statement, so if you would like to proceed?

OPENING STATEMENT OF TIMOTHY F. GEITHNER, ASSISTANT SECRETARY OF THE TREASURY

Mr. Geithner. Thanks. I will do a summary of my statement and ask that you include my full statement for the record.

I am very pleased to have the opportunity to come before you today to talk about the International Monetary Fund and why we believe it is so important to act now to strengthen its financial resources.

We think this is an important debate and an appropriate debate to have, and as a career civil servant at the Treasury, I am particularly pleased to have this opportunity to testify before the Joint Economic Committee.

The crisis that began this summer in Thailand and spread throughout southeast Asia and to Korea presents serious potential risks to American interests. Our economic interests are at stake because large and sustained depreciations in the currencies of our trading partners and deep recessions in their economies will reduce the competitiveness of American companies, reduce demand for American exports, reduce the earnings of American firms and reduce the value of pension funds across the country, all of which of course will affect American families, American workers, and American farmers.

Our security interests are at stake because economic instability, when it is acute and sustained, can threaten political stability. This risk is real not just in places where we now have American troops on the ground. It can be significant in any country where the basic institutions of the government are untested in crisis or where there does not exist a stable, established pattern for succession.

In response to these developments and in an effort to limit the risk they present, we have led a major international effort to help reestablish financial stability in Asia and to help strengthen the international financial architecture.

The IMF is at the center of these efforts and it will remain critical to any effective U.S. response to protect our interest in this crisis, as well as in future crises.

The centerpiece of our approach has been to support strong programs of reform. These programs are designed to address the specific causes of the crisis in each country, to create the conditions necessary for stronger, more stable exchange rates and for a quick return to rising living standards.

Although the specifics have varied across countries, the principal elements of each program include measures to strengthen the financial systems, structural reforms to make the economies more market oriented, the liberalization of restrictions on trade and investment, and true transparency and disclosure, measures to reduce the impact on the poorest segments of society of adjustment, and a supportive framework of monetary and fiscal policies.

These programs are essentially programs of growth-oriented structural reform. They are not austerity programs. It is the crisis, not the program, that induces economic distress, and it is the programs that help cushion declining growth in living standards and help create the conditions necessary for recovery.

Countries that have tried a different path of delayed adjustment and less comprehensive reform have normally found that by doing so, they simply lengthen the crisis into later recovery.

The other common element in these programs is that they can be adjusted in response to changing circumstances. When growth slows more sharply than expected, the IMF can move, as it has in each of the cases in Asia, to modify the fiscal targets in the program, so as not to impose excessive contraction and weaken economies; and when problems in the banking system become more acute than originally estimated, the IMF can act, as it has in Thailand and Indonesia, to strengthen the programs in response.

In support of these programs, we have mobilized temporary financial support, led by the IMF, to help rebuild reserves and provide confidence. This financial assistance is an essential part of the solution to these crises. It is necessary to induce stronger reform programs to provide some breathing space for the reforms to take hold, to supplement the countries' official reserves and to help ensure that these governments can meet their international obligations and can stand behind their financial systems.

There is no amount of official money, however, that can substitute for or compensate for a lack of commitment to reform. That said, even the most credible and most committed governments could not successfully confront problems of this scale without temporary financial assistance. It is useful to recall, although this is not a perfect analogy, it is useful to recall that the U.S.–this country–itself drew a substantial amount of our reserve deposit in the IMF in 1978 when we faced a major decline in the value of the dollar.

The IMF reform programs are structured carefully to help ensure they work to help limit the moral hazards that are inherent in any provision of official finance and to maximize burden sharing. Several of these features are worth highlighting:

Disbursements are tied to strict compliance with very detailed, concrete time-specified policy commitments. They are tranched or phased to induce up-front actions and to help sustain follow through. The money does not flow unless the policy commitments are carried out.

The assistance is provided in the form of temporary loans, not grants, at market-related interest rates and, in fact, after the establishment of a new IMF facility at our initiative last December, much of the assistance for Korea and for future cases will be made available for short maturities at a substantial premium to minimize use and maximize the incentive for countries to repay early.

The IMF's assistance comes with strict limitations on the use of the money, with restrictions on support to private corporations and with limitations and conditions on liquidity support to banks.

And the assistance is led by the international financial institutions, not by bilateral donors, which helps ensure conditionality is maintained and that we leverage substantial contributions from the international community.

Not providing this assistance, in our view, would risk more acute instability, a greater, more protracted loss of economic output, deeper, more sustained depreciations in the currencies of our trading partners, and greater contagion, all with much greater risk to the United States.

The IMF is essential to this effort. If it did not exist, we would have to invent it again. We have a huge stake, we believe, in making sure it has sufficient resources to respond to any intensification or spread of the current crisis.

Today, as much as when it was established with U.S. leadership more than 50 years ago, the IMF acts sort of as a forward defense for American interests. It has played a critical role in supporting reform and growth in the transition economies, helping bring Russia back from the brink of hyperinflation and pulling Poland from near collapse to one of the fastest growing economies in Europe. In Uganda it has helped underwrite 10 years of remarkable reforms which have generated average annual growth rates in real terms of 6 percent a year over the past decade. And in Argentina, to point out another example, the IMF has supported a successful transformation from a country characterized by hyper-inflation to one that enjoys strong growth, 7 percent in 1997, near zero inflation, declining deficits in a much more private-sector oriented economy.

The IMF has been successful in these cases and in many other cases because it promotes the core American economic values of sound money, respect for market forces and free trade.

I thought it would be useful for me to say a few words about the financial structure of the IMF. In some ways, the IMF operates like a credit union. That is not a perfect metaphor but it is a reasonably clear one. We extend a credit line for most of our quota subscription and for a GAB or NAB commitment. The IMF can draw on this credit line. Any drawing by the IMF gives us sort of a deposit in the IMF, which is of equal value, pays interest, is backed up by more than $30 billion in gold, and which we can withdraw essentially on demand if necessary. For these reasons, the U.S. participation in the IMF is treated as an exchange of financial assets. Our transfers are not scored as budgetary outlays and don't come at the expense of domestic programs.

Chairman Greenspan and Secretary Rubin have testified on a number of occasions over the past few months about the risks in the current crisis and about the importance of action by the Congress to strengthen the IMF resources.

As you know, the President's request has two components. The first component is to authorize U.S. participation in an expanded emergency reserve fund for the IMF, called the New Arrangements to Borrow. This was proposed in 1995, after the Mexican financial crisis, and it is modeled on the General Arrangements to Borrow, which was established by the U.S. in cooperation with the G-10 more than 30 years ago. The NAB would make available an additional $23 billion from some 25 countries to supplement the IMF's normal lending resources in the event of a serious threat to the stability of the international financial system. Just for reference, the GAB was last increased in 1983, in response to a request from President Reagan, and also in conjunction with a new alignment of quota increase. In the ensuing 15 years, the growth in the world economy trade, and most importantly perhaps, global capital flows, have left these arrangements too small to deal effectively with the challenges in today's capital markets.

Just to point out one fact that is useful, IMF resources as a percentage of private capital flows to developing countries are now one-twentieth as large as they were 15 years ago.

The second component of the President's request is to authorize our participation in the regular periodic increase in IMF quotas which are the normal lending resources of the institution. These resources have been increased on average every seven years to help ensure the IMF can keep up with the growth in the world economy and the global financial system, not fully keep up but keep up to some extent. This latest increase would increase the overall quotas by about 45 percent and provide roughly $65 billion in additional lendable resources. This was negotiated last year, really before the crisis took on its full dimensions, in consultation with the relevant congressional committees.

The IMF's recent reform programs in Asia have depleted its resources to levels approaching historic lows. Although the IMF has $45 billion now in uncommitted resources, only 10 to 15 billion of these resources, in our view, are available for lending for new programs because the IMF needs to reserve the remainder to accommodate possible withdrawals by Members. This is neither a sufficient cushion of resources to enable the IMF to perform its basic mission, nor is it sufficient to ensure the IMF could respond effectively if the Asian crisis deepens or spreads to other markets.

We believe it is extremely important that the Congress move quickly to approve both the NAB and the quota request so that the IMF has sufficient resources to help protect U.S. interests in what is a very delicate moment in the international financial system.

Now at the same time that we have worked to confront the immediate crisis in Asia, we have been working to help build consensus on reforms to strengthen the architecture of the international financial system. We have a very strong interest in trying to identify changes to the system that could help reduce the risk of and make the system more resilient in the event of future financial crises of this magnitude.

The President began this effort four years ago at the G-7 Summit in Naples and at the Summit that followed in Halifax, we launched a major effort to help make the financial architecture, in Secretary Rubin's words, "as modern as the markets."

Building on those steps, we have supported a number of changes over the past few months, and I will just list the most significant of these quickly:

We launched a new effort to strengthen transparency and disclosure standards, to help reinforce market discipline.

We have won support for a number of steps to improve transparency in the operations of the IMF, which I would like to review in detail for you during the question period.

We have changed the policies and operations of the IMF and the World Bank to make it possible for them, when necessary, to mobilize large-scale, front-loaded, more innovative programs of financial assistance that are more appropriate to today's capital markets.

We have established a new forum for surveillance and cooperation in Asia to help deal with risks that might precipitate future crises.

And we have encouraged greater participation by private financial institutions in the resolution of these crises, with a global effort by the major banks to refinance their short-term claims on Korean financial institutions.

We are now in a comprehensive review of changes to the system that we hope will help ensure we have effective institutions to manage the risks that accompany all the benefits of global capital market integration and to help us deal with the world in which we are all more directly affected by what happens in other economies and governments. But we don't have the capacity to induce sovereign states to take actions they do not yet perceive to be in their interest.

This is going to be a complicated and difficult process, with lots of interesting, compelling solutions to be explored. The temptation for some, I think, will be to try and stop the clock somehow to suspend the crisis while we try to figure out the best way forward, but we don't think that is a tenable approach given the risks we now face.

The U.S. role is critical because the IMF cannot strengthen its resources without us. If we do not act, the NAB will not come into force, the quota increase will not go into effect. We can't guarantee that by acting we can turn things around and successfully eliminate any fallout for the U.S. economy. Most of the solutions to these problems have to come from the countries themselves, but we have a responsibility to do what we can to help protect our interest in this crisis, and the strength of the IMF is essential to that objective. Thank you very much.

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

Representative Saxton. Thank you very much. We want to thank you for your testimony. And let me just say at the outset that when Congress is asked to appropriate a sum of money that amounts to very close to $18 billion, obviously Members on both sides of the aisle take it very seriously. So we are sincerely looking for the information that we need to know how the money will be used, hopefully effectively, to solve problems that the IMF identifies.

Information to us is very important, therefore, relative to the operation of the IMF. And I must say that partly because the IMF has not been forthcoming, and partly because of the complicated nature of the information, it has been very difficult for us as Members of Congress to understand it.

Now as you know in recent months, there has been quite a bit of debate about these issues. One purpose of this hearing, therefore, is to try to elicit more facts about the IMF so Congress can make a more informed decision about the Administration's appropriations request. I would like to ask a series of questions relative to this information.

First of all, let me ask you about my request for three of the IMF reviews of the bailouts of Thailand, Indonesia, and Korea. Under the law, Congress must take the performance results and take the results of agency policies into account, in consideration of funding issues. We do that consistently. Yet the Treasury and the IMF refuse to release the IMF studies of the effects of its own policies for the use of public policy debate, even as it asks Congress for an $18 billion IMF appropriation.

This raises questions to me, at least, about the seriousness of Treasury's commitment to IMF transparency, something you mentioned several times in your opening statement. The failure of the IMF to even respond to my letters raises the same kind of questions. As I have publicly stated, I understand that classified and proprietary information may have to be deleted. I understand that and have no objection.

Let me ask you, have you read the IMF staff reviews I have mentioned, including one entitled "Indonesian Standby Agreement?"

Mr. Geithner. Yes.

Representative Saxton. Very good. Now, did the IMF study conclude that the IMF's recommended bank closures, far from improving public confidence in the banking system, have instead set off a renewed flight to safety?

Mr. Geithner. I think that is a slight mischaracterization of the conclusions reached in that report, and maybe it is worth reviewing those in more detail. As part of the initial program, the government of Indonesia decided to close 16 banks that were very weak, undercapitalized, essentially insolvent. That was, I think, an appropriate step in everyone's judgment. It is hard to imagine that they would be better off or the financial system would be better off by trying to keep afloat insolvent institutions longer than they should.

The result of that action was concern, quite inevitably, concern among depositors in other Indonesian banks that the situation was worse than people had previously expected. So there was a flight of deposits from the system as a whole and the flight to quality within the system as a whole, but that is a necessary, inevitable result of any situation like this. It has been true. It has happened in Japan. It has obviously happened before in the United States, and it has happened in a whole range of countries across the region.

I don't think it would be appropriate to conclude from that that the IMF or the Indonesians themselves were wrong to act to close. It is perfectly accurate to say the effect of that was heightened concern about the stability of the system as a whole, but that would have been unavoidable and would not have been made better by keeping these institutions open.

Representative Saxton. I thank you for that. But at the same time, did the IMF study say–you indicate that there was a run on other banks –as a matter of fact, that two-thirds of the country's banks had experienced runs on its deposits? Two-thirds?

Mr. Geithner. Well, that may have been in the report and that may be true, but as I said, I think that is perfectly understandable in the context and probably unavoidable.

Representative Saxton. Did the IMF study state as a result that the central bank had to pump money into the banks equivalent to about 5 percent of GDP during the last two months?

Mr. Geithner. There is another report in front of me. I am reluctant to verify the specific numbers in there, and that may be true. I am a little uncomfortable, partly because I don't have it in front of me, walking through all the details of that report, and maybe it is worth talking a little bit about the concerns you raised about these reports as a whole.

We provide and are able to provide any document in the IMF, any staff report, any letter of intent, any program documentation, any analysis that the Congress requests, as long as we have appropriate protections in place to prevent the release of that information. We have also supported a whole range of policies in the IMF to make its prescriptions and its conclusions more transparent, and if you give me a chance, I would like to run through some of those policies.

Representative Saxton. If you can do it quickly, because I have a line of questions.

Mr. Geithner. Would you like me to wait, or should I run through that now?

Representative Saxton. Let me just back up to the question I just put to you relative to whether the central banks injected funds equivalent to about 5 percent of GDP during the last couple of months. Would you say that a significant amount of money was pumped back into the banks during the last two months?

Mr. Geithner. Absolutely.

Representative Saxton. And that 5 percent is probably within the realm of what it may have been.

Mr. Geithner. That–I want to look at the reports before I verify that.

Representative Saxton. That is fair enough. We appreciate that. Let's switch to Korea for just a minute. Does the IMF review of the Korean bailout examine the failure of the first Korean bailout to restore confidence?

Mr. Geithner. I'm sorry, does the–

Representative Saxton. Does IMF review of the Korean bailout examine the failure of the first Korean bailout to restore confidence?

Mr. Geithner. Absolutely.

Representative Saxton. Does it contain suggestions that additional steps might be needed, such as a second bailout during the Christmas holidays?

Mr. Geithner. I am not sure, actually, what the staff report at that point said about what was appropriate to the future to respond to the circumstances. I can tell you what we did that we thought was appropriate for a variety of reasons, many of which were political and had to do with credibility and a loss of credibility in the then- government. The initial program was not followed by an improvement in confidence; in fact, confidence deteriorated quite quickly after that.

In response to that, we thought it was necessary to work with the Korean authorities and the IMF to strengthen their program, to give them a chance to demonstrate through concrete actions that they were actually serious about trying to fix the problems that led to the crisis.

And supportive of that, we agreed to do two things which are very important to what has happened since. We agreed to pull forward some of the existing commitments–the disbursements in the pipeline from the IMF and World Bank, because at that point Korea was very short of reserves and was a day or two away from default.

We also agreed to make available part of what is called our "second line commitments," in the context of a broad agreement by the major international banks to refinance their existing claims on Korean financial institutions, and that process, as I think you know, has been quite successful in helping bring back a little confidence in Korea. And I think those steps were appropriate and have proven to be quite helpful.

Representative Saxton. Thank you. Now let's move to Thailand. Does the IMF review of the Thai bailout recognize that the IMF conditions on Thai fiscal policies were unnecessarily harsh and should be relaxed, as has been done in recent weeks?

Mr. Geithner. No, I don't think that is the correct characterization. I think people sort of tend to perceive these IMF programs as rigid, formulated prescriptions, that once applied never get adapted and changed. And in reality, they are quite flexible and they get adjusted in a rolling process as circumstances change.

In each of the cases, growth has proven to slow much more sharply than originally expected, and in response to that, the IMF has adjusted its fiscal targets in each case to make sure it was not imposing unnecessarily harsh adjustment, as the economy slowed further. But it wasn't the initial prescription that induced the declining growth; it was the sort of loss of confidence and credibility in the crisis that induced that.

Representative Saxton. Thank you. I know that you agree that we ought to address the issue of transparency, and unfortunately what we have to work with are your impressions of what is in the reports at this point.

Is there any doubt the IMF studies would be of great interest to Members of Congress in reaching informed decisions about the merits of IMF appropriations? Why should these documents not be publicly released after deletions of any classified or proprietary material?

Mr. Geithner. Well, I want to try to respond to that as well as I can. There are a variety of aspects to the transparency question and it is important we walk through those, I think.

The first is to make sure countries disclose to the markets better information, more comprehensive information about the quality-about the underlying financial condition of the country. That is something we supported very actively, the IMF has been very centrally involved in, we made some progress on, but we need to make more.

We also think it is important for the IMF to make available to the public more information about the contents of their programs and about the conclusions of their annual reviews of countries, called the Article 4 process. And we have, over the past several months, made important progress in those areas. For each of the major Asian programs, at our insistence, the IMF has released the letters of intent so the full details of the program are available to the markets, and that is critical to the effect of these programs, critical to credibility in our view.

We have also supported a more systematic external evaluation process at the IMF so that committees, ad hoc committees formed of external independent auditors and evaluators, can assess IMF programs in a number of areas and those results will be made public.

One more thing on the financial statements. We find the IMF financial statements hard to decipher too, and I think we share your frustration in trying to figure out what is actually behind them, but that is just because it is a complex institution, not because there is any mystery to the facts.

The IMF has a regular external audit every year of its financial statements and the conclusions of that review are made public. Now, just like in the Administration and I suspect in the Congress, we produce documents every day that have sensitive information in them or national security classified information that we are not prepared to make available to the public for lots of understandable reasons. The IMF has a number of documents that fall into that category, too. We make those documents available to the Congress upon request. You each have full access to that information and to those documents, but we do not have the capacity to release that information to the public; we don't have procedures in place that would allow us to release systematically redacted or modified versions of those documents to reduce classified information.

We are for more transparency in the IMF and we are very interested in working with you in the Congress to try and figure out ways to do that, and I would be happy to work with you and talk to your staff in more detail about things we might be able to do to respond to your concerns. We think it is very appropriate you have access to this information and you do have access to that information now.

We also think it is appropriate markets have access to more information and we have been supportive, quite successfully, in a number of steps in that direction, particularly over the last several months.

Representative Saxton. It is very difficult for us to understand why the Treasury and IMF cannot release declassified information to us. I understand that there is certain sensitive information that cannot be released. I understand there is classified information that cannot be released. Why can't the reports be released publicly on a declassified basis?

Mr. Geithner. Maybe the best explanation now is to say we are caught between the old and the new. This is an organization that has procedures in place to protect against the release of sensitive information, and we do not as members of that institution, under its current rules, have the capacity to make those public. And there are no procedures available now for us to systematically, as you put it, declassify or redact those documents. But as I said, I think you are making important points, and we share many of the objectives you have stated and we are prepared to work with you to see if we can accomplish those.

Representative Saxton. Congress deals with classified information all the time. We have an Intelligence Committee, and it deals with classified information on the third or fourth floor of the Capitol Building. I understand the walls are lined with lead, and the people who come out of those rooms never mention classified information, at least not on an authorized basis. We deal with those issues, and some of that information, from time to time, is declassified because we think the public has the right to know. The public ought to know that these issues are best decided when they are discussed publicly.

Is the real reason Treasury and IMF want to keep the study under wraps because it reflects badly on the IMF?

Mr. Geithner. Absolutely not. As I said, we think the programs are more likely to work if the markets have full information on the details of what is going on, and that is why we are providing more information to the markets. I think you are absolutely right about that case. But we have to be careful not to go–not to adopt changes that are going to make it impossible for the institution itself to function effectively in providing quite brutally candid assessments of what is going on in these countries and quite brutally candid prescriptions for what countries have to do to get back on track. And we have to find some way to balance the broad objectives of transparency with the same imperative which, as you acknowledge, leads the executive branch and the Congress to have procedures in place to prevent release of sensitive, classified information.

Representative Saxton. Let me ask one final question, and then we will move to Senator Bingaman. Is there any reason why the IMF financial statements should not be available in an understandable fashion to a typical economist or banker? Is there a useful purpose served by the opaque and confusing IMF accounting system that is currently used? And could you explain, for example, the accounting definition, "renumerable reserved tranche position," please?

Mr. Geithner. You know, I have been at the Treasury 10 years, and I am not an economist or an accountant, and I have found this stuff hard to figure out and understand.

Representative Saxton. We have had accountants and lawyers and economists working on it and trying to understand this stuff for weeks.

Mr. Geithner. You can take the balance sheet of any company in the United States and you may have a similar challenge.

Representative Saxton. Excuse me. You look at IMF documents -and it says here our quota is $26 billion, which is really $36 billion. You look at this and there is $13 billion. What is the term? The reserve tranche position is $13 billion, which is really not $13 billion. And CRS looks at all this stuff, and it comes back scratching its head. We cannot understand it, nobody will help us, and we are not going to appropriate money until we understand it. It is pretty simple.

Mr. Geithner. I think that is a perfectly reasonable concern, and we are happy to try to help the CRS understand. The GAO has conducted a number of studies of the IMF over time. They have a fair amount of expertise. We helped them walk through the accounts and explain them. They are hard to understand because of the institution, but there is no mystery to the facts and no mystery to the numbers and no mystery to the basic financial operations of the institution.

Representative Saxton. Just define for us the term "remunerated reserve tranche position."

Mr. Geithner. That is what I called in my testimony in simple terms, the claim we have in the institution that represents the IMF's drawing down of our credit line. That is an interest-bearing asset, and that is why it is sort of the offsetting claim to what they draw down on our credit line, and that is why our participation in the institution is not scored as requiring budget outlays.

I think the simplest answer is a deposit that pays interest that is liquid that we can withdraw.

Representative Saxton. Thank you.

Senator Bingaman.

Senator Bingaman. Thank you very much, Mr. Chairman.

I would like to begin by asking about the general way out of this financial crisis in Asia. A few weeks ago I read an article by Martin Feldstein, in which he said much of the cause of the crisis was due to policies which the Japanese government pursued in weakening the yen. He provided an explanation in the article, which I guess economists can argue about.

But when you get to the question of how Asia digs out of these circumstances, it seems that there is not much argument. The only way for most of these countries to dig out of the crisis is to export their way out, and the United States is the only market that is open and ready to accept those exports. The Japanese government, although we have urged them to stimulate their own economy and begin to accept more exports, don't seem to be willing to do that.

I guess I would ask, what specific actions are we urging the Japanese to undertake, other than just continued wringing of our hands. It seems to me, if the Japanese do not participate in the solution to the problem, the crisis is going to be much more protracted, and it is going to be much worse for U.S. workers and U.S. companies.

What specific things we are urging the Japanese government to do and what are the prospects for their implementation?

Mr. Geithner. Let me start by saying, we agree with your concerns and I certainly agree with much of what you said. There are three areas in which we think it is appropriate for the Japanese to take more forceful actions to deal with the challenges we now face.

The first is to use macroeconomic policy and fiscal policy with additional actions in the short-term to help strengthen domestic demand.

If you look at the trajectory of Japanese fiscal policy over the next fiscal year, it builds in significant additional contraction, and I would say the markets think that is a bit risky in the context of an economy this weak; and we suggested, as have the IMF and a number of other countries suggested, it would be more appropriate for the Japanese to act to stimulate demand with fiscal policy in the short term.

Senator Bingaman. That is a tax cut.

Mr. Geithner. There are a variety of ways they could do so. They are a sovereign country and we have been a little reluctant to prescribe in detail, certainly in public, the precise sets of policies they could take to meet that challenge. What is important to us is they do something that is going to work and work quickly.

The second area where we have been supportive of additional policies is in the financial system, where we want them both to stabilize, reduce systemic risks in the system and act to try and put the problem behind them more quickly. They have taken a number of steps recently in those directions, but they have not yet generated confidence in the markets. I think generally in Japan that they have got an effective medium-term plan for how to put this behind them.

The third area is just in the familiar area of opening their markets further. I think Japan would do Asia a great service if it was prepared to import more from the region, and so we have been actively promoting, generally in a variety of specific sectors, a more active market opening by the Japanese.

Senator Bingaman. Let me emphasize something you just referred to briefly. The Treasury Department has made apparently successful efforts in bringing together the foreign financial institutions which made large loans to Korea in order to restructure those loans. It seemed to me, the little bit I know about these circumstances, that that is an essential part and perhaps the most effective single thing that has been done so far in stabilizing the situation in Korea.

To what extent are you working in connection with the other countries in difficulty in the Far East in this restructuring effort. Second, are there plans to make this restructuring effort a normal part of the prescription or a normal part of the remedy that is put in place in these types of circumstances?

Mr. Geithner. I think we all want to find a way to make it possible for private investors to bear more responsibility for the risks they take in these investments and to be a greater part of the solution in resolving these crises. We don't have the capacity to force lenders to lend to countries in crisis if they don't think that they can do so, and it would be prudent to do so, or that their shareholders would be particularly enthusiastic to do so. We don't have the capacity to force them to take losses in these countries without assuming all the risks that come with a moratorium–the fear of sustained loss of access to the capital markets, the fear that banks would pull back from other markets around the world and that the crisis would be much more acute as a result.

Each of these circumstances is unique. What has happened in Korea has happened in part because the regime of the new government has been viewed as so credible and serious and, in part, because it was a very quick realization by the major international banks about the stake they had in trying to work this out. It is very hard to see whether those conditions would make it possible to adopt a similar solution in the other cases in Asia, much less in other cases elsewhere in the world, but one of the core features of what the Secretary and Chairman Greenspan have been trying to do, the process by which they tried to begin to strengthen the architecture, is to try and design mechanisms to help us do in the future what we tried to do in Korea.

Senator Bingaman. I recently received a letter from Mr. Dave Schlegel, who is the President and Chief Executive Officer of a company in Albuquerque, called Envirco Corporation. The company makes clean air equipment for use in semiconductor processing. The corporation employs about 100 people in my state, and it has been successful over the last several years in expanding its exports. By the end of last year, about 40 percent of their revenue came from exports.

They now face a situation where, as they put it, "overnight, the Asian crisis provided their Korean competitors a 50 percent cost reduction." They also say that, "We should not allow the United States to soak up excess Asian production capacity so that Asian countries can export their way back to prosperity at the expense of American workers and jobs. Any ensuing American economic hardship must not solely fall on the American workers in industries vulnerable to Asian exporters using devalued currencies. Our export success," he is talking about his company, "has helped restore prosperity to the country, our people have worked hard, they have played by the rules, and they have succeeded. If they are now considered expendable to cure the Asian crisis, then their faith in American values and America's future is rightfully shaken." I may ask you to respond to this letter.

Do you have any response you could give us this morning as to what we tell this gentleman? It seems to me we have programs in place to increase assistance to large companies that do business internationally. What do we tell smaller companies of 100 employees? Do we just tell them, tough luck, all our efforts to encourage you to export were misguided?

Mr. Geithner. No, absolutely not. I think that is a terrific example of why we are doing what we are doing. It is useful to just review again why these programs are important.

They are important because unless we can put in place the conditions that are going to generate stronger, more stable currencies in these countries, and unless we can generate the conditions that can allow them to return to more rapid growth so there is a growing demand for U.S. exports again, we are going to face in companies across the United States a significant loss of exports and significant effects on their earnings.

The most effective thing we can do for companies like this one is try and shape an effective response that is going to bring the currencies back and bring stability and confidence and growth back to these countries. That is the most powerful solution to these problems, and it is exactly why we are acting.

Senator Bingaman. Thank you.

Representative Saxton. Thank you.

Before I move to my friend, Mr. Ewing, Senator Bingaman mentioned the interest of Martin Feldstein, who is the Chairman of the National Bureau of Economic Research, in this subject. I received a letter from him, which I would just like to read for the record. He says

"Dear Jim, I received your press release calling on the IMF to release documents relating to their programs in Asia. I support this request. I think the basic program documents should be available so they can be examined by a broader group of experts than just those in the IMF."

"The fund will no doubt," he continues, "reply that they can only do so with the permission of the countries themselves. I think it would help if Congress made it clear congressional support for IMF activities depends on getting these program agreements, and that it is therefore in the interest of the countries to agree to have these documents released."

That makes sense to me.

Mr. Geithner. Much of that makes sense to us, and that is why we pushed to accomplish what he described. Basic program documentation in each country was released to the public. He is absolutely right. It is perfectly appropriate for the broader community of investors and analysts and academics and economists to have access to information to allow them to assess the quality of that advice and the effectiveness of the program.

Representative Saxton. As well as the documents that we requested by this Committee.

Mr. Geithner. As I said, we are happy to try and work with you to figure out if we can design ways to facilitate greater release of those things and still protect sensitive, classified information. We don't have that right now, so I can't give the documents to you right now, but we are happy to work on that area.

Representative Saxton. Mr. Ewing, who got up at 3:00 a.m. to be here today, by the way.

OPENING STATEMENT OF REPRESENTATIVE THOMAS W. EWING

Representative Ewing. I am waiting for the Chairman to tell me it was all worth it.

I want to, if I can, Senator, follow up on your question for a minute. I think that is the real crux of some of our constituent concerns back home. If we do nothing and their economies plummet and the currencies are devaluated, our producers are–people who are trading overseas are going to be at a tremendous disadvantage, those markets are going to disappear or whatever. If we go in, as we have, and we try and stabilize the situation and there is tremendous devaluation in their money, we are still at a tremendous disadvantage in the trade issue with their currencies being devaluated. And we hear about this so much.

I am asking, what is the answer? I mean, either way, it is bad. Maybe we should just save our money if it is going to be bad either way. What would you say to that?

Mr. Geithner. I don't think I agree with that.

Representative Ewing. I didn't think you would agree, but how do you answer if it is going to be bad either way?

Mr. Geithner. Our view is that there is no way to avoid some of the effects of the crisis that has happened so far; that will affect us no matter what we do, going forward. But if we are not successful in trying to stabilize these countries and get them back to growth, then the loss of U.S. exports, the loss of earnings, the risk to U.S. companies would be far greater. That is not something we can prove to you, but we have lots of other past examples to illustrate why the effects would be much greater if we fail to succeed in helping these countries reestablish stability.

So I don't think it is fair to say that we have two outcomes here and that in both cases we have equal effects on the U.S. economy. I think in one case, the effects will be modest but significant. In the other case, it could be far greater.

Representative Ewing. This leads into a question I wanted to ask you dealing with agricultural products, because I think, since January, they have fallen about 5.8 percent in value, price, here in the United States. And that is probably because, again, of the depreciation or devaluation of the Asian currencies.

How fast do you see these currencies coming back in? Are they facing rather high inflation that will bring that currency a little more up to where it was, more rapidly than we are in this country?

Mr. Geithner. Well, I think that will be part of the mechanism that will help, over time, to limit the decline in their real effective exchange rates; but how fast they come back depends on how successful they are. It would be nice, but we can't will these exchange rates into higher levels and just keep them there through an active will. It only happens if you can generate confidence and confidence comes back; and as I said in my statement, once you lose confidence, it is hard to regain it. So it is hard to say how quickly the nominal exchange rates will come back.

Representative Saxton. You believe then that Members from agricultural areas should be very supportive of additional funding for the IMF?

Mr. Geithner. Well, they actually have been very supportive. In some ways, they have seen more graphically and more quickly the potential loss of exports. I think the estimates from the United States Department of Agriculture (USDA) now are that we could lose $2 billion in exports this year. Even if things stabilize here, that is a fairly substantial amount of money; and they have been very, very supportive in what we have been trying to do with the IMF in these cases.

Representative Ewing. We are talking about $18 billion in additional money. That was explained to me by Secretary Rubin and Chairman Greenspan, that this was to replace monies already obligated, kind of a standby in case there was a further worsening of the crisis; is that correct?

Mr. Geithner. Absolutely. As he put it, we feel it is important to have it to deal with any spread or intensification of the current crisis.

Representative Ewing. One last question. How do you get the most bang for your dollar when these economies have suffered hundreds of billions of dollars worth of loss from devaluation, and we are putting in a modest–how many billion–40 or 50 billion?

Mr. Geithner. Well, it doesn't seem very modest.

Representative Ewing. Compared to the estimated loss in those economies, it is modest. It certainly isn't a replacement.

Mr. Geithner. That is actually right. The amount of official assistance that has been made available and actually disbursed in these countries is very small in comparison to the scale of external liabilities, and that is why the programs work, if they work, only because they engender the confidence necessary to have savings stay in the country in foreign capital and private capital.

They don't work because the official money is there, although that is a necessary condition to make them work; they only work if private money will stay or come back in.

Representative Ewing. I guess it still isn't an answer to how a rather limited number of dollars, compared to what the loss is, replaces it and stabilizes the economy.

Mr. Geithner. You said it perhaps more clearly than I did. It is a relatively small amount of money in comparison to the losses experienced, and it is a relatively small amount of money in comparison to the losses that could be experienced.

Representative Ewing. My question is, how does that work?

Mr. Geithner. It works because–in some ways, it is like putting money in a loan window or augmenting the country's reserves. In association with these strong programs of reform, you give the people of the country and foreign investors more confidence that the country will be able to meet their obligations, that there will be enough time for the reforms to take hold, that they are going to believe they can have confidence they will earn a reasonable return on their investment as they bring it back in.

That is the theory of it, if it works.

Representative Ewing. Thank you.

Representative Saxton. Thank you.

Senator Sessions.

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. I would like to say, I do support you in your view that this Committee and all the Members of Congress ought to be able to understand the situation before we appropriate monies.

Let me ask you this. With regard to the amount of money needed, some have said there is sufficient money in the fund now. How certain are you that more money is needed at this time? Might it not be better for this Congress to sit back, make sure we get full information from the IMF, and see the kind of reforms we want to see, before we give the additional money?

Mr. Geithner. Let me start by saying, we think it is absolutely appropriate and necessary for you to have access to the information you need to make an informed judgment; and we think it is perfectly appropriate for you to have a thoughtful debate about the broad policy questions we face in the institution. We would not be up here if we did not think the risks in the current situation were serious enough to make the prudent act an act now to try to strengthen the IMF's financial resources. We would not put you through this or ourselves through this if we did not think it was important.

I think Chairman Greenspan has been eloquent in trying to describe that although the effects so far on the U.S. economy are going to be relatively modest, the potential risks to the U.S. economy are really quite significant; and there is a very small, but not negligible chance that this crisis could become a crisis of truly global scale.

In comparison to those risks, the existing financial cushion in the IMF, the $10 or $15 billion now available and the $23 billion now available in the GAB are very small in comparison to those potential risks. They are not just small in historical perspective, but they are very small in comparison to the magnitude of the risk we now face.

Just for comparison, the IMF's program in Korea is $20 billion, and the IMF normally lends, I think–and I might get the numbers a little bit wrong, but I can clarify them for you-I think the IMF normally lends $5 to $7 billion a year in times of much more common stability in the system.

So the existing cushion is quite low, and we think it would be prudent to act to strengthen the IMF so that we have the capacity to protect U.S. interests if this crisis were to deepen or to spread.

Senator Sessions. I just heard it had $85 billion in liquid resources in April-8.6 billion more than the previous April available to them. So, even if you took the whole proposed package, there would still be substantial reserves left, it would appear to me.

Mr. Geithner. A lot has happened in the world since April, and all that has happened in the world since April has left the IMF, as I said in my statement, with roughly $45 billion in uncommitted loanable resources now. But that overstates what they actually have available to lend to countries, because a substantial portion of that has to be kept to accommodate any possible withdrawal of-what we were discussing with the Chairman a few minutes ago-of our deposit in the institution, deposits other countries have in the institution.

So, in effect, we believe the IMF has roughly $10 to $15 billion available now and an additional 23 available that it could draw in some circumstances from the GAB. But these are historically low levels and imprudent levels, we believe, given the risks we now face in the system.

But we would be happy to walk you through, if you want, a little bit of how we got from April to where we are here and what existing commitments are outstanding, relative to the existing resources.

Senator Sessions. Let me ask this. I am concerned, ultimately, with how the IMF views itself and how we view the IMF. It is an institution that we expect to continue to grow, presumably to deal with crises continually, some of which are larger or smaller than this? Or is this, the Asian crisis, an extraordinary event that we don't expect to be duplicated anytime soon?

Mr. Geithner. Well, it is certainly an extraordinary event. I don't think any of us can say with confidence we are going to create a world in which the risks of these crises will fade away. I think the only way people know to prevent a crisis from just happening is for all countries to cut themselves off from the global capital market; and we think sacrifices-most countries believe the sacrifices and the forgone gains and growth in that would be inappropriate. So we are probably likely to live in a world for some time where there are some risks of crisis, and no matter how successful we are in strengthening the architecture of the system, the potential for crisis is likely to persist. It is also true that our interests are affected when a crisis happens, so the question we face is, what is the most cost-effective, prudent and effective way to protect our interests when the crises happen, if they happen in the future; and our view is, the most cost-effective way to deal with that is make sure the IMF is there with burden-sharing to help us respond.

Senator Sessions. Just briefly, with regard to the operating expenses of the IMF, how is that funded?

Mr. Geithner. The IMF charges its borrowers a little bit more than it pays its creditors, in a sense, and that margin funds the administrative budget of the IMF.

Senator Sessions. Thank you, Mr. Chairman.

Representative Saxton. Mr. Stark.

Thank you, Senator Sessions.

OPENING STATEMENT OF REPRESENTATIVE FORTNEY PETE STARK

Representative Stark. Thank you, Mr. Chairman.

Mr. Geithner, I heard you respond earlier to Senator Bingaman's concerns in suggesting that the Treasury does not support the idea of basically bailing out U.S. and European banks whose lending can charitably be described as "reckless," at best, in countries like Indonesia. But you say you don't think you could do anything about it. In other words–is that, in effect, what I heard you say?

Mr. Geithner. Well, if I did, I didn't do it well.

I think it is important to recognize that U.S. banks, foreign banks, Japanese banks, European banks have taken losses across the region, and I am sure there are more to come. They have not been insulated from the consequences of the loans they made.

Representative Stark. But they want to get bailed out, they want to get paid back with this IMF funding, don't they?

Mr. Geithner. Well, I think we all want to be in a situation where confidence and stability return to these countries.

Representative Stark. Wait a minute. They made bad loans, okay? By anybody's standards, they were, charitably, bad loans.

We have the experience of the 1980s in South America, we had it in Mexico; we have been up and down this hill a lot of times. They made bad loans.

If somebody was in the auto loan department of Chase, they would now be walking the streets had they loaned on Edsels at the rate these guys have loaned, with no protection for security devaluation, and lending short- against long-term obligations they knew they weren't going to get back. So, I mean, by any banking standards, they weren't good loans, and I think I heard Secretary Rubin say, when he addressed the Democratic Caucus, that he didn't think we should be bailing out our banks or Wall Street for their mistakes–let's say, their "zealousness." Did I hear him say something like that?

Mr. Geithner. To use his famous phrase, he said, "I wouldn't give a nickel to bail out investors in this context."

Representative Stark. Then did I just hear you say that is a difficult thing to do while you are trying to create stability in the region?

Mr. Geithner. Well, what is difficult to do is to force banks to lend to countries in crisis if the shareholders don't think it is prudent, and what is difficult to do is force them to take losses without, in effect, inducing default and without creating a situation where you are going to face the prospects of a much more acute crisis in these countries, and a more protracted loss–as the Latin American countries faced in the 1980s, a more protracted loss of access to the capital markets and to finance. Those are two things we can't do in the current situation. We may never be able to do.

But what the Secretary and Chairman Greenspan have said they would like to try to do is try to develop mechanisms that will ensure private investors bear more responsibility, more fully bear, to the extent practical, the consequences of the decisions they made in investing and making these loans.

Now, if you had them up here, they might have a different perspective on the prudence of the loans they made.

Representative Stark. If they think the loans are so good, why don't we just let them keep the loans and let them get what they can in the currencies they can get it in and say, that is it, guys? I mean, we don't do it around here for banks.

And I just want to come back–I think that I heard the Secretary say and I think I heard you say that we all agree we shouldn't be bailing out our banks. I mean, that isn't the purpose of this, is it? We are not trying to bail out Chase or Citicorp or BofA, for bad loans.

Mr. Geithner. That is right. We could care less about bailing out U.S. banks; we could care less about insulating the decisions they made. What we want to do is reestablish confidence and stability; and it is true, although–

Representative Stark. You know, I don't think these guys need any confidence and stability. They have made such stupid loans in the past, what the hell do they care, they just throw the money away because they know we are going to bail them out. I suspect that, yes, one of the problems would be, if we made them bear the consequences of bad business decisions–I mean, it is interesting.

When they make a profit overseas, we don't share in that, we don't collect any taxes, they keep that overseas, and we postpone the taxes so they can reinvest it overseas, right? That is a win-win-win. So when they make a lot of money overseas, none of us can use it to pave roads or support children's education or health care for the uninsured in this country; we do that in the name of increasing exports.

Now, when the situation is reversed, they don't want to pay any losses either; they want us to bail out their losses. Now I am just asking you, if we could figure out a way to help out the poor Indonesians– mostly that is the Suharto family–but if we could figure out a way to bail them out and not have any of that go to U.S. banks and investors, would you support that?

If I could just find that nice piece of legislation, and I suspect that would rest in the Tax Code, and we could work it out so Chase and Citicorp and all those guys didn't get any money, would you support that?

Mr. Geithner. Absolutely.

Representative Stark. That is all I wanted you to say. Thank you.

Thank you, Mr. Chairman.

Representative Saxton. I would just like to emphasize Mr. Stark's point. He said that these folks have not used the best discretion with some of these loans. It seems to me that if we continue to pump money into them as an encouragement to continue to make bad loans, then the bad loans are on our conscience as well.

Representative Stark. The Chair is correct.

Representative Saxton. Mr. Thornberry.

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. Thank you, Mr. Chairman.

Mr. Secretary, it is probably a mixed blessing that the current difficulties in Asia provide a number of us and the American people a time to really focus on the IMF as an institution. It is all bottled up in the same situation, and maybe that is not a good thing.

As you know, there have been a number of very knowledgeable and prominent people who believe the IMF has outlived its usefulness, that an institution set up after the war to help stabilize currencies at a time when we have so much of global economy where technology allows capital to move back and forth is, in its current form, at least, no longer useful.

I am trying to get the basics of your argument down, and it is somewhat related to Mr. Stark's line of questioning. As I understood your answers to a couple of previous questions, your belief is the IMF loans increase confidence in these countries and that increased confidence will result in investments being made that would not be made otherwise; is that true?

Mr. Geithner. Well, just to say it slightly differently, it is strong reform programs by credible governments with credible economic teams, backed by temporary financial assistance, that are essential to bring confidence back.

Representative Thornberry. Let me break that down. How much of the increased confidence comes from the conditions we impose on these countries and how much comes from the cash?

Mr. Geithner. I would say if these things work, it will be predominately because of the conditions.

Representative Thornberry. So we have to be smart enough to figure out what conditions will work in each of these countries and bring about economic growth; and if we mess up in putting those conditions on there, then it could actually be worse than otherwise?

Mr. Geithner. It could, but I think no one would disagree with the fact you need a change in policy to try and fix the cause of the crisis, and you need a change in policy to help improve the prospects for recovery.

47-557 O - 98 - 2

That is a difficult job, and the country and the IMF together try to come up with what they think is the right way forward, and we play some role in trying to make sure they focus on the right things.

Representative Thornberry. Are you not concerned that by providing this safety net, if you will, for investors, that we are denying these economies the benefits of economic restructuring that may go with some defaults and bankruptcies? And, of course, as someone coming from Texas who went through a great deal of restructuring, if you would like to call it that, in the 1980s with the price of oil and so forth, it is a painful thing to go through, but perhaps you come out stronger economically at the end. And aren't we denying them that opportunity?

Mr. Geithner. Absolutely not, because these countries are going through wrenching adjustments right now, as a consequence of the crisis. They are not insulated from the wrenching adjustment they have to go through. There are already happening widespread bankruptcies across these countries, and it would not be appropriate to try to avoid that effect. To allay it, soften it, cushion it, that would not be appropriate for the reasons you said.

Representative Thornberry. Isn't that the effect of what we are doing? If we do not allow these defaults, then there are still some bankruptcies that are going to happen, but there are fewer than would otherwise happen.

Mr. Geithner. That is true, there are fewer than would otherwise happen, but there are corporations across the region that are overextended, which are now in the hundreds, going through bankruptcy and through workout, and that is only going to get worse before it gets better.

Representative Thornberry. Let me ask you this. A number of people have observed that investors perhaps in other parts of the world will see what the IMF does in this situation and condition their future behavior accordingly; the relationship between what happened to Mexico perhaps led to more risky investments in Asia is the example argued.

Do you agree that other investment decisions will be made, in part based upon how the IMF treats this situation today in Asia?

Mr. Geithner. They will. I think it is an important risk, the moral hazard risk you are referring to. It is something we worry quite a bit about. We design the programs to try to minimize it, but you can't eliminate it.

There are two types of risks in this context. One is the risk that countries will behave imprudently because of the expectation the IMF will be there. I think that is not as significant a risk because any country that watches what Mexico went through, or Korea and Thailand are going through, I think would be quite hesitant of following in their footsteps.

There is another risk, which is that investors will make imprudent investments in the hope IMF will be there to bail them out, and that is a more complicated issue. We think it is very important the IMF not be in the position where it is protecting private investors from the losses they took, and it generally does not. There is not remotely close to enough official money on the table to make investors whole.

The IMF is generally not making investors whole. People, banks, individuals are taking substantial losses across the region; we think that is necessary and appropriate. But I think you raise an important concern. We work in the context of these current programs, and we are going to be working in the future to try to figure out ways to minimize those risks.

I wanted to say one more final thing, which is that I think it is quite a popular view, but hard to support with the facts, the view what the IMF did in Mexico was somehow responsible for this crisis. I think that is hard to support with the facts. I think if you look at what has happened in interest rates in the United States and other countries across this period of time, what you have seen is a substantial compression in spreads, a significant narrowing in spreads across a whole range of asset classes, not just in emerging markets over this period of time; and that suggests there is something more at work than simply the existence of the IMF.

Investors took a lot of losses in Mexico, too, and it is very hard for any investor who went through that process to view what is happening now comfort for the future that they are going to be made whole if they go in.

Representative Saxton. Thank you very much.

Mr. McCrery.

OPENING STATEMENT OF REPRESENTATIVE JIM MCCRERY

Representative McCrery. I don't have any questions.

Representative Saxton. Mr. Ganske.

OPENING STATEMENT OF REPRESENTATIVE GREG GANSKE

Representative Ganske. Thank you, Mr. Chairman, for allowing me to join your panel today. I think this is important.

Representative Saxton. We are glad to have you.

Representative Ganske. I do come from a farm state, and there is a lot of interest in exports. I want to follow up on Congressman Thornberry's question. When we look at the Leach bill, okay, there are recommendations, basically there are a number of clauses in there that recommend that the U.S. representative advise the IMF on different policies. I want to know, specifically, how do you put teeth into that legislation to make sure that the IMF would follow the recommendations of Congress? What would you put in that bill to specifically put conditions on the IMF to make sure they are doing it right?

Mr. Geithner. Well, that is a question that preoccupies us quite a bit these days. We are 18 percent of the institution, an institution that has 182 members. Because we have 18 percent of the institution, we have the capacity to block some major policy decisions, but we don't have the capacity to force unilaterally on the institution a whole range of things, even those things we think might be appropriate. We don't have the capacity to force on the institution and we would not view kindly any attempt by other countries to force unilaterally those types of changes on the IMF.

Representative Ganske. Excuse me, Mr. Geithner, but if the U.S. doesn't appropriate these funds, the other countries aren't going to either.

Mr. Geithner. That is right.

Representative Ganske. So we do have the ability to effectively enforce some changes on the IMF.

Mr. Geithner. Well, let me say it a little differently. We have substantial influence in the institution. We have achieved substantial reforms in the institution, because of the efforts we have made, many in response to the objectives raised by Members of Congress. We are going to continue to promote the types of reforms in the institution. We think it will make it a more effective place. And it is true, if we do not act to approve the quota increase, it will not go into effect.

Representative Ganske. Well, give me some examples of specific things we should be asking the IMF to do, specifically. It is not just in the form of a recommendation from Congress for the appropriation. We recommend that the representative from the U.S. advise the IMF to make these changes. Things like funding will not come from Congress, unless the IMF does this. What would be your conditions?

Mr. Geithner. Our view is that would be inappropriate, because that would likely ensure that this quota increase will not happen and that would likely leave us with inadequate resources to deal with risks to the U.S. interest in the system.

Representative Ganske. You are saying if Congress would pass legislation that says "As we have looked over the effective policies of the IMF, they are contrary to their goals, and we feel that using U.S. taxpayer dollars going to the IMF are contingent upon these changes," that we shouldn't do that?

Mr. Geithner. That is not an approach we would support, because -actually, let me start somewhere else. I think if you look at the IMF and you invest the time necessary to look at what the IMF does in these places, you will find what the IMF does is quite consistent with core American economic values we think are appropriate for our country and for many other countries. We think it is perfectly appropriate for you to have a debate about whether that is the case and to look very carefully at what the IMF does in these cases and we think it is very appropriate for you to support our efforts in promoting reforms in the institutions that are going to make it more effective.

Representative Ganske. Your position is basically that there shouldn't be any more conditions than what are in the Leach bill, which is basically an advisory recommendation.

Mr. Geithner. No, I was trying carefully not to say that. What the Secretary said, in response to the Leach bill, been quite positive about the broad objectives of the bill and quite positive to see such an early demonstration of support for funding, both the quota increase and the NAB. But I just think it is important to recognize that we do not have the capacity to unilaterally impose on this institution a whole range of reforms as a condition for a quota increase, and to do so would risk not having it happen.

Representative Ganske. Let me go on to a different area then, and this goes back to what the Chairman was talking about in terms of getting the information from the IMF, basically their internal reports and the reports to the Treasury. Now, you mentioned that a Congressman can have access to that, so you could bring that over to my office.

Mr. Geithner. Absolutely.

Representative Ganske. Okay. Let me point out the problem with that. You bring that over to my office, and I review it. On the basis of my review, I decide that the IMF policies have actually been detrimental to solving this problem, okay, but now I cannot release the specifics of my review on that. Furthermore, I, as a Congressman–and I am a physician, I am not an economist–I am going to have to vote on this, okay; so my assessment is they are bad policies, detrimental; I am skeptical about the IMF actually being effective on this. I have looked at this, I can issue a press report saying I have reviewed this, my assessment is that their are not–I can't give out specifics, my assessment is the policies have not been effective, in fact in Indonesia have been detrimental; but I am not able then to get that out to the public to have people who are trained in this area, staffers from this staff, for instance, or independent analysis to back me up. That puts me in sort of an untenable position.

Mr. Geithner. I actually think you can do most of that now. The precise details of the policy commitments in these programs are now publicly available in each of these countries, and you can see on the ground now where they are working, where they are not, and there is a whole range of issues that affect that kind of judgment. That information is available to anybody who wants to look at it now, and I think you can make that judgment now.

Representative Ganske. Assistant Secretary, my time is up. I would just like to ask to set up an appointment with the Treasury Department to bring over to my office those reports, because I would like to review those.

Mr. Geithner. Absolutely.

Representative Ganske. Thank you.

Representative Saxton. Thank you, Mr. Ganske.

Mr. Geithner, I have a book full of questions that need answers, some of which you have touched on this morning. We have to move on to the next panel. And because we have a series of questions, I wonder if you would be kind enough to respond to them in writing.

Mr. Geithner. Absolutely.

Representative Saxton. They include a number of issues. Some are rather broad in scope. There is one that you just mentioned. I think I heard you say–my arithmetic shows an 18 percent figure–on monies that are actually loans through the IMF system at closer to 26 percent. I would like to get clarification on that.

Mr. Geithner. Absolutely.

Representative Saxton. Also issues involving what is generally referred to as the "moral hazard," which has to do with whether we are encouraging bad loans by standing behind these banks time after time. The issue of transparency or the lack thereof, which we have discussed some here this morning, but which I have more questions about. The issue of taxpayer exposure, both American taxpayer exposure and taxpayer exposure in the receiving countries as well. The issue of whether the interest rates should be subsidized or whether they should be driven more by the market. The issue of whether some of the conditions that you have mentioned here and in other answers are actually counterproductive in helping countries and institutions in some of the receiving countries to grow. The issue of whether these conditions that the IMF imposes are actually counterproductive.

So these are all issues that I have more questions than we can possibly go into today, and I would like to submit them in writing and hope that you will be able to answer them.

And I would also just like to mention that we may like to have you or one of your colleagues back, perhaps in the future, as we continue to try to educate ourselves on this series of issues, I should say.

Mr. Geithner. We would be happy to do that and we would be happy to spend a bit of time walking your staff, if you want, through the financial dimensions of the IMF in more detail so they can help read the numbers with a bit more perspective. Thank you very much.

Representative Saxton. And now we will hear from our next panel of witnesses, in the following order: Charles W. Calomiris, Paul M. Montrone Professor of Finance and Economics, Columbia Business School, and Director, American Enterprise Institute Project on Financial Deregulation; Lawrence B. Lindsey, Resident Scholar, The American Enterprise Institute; Allan H. Meltzer, The Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University, and Visiting Scholar, American Enterprise Institute; and C. Fred Bergsten, Director, Institute for International Economics.

Representative Saxton. Gentlemen, welcome. We are anxious to hear your testimony.

Mr. Calomiris, each of you will have about 12 minutes for your opening statement, and then we will move to questions. Mr. Calomiris.

OPENING STATEMENT OF CHARLES W. CALOMIRIS, PAUL M. MONTRONE PROFESSOR OF FINANCE AND ECONOMICS, COLUMBIA BUSINESS SCHOOL, AND DIRECTOR, AMERICAN ENTERPRISE INSTITUTE PROJECT ON FINANCIAL DEREGULATION

Mr. Calomiris. Thank you. I would like to ask that the full statement be entered into the record.

Representative Saxton. Without objection.

Mr. Calomiris. I will just summarize it briefly. The responses by the IMF and the U.S. Treasury to the Mexican crisis and the recent Asian crises have been shortsighted and counterproductive. The suggestion that the IMF's capital and facilities should be expanded to permit it to engage in more such activity in the future is troubling. The principal lesson of these bailouts managed by the IMF and the Treasury is the vital need to find a way credibly to commit not to sponsor them in the future.

Why are these bailouts so misguided? A guiding principal of a well-functioning market economy is that those who undertake risks should either lose or gain according to the outcomes produced by those decisions.

What have been the costs of violating that guiding principal through government absorption of financial losses? Three kinds of costs figure prominently. First, undesirable redistributions of wealth from taxpayers to the politically influential in developing economies. Second, the promotion of excessive risk taking and inefficient investment. And, third, the undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote.

While bailouts entail loans from the IMF and foreign governments at subsidized interest rates for developing country governments, taxpayers in the United States and other developed economies who pay the loan subsidies are not the biggest losers from the bailouts. The IMF and the U.S. Treasury in most cases are repaid, but these loans provide powerful justification for increased taxation to repay them. When the crisis has passed, the big winners are the wealthy, politically influential risk takers, and the biggest losers are taxpayers in countries like Mexico, Indonesia, or Korea.

The bailouts not only produce a one time wealth transfer, but encourage a repeat of the same problem in the future. If risk taking bankers know future gains from taking on risks will be private but losses will be borne by taxpayers again, that amounts to a government subsidy for risk which thereby encourages excessive risk taking, the so-called "moral hazard problem."

Studies by the World Bank and the IMF, independently, have documented some 90 episodes of severe banking crisis since 1982. In more than 20 of those cases, the bailout costs to developing country governments have exceeded 10 percent of their GDP. In roughly half of those cases, including the estimated losses of some of the current Asian countries, losses have been in the range of 25 percent of GDP. These losses are unprecedented. For example, in the United States during the Great Depression, banking losses were comparatively small, roughly 4 percent of GDP.

What can explain this epidemic? Not shocks of unprecedented magnitude like oil price hikes, wars or global downturns in demand, since such influences have been absent. The explanation is the roller coaster of risk produced by the choices of banks in developing economies, choices that are the by-product of government subsidies for risk taking.

Private business in many developing economies is dominated by conglomerates, often controlled by a small minority of wealthy, politically influential families or corporations. At the center of the unhealthy partnership between government and business is a new kind of bank, what I call the "quasi-public bank." Quasi-public banks are private institutions with an implicit claim to public resources which pay for their losses. They are a key instrument of economic control for conglomerates who own them, and a key vehicle for the transfer of political patronage from the government to these conglomerates. The key to understanding how quasi-public banks magnify economic risk is to consider how they respond to initial losses.

Normal private banks experiencing loan losses tend to reduce their portfolio risk to restore the confidence of their depositors and limit the risk of bank failure. But quasi-public banks need not concern themselves with the risk of failure, since bank depositors and stockholders are all insured against loss by taxpayers. In the wake of losses, these banks face opposite incentives, to channel ever riskier loans for their conglomerate owners.

Financial crises in these economies tend to go through three stages. First, initial loan losses are followed by purposeful increases in high-risk bank lending to conglomerates. Second, the fiscal problems created by the governments, off balance sheet obligations to bail out these weak banks, raises the likelihood of devaluation. Banks then undertake purposeful increases in their currency risk to take advantage of lower dollar-denominated interest rates, given this market perception of an increased probability of devaluation. And third, when large devaluation comes, it results in enormous losses to banks, and thus taxpayers, from the high bank exposures to credit risk and currency risk; again, purposeful exposures.

The consistency of this pattern is uncanny. It was first visible in the Chilean collapse of 1982 to 1983. The same pattern was followed in Mexico in 1994 and 1995 and in many other countries, and most recently in Thailand, Indonesia and Korea in the current crisis.

Domestic governments, as I have reviewed, have often been the most important source of perverse incentives for their banks. Where does the IMF fit in? The main influences of IMF and the U.S. Treasury in the 1990s have been to aggravate the problem in two ways, first, by lending legitimacy to domestic bailouts by calling for domestic taxation to repay loans from the IMF and the U.S. Treasury, thus making the wealth transfer within the developing countries much easier; and second, by insulating foreign creditors from losses during the crisis.

Insulating foreign investors from loss, (not foreign stockholders, but the banks who make short-term loans that aggravate the crisis) removes the incentive for those foreign investors to avoid lending to high-risk countries. That aggravates the moral hazard problem and magnifies the losses when the devaluation comes by promoting the flow of dollar-denominated hot money during the financial crisis.

What will foreign lenders learn from the Mexican crisis or the recent Asian crisis? I fear they are learning that they can lend without risk of default because of implicit protection of the IMF and the U.S. Treasury, and it does not help matters that the IMF and the Treasury are signaling their intent to provide ever-expanded bailouts by calling for ever-increasing amounts of IMF capital and new IMF lending facilities. That, of course, will add fuel to the fire of risk-taking in developing economies.

But the cost of ensuring foreign lenders against loss runs even deeper. The IMF and U.S. Government are undermining the natural process of reform in many emerging economies. If foreign investors are protected by the IMF, they will be less discriminating about where they place their funds and thus provide less of an incentive for reform in developing economies.

Some proponents of IMF bailouts, of course, argue that by intervening, the IMF is able to promote reform of domestic banking systems, which are really the centerpiece of the fragility, as I described it, and thus IMF intervention may reduce the likelihood of future bailouts. But the 1994-95 intervention in Mexico and, already, the recent Asian interventions are providing contrary evidence; and I can review some of that in the question-and-answer period.

So far, nothing substantive has been done to introduce market discipline into the Mexican banking system since its crisis, and there is no reason to believe anything will be done to limit the current system of subsidizing the risks of the industrial conglomerates and the banks they effectively own in Mexico. I expect similar results from the current conditions being attached to IMF assistance in Asia.

It is very hard to undermine the corrupt partnership between powerful industrialist bankers and their governments by giving them both money in exchange for promises to reform sometime in the future. That is not to say that IMF conditions of all kinds always fail. The IMF has been somewhat successful in getting countries to change tax or expenditure policies, foreign trade policies, and monetary policies.

Banking policy is fundamentally different for two reasons. First, real reform in the banking system takes years to accomplish, because it entails new ways of measuring and managing risk, new regulations and new supervisory procedures.

The time horizon necessary to implement successful reform is at least five years, in my experience. The horizon of IMF crisis assistance and conditionality, typically two years or less, is simply not suited to achieve true reform in these banking systems.

Second, banks are controlled by powerful and concentrated vested interests who are willing to fight hard to maintain their access to subsidized credit and to block these reforms. Thus, in practice, crisis countries tend to find it easy to promise, but never deliver, true banking reform. Instead, they tax quickly and deeply, pay back their loans to the IMF and the treasury, replenish the wealth of risk-loving conglomerates and their banks and return to business as usual.

Neither can IMF programs be justified by appeal to the threat of contagion or the need to prevent panics. In particular, there is no connection between current IMF bailouts of insolvent banks in Asia and appropriate historical interventions by central banks to stem banking crises. Historical lender-of-last-resort assistance during banking panics, in contrast to bank bailouts, was geared to prevent the failure of solvent banks which were temporarily in need of liquidity to prevent their unwarranted failure. That has nothing to do with what is currently going on in Asia.

Given some of the recent concerns of a threat from irrational contagion voiced by policymakers in the popular press, it is also worth emphasizing that random, irrational attacks on financial systems are simply not evident in financial history. Thus, concerns of irrational contagion, spreading all over the world, without any fundamental explanatory link are simply unwarranted. Such concerns should not be used to justify financial bailouts.

Let me close with some specific recommendations; I have four. First, stop the bailouts. The more the developing countries are forced to handle their own financial insolvencies and the more foreign investors are forced to bear the cost of their investment decisions, the more developing countries will be attracted by the benefits of true liberalization.

Second, there is no reason to expand the IMF's capital or develop the new proposed lending facility to provide fast-track bailouts to financial systems in distress. Indeed, an expansion of IMF capital or facilities would do real harm by signaling an intention to strengthen and expand the IMF's commitment to provide bailouts in the future. The U.S. Government should do all within its power to encourage the IMF to revert to pre-1994 goals of advising countries on their macroeconomic policy and serving as an international delegated monitor charged with tracking those policies.

Third, denying the IMF its desire to increase its capital and facilities and working to restrict its purview are not enough to stop the trend toward unwise expansion of global bailouts. Congress should abolish the exchange stabilization fund, a legacy of the Great Depression which has no legitimate role in U.S. monetary policy today. The World Bank should also be prevented from serving as a substitute vehicle for bailouts.

Fourth, IMF secrecy is contrary to its proper role as the source of independent, objective and informed opinion about the economic performance and financial risks of member countries. In pursuit of its appropriate mission, any policies or conditions for assistance advocated by the IMF should be revealed publicly. That will encourage a lively debate about their merits and permit critical evaluation about their effectiveness. Thank you.

Representative Saxton. Thank you very much.

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

Representative Saxton. Mr. Lindsey.

OPENING STATEMENT OF LAWRENCE B. LINDSEY, RESIDENT SCHOLAR, THE AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. Lindsey. Thank you, Mr. Chairman. I value the opportunity to be here today. I also ask that the entirety of my remarks be submitted for the record.

Representative Saxton. Without objection.

Mr. Lindsey. I think there are three salient points that have not been adequately addressed to date by the Administration in its request to the Congress for funds to support an IMF expansion. First, I think the prospective cost to the American taxpayer is greater than the Administration has suggested to date. It has been described as an essentially riskless investment, like putting money into a credit union. This is not the case.

Second, an expansion of the IMF has been described by the Administration as essential for our macroeconomic stability. It has been suggested, that millions of American jobs are at risk if the increased IMF funding is not approved. Again, I don't think this is the case.

Third, and I believe most important, an enlarged IMF is simply not the best way to advance a sound international economic policy for the 21st century. The IMF is a relic of the Cold War. It may have worked well in the last half of the 20th century, but it is not central to a sound global economic strategy for our country, going forward. Congress should use this opportunity to consider an alternative.

Let me begin with the nature of the U.S. contribution to the IMF. I believe it was three weeks ago, I was on a similar panel and I heard a senior Administration official liken American contributions to the IMF to deposits in a credit union. Consequently, this official argued, the money involved was not really an expenditure. He added 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 it is an unfortunate comparison, and I hope and trust the Administration itself is not confused by its own analogy. I noted Mr. Geithner moved away a bit from that analogy this morning.

Let me put on my hat as a former regulator to examine the comparison. While the IMF is like a credit union in that it lends only 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 significantly, credit union loans are backed by an automobile or house; unsecured signature loans carry a very high interest rate and are ultimately backed by the bankruptcy statute for the borrower's state of residence.

By contrast, the IMF does not lend on collateral, but effectively makes only signature loans. There is no bankruptcy statute or right to attach assets in the event of default. Furthermore, there is no real assessment of creditworthiness; quite the contrary, an apparent requirement to get an IMF loan is that you not be creditworthy.

As far as the gold backing is concerned, I would find it somewhat troubling as a bank regulator if one of the banks I was supervising had an asset that was as volatile as gold backing up a substantial portion of my balance sheet. I note that gold has lost roughly 20 percent of its value in recent months; this is certainly not reassuring.

While I have not performed the analysis myself, I do know that at least one private-sector analysis, a group with a lot of money at stake in the issue looked at the IMF balance sheet as if it were a bank and concluded serious questions could be raised about the IMF's capital adequacy. Usually this would mean shrinking the size of the institution if you were a regulator looking at it, not enlarging it.

I would stress that the IMF is not a bank and shouldn't be treated as such, 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 to this point has lost money in the IMF. Of course, if it were really such a great investment, the IMF would go directly to Wall Street to raise the money and not to the U.S. Congress to get the funds it needs.

I think the better comparison is that the IMF is like the FDIC in the late 1970s or early 1980s. At that time, taxpayers had not lost any money in the FDIC either. 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.

I really think that is the rationale behind the IMF request for a quota increase, and the observation you made, Mr. Chairman, that a further quota increase beyond this is likely in the foreseeable future. Due to a variety of reasons, not the least of which involves the concept of moral hazard, the IMF considers an ever larger quota necessary to cover the risks involved in ever larger international lending positions.

The question, therefore, is a good one. If this really is the equivalent of 1980, and we really are dealing with the equivalent of the FDIC, we desperately need to reflect on whether we want to make the institution even larger, or whether we want to contemplate new arrangements to cover the missions of the institution.

The second fundamental question I would like to address has to do with the supposed necessity of contributing to IMF for reasons of economic security. We are told that the economic consequences of not approving the $18 billion request will be dire for America. There are two separate arguments which support this claim. One has to do with trade, the other has to do with the banking system. Let me look at each one closely.

Let's consider the big picture for a moment. The same people who are warning of dire consequences if the IMF funding is not approved tell us in other venues that the U.S. economy is in better shape than ever. Now, it would be a truly unusual circumstance in economic history that a record-breaking economic recovery would be so fundamentally fragile that it relied on an appropriation equal to one-quarter of a percent of GDP for its continued success.

There is one possible link between record-setting expansion and economic fragility that needs to be considered. Is the United States economy really just resting on an economic bubble of excess credit expansion? Although I think the answer to this question is, on balance, no, I would feel more comfortable with the intellectual consistency of the advocates of this funding if they were to resolve the apparent paradox in their arguments.

But if the link between expansion and fragility were in fact the result of a financial bubble, an $18 billion appropriation for the IMF is, at best, irrelevant. There are other actions we should be taking and other questions we should be asking. Why are we effectively easing bank supervisory standards in the midst of a financial bubble? Why are we not gradually trying to deflate the bubble through a more restrictive monetary policy? Why is the Administration advocating $40 billion in new spending programs, rather than pursuing a more contractionary fiscal policy? Shouldn't public officials be trying to talk down the stock market if this is really a bubble?

Again, my own judgment is, the United States economy is not so fragile at this point in time that failure to approve this money would lead to an economic recession. However, I do believe we may be at risk of encouraging a future financial bubble to develop through actions now being proposed. Increasing the capacity of the IMF is not helpful in this regard, as it sends a signal to borrowers and lenders alike that a U.S. taxpayer-funded safety net is being expanded to rescue them.

Now, let's consider the two detailed mechanisms, which supposedly link our economic security to the IMF funding package. First, consider the trade argument. The Administration is pursuing a lobbying campaign, claiming jobs would be lost in various Members' districts if the IMF package is not approved. I can well understand the need for some form of political protection on this issue, but a careful examination of their claim suggests it is not well constructed.

My favorite trade story in this lobbying came from recent IMF hearings before a committee of the other House of Congress. There, one Senator from Nevada noted that the entertainment facilities in his State had been emptied since the Asian crisis began. State revenues were particularly threatened in Nevada. While the Senator was not explicit, the supposed logic followed that we needed to replenish the IMF so that we could bailout Asia, so Asian high rollers could return to Las Vegas and lose the money back to us.

While this might cause some to chuckle, I am sorry to say the fundamental logic of this argument is exactly the same, no matter what industry and no matter what State is involved. The notion that you can indirectly channel money to repay a bad debt and then expect the other guy to buy, on net, more goods from you than your initial gift is plainly fanciful. I do not believe that the act of creating jobs in one district should be the *sine qua non* of a Congressman's decisionmaking, but the Administration, by making this argument, is advancing a logic which is fundamentally false. The IMF quota increase will not be a net job creator in the United States economy, and Congressmen who base their vote on this argument alone are at best doing their constituents a disservice.

The other detailed link between the IMF package and the health of the American economy has substantially more merit. It falls on the well-being of the banking system. Chairman Greenspan has testified the risks from the current crisis pose, and I quote, "a small but not negligible probability" of placing the global banking system in jeopardy. I concur with Chairman Greenspan's evaluation. The question is what are the best ways to deal with that risk.

Chairman Saxton, as you pointed out in your opening remarks, the money for the IMF that we are now considering is not related to current commitments the IMF has made to Asia. Frankly, if approved, this additional funding would be used if events in Asia proved a bigger debt problem than the IMF now expects, possibly from other regions.

I don't believe that either the Fed or the IMF believes the Asian crisis, if contained to current levels, poses the kind of risk we are now talking about. But if that crisis were to worsen or financial problems were to spread to other regions, the IMF could be of only limited usefulness in stemming it.

Of much more importance are the actions we have already taken to protect the U.S. banking system. First, our Nation's regulators and its banks paid a high price in the early 1990s to build capital for our banks. Second, the Fed, under the leadership of Governor Phillips, worked closely with banks to develop highly sophisticated computer models of banks' balance sheets.

I disagree with Congressman Stark; I think our banks could easily lose this money. They are much less exposed than those of our major trading partners to any problems here, and it is thanks to the hard work we did in this country that that is the case.

And, finally, our monetary policy for the last 17 years has been used to build credibility. When we went to the IMF in 1978, we were in desperate shape; now we are not. I think it is our monetary policy in the end which will protect us from any problems.

In sum, Mr. Chairman, and I note the red light has come on, I do not think that we need to appropriate this money to save our economy, I think we have other protections in place, and I would also point out that I think the Administration is underestimating the cost to the U.S. taxpayer of the proposed bailout.

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

Representative Saxton. Thank you very much.

Mr. Meltzer?

OPENING STATEMENT OF ALLAN H. MELTZER, THE ALAN H. MELTZER PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY, AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. Meltzer. Thank you, Mr. Chairman. It is a privilege to appear once again before this distinguished Committee. It was as a part-time member of the staff many years ago that I first began the detailed study of domestic and international financial arrangements.

Between 1990 and 1996, capital inflows to emerging market countries rose from $60 billion to $194 billion. No one carefully monitored these flows. When problems developed in Asia last year, neither the International Monetary Fund nor the private lenders knew the magnitude of all of the countries' debts within a large range. The firms borrowed directly and through their subsidiaries. Often, the total was not shown on any balance sheet. Provisions of the IMF Articles of Agreement requiring surveillance, and the decision to strengthen surveillance at the Halifax meeting, following the Mexican problem, proved to be of little use.

Though important, the IMF's failures to monitor seem small beside the elementary mistakes of private lenders who ignored three principles of prudent behavior.

First, Asian banks and other borrowers used short-term renewable credits from foreign banks to finance long-term loans.

Second, Asian banks and corporations borrowed in foreign currencies and loaned in local currency. They accepted the exchange risk without hedging. The reasoning is appalling: Interest rates were lower abroad. None realized the difference in interest rates, after allowing for differences in inflation, included the risk of currency depreciation. I suspect this risk is now apparent.

Foreign lenders shared this myopia. They didn't show concern about making short-term dollar and yen loans to borrowers that financed long-term domestic assets.

U.S. and other bankers added a third elementary error. Many, perhaps most, did not ask to see consolidated balance sheets; they did not monitor total assets and liabilities of the borrowers. Try to borrow on your house or your car without showing your balance sheet. Yet tens of millions of dollars were loaned without any knowledge about what was being offered by the borrower.

The banks' behavior is evidence of the pervasive problem of moral hazard. The banks expected to be bailed out again, so they acted imprudently, without regard to elementary banking principles.

What has been the result? Equity investors, debt holders, and owners of claims denominated in foreign currency have taken large losses. By mid-January 1998, stock markets in Indonesia, Malaysia and Thailand had lost 75 percent of their value.

What about the U.S., Japanese and European banks? Their loans are in dollars, yen and other hard currencies. They want repayment in full. The IMF and the principal governments lend money to the Asian governments so they can pay the interest on their bank loans or repay the principal. It helps the Asian banks to avoid default, but the money goes to the foreign bankers.

Instead of taking losses like the holders of currency, stocks and bonds, the banks collect with relatively small losses. And in exchange for extending repayment, the banks collect fees for renegotiating the loans. They demand government guarantees of the loans they made to the banks, financial institutions and private corporations.

This policy is the fourth mistake. I believe it is the greatest mistake of all because it invites a larger financial crisis in the future. The Mexican bailout required $40 billion. This time the IMF and the developed country governments have promised three times as much.

Capitalism without failure is like religion without sin. It doesn't work. Bankruptcy and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence is the missing element in the Mexican and Asian problems. In its absence, bankers and other lenders have taken excessive risk.

The IMF's programs help governments to drive a large wedge between the social risk–the risk borne by the troubled country–and the private risk borne by bankers. This is one source of moral hazard, and one reason we have a crisis-generating system. A common argument in its defense is that Mexico repaid its loans to the U.S. Government and the IMF. That argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury-IMF intervention. This is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad, at higher interest rates in most cases. It ignores the effects on the Mexican economy.

The results have been disastrous for the Mexican economy and its people. Despite enormous growth in the world economy for the past 20 years, Mexican real income in dollars was the same in 1996 as in 1974. You can see the chart following page 4 in my paper for a demonstration.

The Mexican people have been on a bumpy road but they have gone nowhere. In the same period, Mexican debt in constant dollars increased from $40 to $160 billion. That is shown in chart 2, following chart 1. Much of this is the price that Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would learn to run better policies, would have less debt and, I believe, would have made more progress.

Frequently the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people to the losses experienced in Latin America in the 1980s, Mexico in 1995, and Asia now. I believe this is true but irrelevant. The issue does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. The government may choose to guarantee the loans by issuing dollar denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea or Thailand.

When the government offers the guarantee, it believes the default risk is manageable or bearable, just as the U.S. Government believed the risk in the savings and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility.

The opportunity to take a possibly small risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister having to make the choice I just described.

The IMF and Treasury lending to Asian countries continues this dangerous system. The risk of a bigger, future crisis increases. Too much of the world has become "too big and too indebted to fail." Neither the IMF nor development banks, nor the U.S. and the Japanese governments can pay for all the errors, mistakes and imprudent actions they help to create.

Secretary Rubin was right when he said in September, "What we don't want to have is a situation where people can do unwise things and not pay a price," but that is the system Secretary Rubin and the IMF have created and sustained.

Many arguments are used to justify these policies. Some are misleading. Some are based on misunderstanding. Some are simply wrong.

One argument commonly made and repeated many times is that South Korea is a large country, the world's eleventh largest economy. It sounds impressive and, indeed, growth of the Korean economy since 1953 is a remarkable achievement. But the inference is that a financial collapse in South Korea would be a world-shaking event. In fact, Korea has a GDP about equal to the GDP of Los Angeles County. It may be the eleventh largest economy, but it is about 5 percent of the U.S. economy.

The role of the lender of last resort is not to bail out failed banks. Its job is to assure that solvent institutions do not fail for lack of liquidity. The Asian central banks have the power to stem a domestic liquidity crisis. The remaining problem is the need for foreign exchange to repay foreign currency loans.

The IMF offers two services. It lends currency on condition of reform, called conditional lending, and it acts as a consultant to troubled countries. Unlike most consultants, it pays the borrower to take its advice by offering favorable terms for its loans. With interest rates in Korea above 20 percent, the IMF lends at less than 5 percent.

Asian problems do not require international loans from the IMF and developed countries. The loans are more likely to delay than to provoke reform. The IMF may threaten to withhold payments, but as history shows, that threat is empty.

Many critics of the IMF oppose the policies of fiscal stringency and control of inflation. I do not share these criticisms in all cases. In countries with inflationary problems, control of spending is essential.

That is not the problem in Asia. The present predicament was not caused by imprudent spending policies, excessive demand and high inflation. Much of the problem arose because one of the principal markets for Asian products, Japan, has grown slowly, and because China increased its share of the Japanese market after devaluing in 1994.

The problem, then, for the IMF and for us is to get faster expansion of the Japanese economy. The longer term problem is to find a solution that avoids moral hazard.

If loans denominated in foreign currencies are withdrawn suddenly, solvent borrowers with excellent long-term prospects are unable to repay their short-term loans on demand. Neither they nor their local banks may be able to obtain sufficient foreign exchange to prevent default.

One solution is to have a true lender of last resort. Unlike the IMF, a true lender of last resort does not subsidize borrowers. It charges a penalty rate, a rate above the market rate, and it requires good collateral.

These requirements are not arbitrary. They are essential. The penalty rate means the lender of last resort will usually do no business at all. Borrowers will only come when they cannot get accommodation in the marketplace at market rates. Similarly, the requirement to offer good collateral induces banks and financial institutions to hold such assets. This reduces risk, and encourages safety and solvency. Unlike the IMF, a true lender of last resort does not create moral hazard.

My second proposal eliminates the main source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending and local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall risk. This reform is not an idealized textbook solution. Citicorp in particular has tried to follow this strategy. The financial services agreement, accepted by members of the World Trade Organization last year, is an important move in this direction. In the proposed system, global banks would internalize the risk or hedge the risk if they chose to do so. The U.S. has strengthened its own financial system by letting banks branch regionally. European banks are beginning to merge transnationally and to operate branches in other countries.

The next step is to strengthen the global system. IMF bailouts and government-enforced restrictions on competition impede the solution. Financial crises in Latin America in the 1980s, Mexico in 1994 and 1995, and now in Asia, should alert governments to the need for fundamental reform. More money for the IMF delays reform of the international system, encourages moral hazard, and subsidizes risk. Fundamental reform begins with global banking and a true lender of last resort.

Representative Saxton. Thank you very much, Mr. Meltzer.

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

Mr. Bergsten.

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

Mr. Bergsten. Thank you, Mr. Chairman. I too have provided a detailed statement. I hope you will put that in the record. Let me confine my oral remarks to three or four basic points and particularly respond to questions raised by other members of this panel.

First, let me try to dispose quickly of three fundamental points. The first is to emphasize that the proposed contributions to the IMF carry zero, repeat, zero cost to the taxpayer. With deference to Mr. Lindsey, I will not make an analogy to a credit union but I will point out that this is an exchange of assets. When the U.S. pledges dollars to the IMF, it can draw out the very next day an equivalent amount of deutsche marks, yen, or any other currency we may need for our purposes.

This is not theory. We have done it. When I was at the Treasury in the late 1970s, we drew in one fell swoop about $3 billion in marks and yen. We used them to defend the dollar, to defend U.S. interests.

So it is an exchange of assets. There is no net cost to the American taxpayer. That is an important point to keep in mind in talking about the cost-benefit ratio of the IMF contribution, because, if the cost is effectively zero, then you have to think the payoff is negative not to do it. So let's keep that in mind.

A second key question is whether the IMF actually needs the money. There was a lot of discussion earlier on how much the IMF has and how much might it have to use. Again, I think if one believes in the fundamental mission of the IMF, and that is an objective question to which I come back, then you want to have more money in the institution. Whether it has $10 or $15 billion available, or even $40 to $45 billion, and the truth is probably somewhere in between, one or two more major currency crises would require at least that much money. Brazil, Argentina, Russia, Malaysia, which has so far avoided the IMF but might need it, represent a very plausible series of additional country problems that might require more money than the IMF has available. That point too should be clear from the outset.

The third piece of debris, to get out of the way at the outset, is your question about transparency. You are absolutely right. The IMF should be more transparent. So should the World Trade Organization and most of the other international institutions. The U.S. has in fact been pushing that for about 20 years, again going back to my period in the Treasury.

What I think is most needed is for the IMF not only to make available the country data, as it is now doing, and try to expand that, but to make available its own appraisals. When the IMF reviews a country situation, it puts out a report. The first part of the report is analytical. That is now made available. The second part is judgmental, in which the IMF staff renders judgments as to whether the country is getting into trouble. That, I think, should be made public. If it were, it would alert the markets and there would be fewer of the crazy loans that everybody on the panel agrees have been made.

Markets can't function well without adequate information. The IMF analyzes country cases. It makes predictions. It did predict the Thai difficulties at least six months in advance. But those pieces of information were not widely available, and they should be.

Those are the kinds of things we should push. With some prodding, in fact, the IMF membership may agree. It is true that these are sovereign countries, many of which are reluctant to make data available. But I think, on this one, Congress is quite right to push. I think you will succeed. You should stay at it.

Let me then go to the fundamental question: Does the U.S. have a national interest in the kinds of programs that the IMF now carries out, and presumably would continue to carry out in the future?

It seems to me we have two central interests in the world economy. The first is the maintenance of maximum rates of economic growth and employment that are consistent with reasonable price stability. The second and related interest is the most widespread possible application of market-oriented policies rather than government controls and directives. These goals, incidentally, serve our foreign policy and national security interest as well as our economic interest.

My submission would be that the IMF plays a critical role in supporting both of those fundamental U.S. objectives. When a member country has a crisis and comes to the IMF for help, the Fund produces two things; financial assistance and policy requirements. It seems to me both are central to inducing and enabling the country to do two things: adjust gradually rather than precipitously to its crisis, and to adopt constructive market-oriented policy measures rather than draconian controls.

When a country faces a crisis and has to decide how to come out of it, it has two choices. It can either act immediately and with draconian controls, deep recessions and sharper currency depreciations, or it can have a more gradual phased in adjustment policy with more constructive, more sustainable policy, measures for the longer run. It seems to me our interest is clear, whether it is an agricultural interest in some states or a manufacturing interest in others, or our interests more broadly in a stable and successful world economy, in countries' doing it in a gradual, rather than precipitous way, and doing it with constructive, sustainable long-run measures rather than draconian controls. Those are the choices in the real world.

The IMF helps push the country in the constructive direction. It doesn't bail out banks. It requires, in the current Asian situation, banks to be closed. Indeed, some have criticized it for doing that too much in the Indonesian case. But the IMF does it; it pushes countries in a direction that will be constructive and sustainable for the longer run.

The basic question raised by other members of the panel today is whether the IMF hurts or helps. All three other members have the view that the IMF creates moral hazard. I think the analysis, while it raises some legitimate questions, is grossly overstated. Let me say why.

The members of the panel, particularly Professor Calomiris, argue that a very large part of the financial crises that have pervaded the world for the past couple of decades are due to the moral hazard problem, including the role of the IMF. I regard that as farfetched, without much evidence or proof. I would in fact like to hear some indication of why he thinks that is the case.

Let me suggest why it is not. The financial crises have not been limited to emerging market economies. They have pervaded industrial economies as well. What is the largest potential risk to the world economy and financial system right now? Not Korea, not Thailand, not Indonesia, not any developing country, but Japan. Is Professor Calomiris or anybody else on this panel going to say the reason Japan has a weak financial system–and could, if its NIKKEI index drops below 15000, face a globally significant financial crisis–is that the Japanese thought the IMF was going to bail them out? That is a farfetched thought; it is ridiculous. Did we get into the savings and loan crisis because we thought the IMF was going to bail us out? Of course not. There are much more fundamental factors that go to the nature of financial crises in country after country.

Timewise, the argument doesn't wash either. These crises have been going on for several decades. They have escalated over the last decade and a half, in periods and in countries where the IMF never had a role, was never even thought about, and can hardly be blamed with the crisis.

Let's take a look at what the IMF does in the actual country cases that we are talking about now. As I mentioned already, when the IMF has come into Asian countries, it has confronted an unusual situation. The rest of the panel seems to agree that the traditional IMF role of requiring more stable and effective macroeconomic policies–fiscal balance, and monetary policy stability–are correct. So maybe that is another issue we can put behind us and go to the point of dealing with financial systems.

The IMF, coming into these situations and finding weak financial systems as the basis of the current crisis, has not in any way sought to shore them up. To the contrary, it is requiring them to be reformed. Professor Calomiris is right that it takes a while. You can't reform fundamental structural elements of an economy overnight. My personal view is that the World Bank, with its experience in dealing with structural problems of this type, needs to be brought into the act in a much bigger way. It is probably a more appropriate instrument and institution to help deal with some of these problems than the IMF, with its more short-term focus.

But if one reads (and one can read) the programs in each of the Asian countries now, at the center of each of the programs is a requirement for fundamental reform of the financial system–new supervisory mechanisms, new regulatory requirements. Indeed, at the IMF's annual meeting in Hong Kong last October, there was an agreement on the creation of the Basel

Core Principles, a set of 25 principles deriving from work that my colleague, Morris Goldstein, did at our Institute for International Economics over the last year, calling for an international banking standard and putting into place on a worldwide basis a series of norms which each country is asked to adhere to in running its domestic financial system. It has to be voluntary, as you can't impose it on countries in this world, but you can certainly publicize those who do adhere to it and therefore are better credit risks and you can publicize those who ignore it and therefore should not get lending in the future. In short, steps have been taken in the direction required to help deal with it.

When the IMF goes into Korea, if you read the program as you can, it says in three different places that Korea must adopt the Basel Core Principles, which have to do with the whole range of sound supervisory and regulatory issues, reserve requirements, et cetera, that I know my colleagues on the panel believe should be implemented. Those are in the IMF programs. They made Indonesia close banks; they didn't bail them out and shore them up. So I am a bit mystified as to why it is that my colleagues on the panel see the IMF as hurting the situation rather than helping it.

Let me add one final concrete recommendation. We know, and it has been agreed earlier in the hearings this morning, that equity holders do take big hits. It should also be clear at least some of the banks have already recorded big hits. If you look at the fourth-quarter statements that have come out of Chase, Morgan, et cetera, several hundred million dollars of hits have been taken directly as a result of the Asian crisis. So they are already taking hits. It is not as if they have been let off.

But I fully agree that, as an integral part of all IMF programs now and in the future, it should be very explicit that the big lenders take haircuts. There is a very good precedent for doing so. The precedent was the second and final workout stage of the Third World debt crisis in the 1980s, which was the Brady bond portion of the response.

You remember, when the Latin American debt crisis began, the U.S. banks and some other industrial countries' banks were not in a position to take hits. Hence, the original Baker plan avoided hits on banks, in large part to keep our own banking system financially afloat. But then by the late 1980s, when our own banks had strengthened their positions, the Brady plan was put into effect and required the banks to take significant losses and provide significant debt relief to each of the debtor countries.

The amounts differed from country to country. The banks were given a series of options for how to do it. But it was an integral part of the program.

Under whose guidance were these Brady plans implemented? The IMF. They did it and they organized it. They had a lot of help–the Fed and the Treasury here, the G-7 and the G-10–but it was done by the international community as part of the eventual, final and successful workout of the Third World debt problem in the 1980s.

So we know how to do it. The new Basel Core Principles move it forward. The individual country programs in Asia are implementing that approach. It should be included systematically and structurally in each future country program where financial sector problems are a difficulty. I think those are the things Congress quite rightly should insist on, along with the transparency recommendations I advised.

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

Representative Saxton. Thank you very much, Mr. Bergsten.

Let me begin by asking Mr. Calomiris a question. I listened with great interest to Mr. Bergsten's analysis of the issue that we have been referring to as "moral hazard," and as a former businessman myself, I have difficulty not believing that there is an effect that we refer to as moral hazard.

In my previous life, I was involved with the sale and building of homes. You would buy a piece of land, and you would say we are going to make a substantial investment and hope to make a profit. Of course business people like to make as much profit as they can. I think one of the principles that you four will agree on, generally speaking, is the higher the risk, the greater the profit. Not always, but we hope that is the case most of the time.

So we decided how to make investments based on how much profit we can comfortably make with a comfortable amount of risk. If I got this investment that I am doing, and I got somebody standing behind me somewhere saying well, if you fail, we will loan you whatever it is that your failure amounts to, at an interest rate of about half what you can borrow from conventional sources. Dr. Bergsten, I respect your position. I am having trouble understanding it. So, Mr. Calomiris, if you would like to respond within this context, I would appreciate it.

Mr. Calomiris. Sure. There is an enormous amount of evidence, both case study analysis and also statistical evidence that clearly links this pattern of collapse since 1982 to the moral hazard problem. So it is not just your own very correct feeling that the logic must be true, it is also that we have studies, two excellent studies coming out of the World Bank that I would be happy to make available to anyone who wants to read them, one looking ex ante at bank risk taking and where bank risk lies on the Efficient Market Frontier (by Jerry Caprio)–and another very nice study by Asli Demanjuc-Kunt, looking at how ex ante differences across countries and safety net policies tend to affect risk. There are also lots of case studies. The interesting thing is some of the case studies are written by finance ministers or central bank presidents in these countries.

In my report, I go on at length about the Chilean experience. This is not someone looking from the outside in, this is the way people in these countries describe them. I have been involved in five countries outside the United States in financial reform, deeply. In Argentina, I have been working there four years. In Mexico, I was part of the advising that went on in 1995. I have also worked in El Salvador, China and Japan.

It is absolutely understood and accepted in Japan that "moral hazard" has played an enormous role in the financial collapse. No, it is probably not IMF-sponsored moral hazard in the Japanese case, but as I pointed out in my report, while the IMF has made matters worse, it didn't invent moral hazard. The domestic governments invented these policies, and it is often part of the way liberalization has taken place in many economies–freedom without responsibility. The IMF simply makes it worse.

If I can have one second to give a little bit of evidence about Asia that I came across yesterday. This is from the February 21st *The Economist* magazine, describing Indonesia. "In January, for example, Mr. Suharto promised to dismantle many of the monopolies and cartels which controlled trade in some products, but he seems to have forgotten to tell the monopolists. The plywood cartel, run by his golf partner, continues to issue instructions to its members. Restructuring of the financial system, a wash with red ink, has barely begun."

Let me read about Korea from this week's *Business Week*, dated March 2nd, page 54. "Kim [that is the new president] wants the banks to stop lending to big companies at preferential rates, but just in the past 6 weeks, banks have provided nearly $1 billion in emergency relief flows to sickly chaebol, [those are the conglomerate companies.] The loans are offered at far below market rates and this is a distorted distribution of limited resources," says the head of research at Daiwa Securities in Seoul.

My experience in Latin America and the experience we are seeing illustrated here show that IMF reforms of banking systems can't work. The IMF conditions in other respects work very well, in fact too well. The IMF is very good at requiring the taxation to sponsor the bailouts of these banks, because tax policy is something it can enforce within a year or two. It is not very good at making sure the reforms in the financial system take place. By the time those reforms would occur, over any reasonable period it would take to implement those reforms, the IMF is already out. The countries drag their heels until the loans are repaid and they are no longer responsible to the IMF. I experienced that in Mexico personally, and I experienced the opposite in countries that have developed their own domestic will to actually reform. The IMF simply doesn't make a difference and in fact makes matters worse I believe.

Representative Saxton. Mr. Bergsten and Mr. Lindsey, if you would answer this question for me. One of the major problems that has been pointed to from time to time with regard to the IMF is that, as Mr. Calomiris and Mr. Meltzer just pointed out the IMF loans money and charges relatively low interest rates, subsidized interest rates, if you will. Is this acting in the best interest of the recovery of ailing countries, or should we be encouraging loans to be driven by market rates of interest?

Mr. Bergsten. I think the first question to clarify, Mr. Chairman, is what we mean in this context by a subsidized interest rate. The IMF lends at what it calls a market rate, by which it means its own cost of money, adding a slight margin to cover its own operating costs and the like. It is not concessional lending like foreign aid, the International Development Association of the IBRD, or anything like that. In that sense, it is a global market rate that the IMF is paying for its money and then charging to its borrowers.

Of course it is right that the market rate in any given borrowing country can well be higher at a given point in time. It is likely to be higher because the country, after all, is in a crisis. So what is the proper rate?

I think the policy implication, though, has been confused. The members of the panel, in addressing the moral hazard question have, properly focused on the risk that private lenders will be induced to make bad loans because of moral hazard. I think they agreed, however, that countries are not likely to be subject to moral hazard. No sovereign country is going to get itself into a financial crisis, throwing itself to the tender mercies of the IMF and putting itself through the wringer of an enormous adjustment problem, because it has money available from the IMF or anybody else, at whatever interest rate.

I think it would be farfetched to believe that any country was going to pursue profligate policies because it had IMF money, even at a subsidized interest rate, available to it. So I am not sure what the thrust of this particular point is. I am afraid it confuses the two kinds of moral hazard.

Representative Saxton. Dr. Lindsey, if you would respond, I have what I believe to be an accurate record of the interest rates that are generally charged by the IMF on a monthly basis, from October to February, and those interest rates seem to indicate that it's about 4.5 to 4.7 percent. That seems to me to be significantly below market rate. Is that correct?

Mr. Lindsey. I think that is a fair conclusion.

Representative Saxton. But what market rate?

Mr. Lindsey. Let me see if I can answer the question, Fred. As Mr. Bergsten said, the IMF lends at its cost of funds, plus a markup. Its cost of funds is not a market rate; that is why it is coming to you to give them the money. It also goes to the Bank of Japan, the Parliament of Japan, the Bundesbank, and everyone else. So the cost of funds to the IMF is a blended cost of funds to the national governments of the world. They are the best credit risks around because, literally, they can print the money to pay off the loan, so there is no credit risk at all.

So what is happening is the IMF is taking an essentially risk-free rate, tacking on a little administrative cost, and calling that a market rate. It really is not a market rate. None of us could borrow at it because we, as individuals, have higher risks than the United States Government, and certainly the Koreans have a higher risk. Any banker charges different rates to different people, depending on the perceived risk premium. So what the IMF is doing–I think the better phrase, rather than market rate, they are charging these countries a risk-free rate. To the extent there is risk in the system, it is not being reflected in what the countries are being asked to pay. With regard to–well, I should stop there. I had responses to Mr. Bergsten.

Representative Saxton. Let me follow up, if I may, Mr. Lindsey. I think you talked about a blended rate, which reminded me of something that I learned a while back on this issue. Isn't it true the IMF pays no interest on some of the money that comes through the quota?

Mr. Lindsey. I think the initial–the IMF was set up right after Bretton Woods and the initial contributions to it were contributions in gold, and I think that is the interest-free component. I admit I am not an expert on the minutia of IMF balance sheets.

Representative Saxton. It is hard to find an expert on that subject.

Mr. Lindsey. But I think that, yes, some of the blended rate is zero, but I think most of it, about 75 percent of the IMF balance sheet, is quota contributions.

Representative Saxton. In any event, it is below the true market rate.

Mr. Bergsten. Mr. Chairman, there has never been a default to the IMF. The IMF lends to sovereign governments. They always have repaid. So if you want to base the appropriateness of the lending rate on the credit history of the institution, there is some reason to lend at what Larry rightly says is a risk-free rate. They have never failed to be repaid.

Representative Saxton. Mr. Meltzer, would you like to respond?

Mr. Meltzer. That is really not the right criteria. For 150 years, we have had the principles of a lender of last resort written down. Those were written down by Bagehot, the editor of *The Economist*. What he said is, you want to lend at a penalty rate. Now, what is the penalty rate in this case? It is a rate which is higher than the rate on the assets that are used as collateral. That is to prevent people from getting subsidies, and it distinguishes, it tells you when there really is a liquidity crisis.

What is a liquidity crisis? It is when you hold an asset and there is no market for it. That doesn't happen very often, but it happened here, for example, in the Great Depression. No one would want to buy your asset because tomorrow they were afraid there would be a run on the bank and they would want the cash, so they wouldn't even invest in a Treasury bill under those circumstances.

Now Bagehot said, correctly, lend at the penalty rate; that will tell you the market isn't functioning, and that way there will be no risk to the organization, and there will be no excessive borrowing. That is a principle which has been established, and once it was established, it worked perfectly for the British banking system. There were no serious problems for the next hundred years. That is the principle we ought to install at the IMF.

And all of this talk about what is the cost of funds to the IMF is really irrelevant to the problem of what rate they should be charging. They should be charging a rate which discourages people from getting subsidized loans relative to the rate at which they, the borrower, could borrow elsewhere.

Representative Saxton. Thank you.

Mr. Ganske.

Representative Ganske. Thank you, Mr. Chairman.

Mr. Calomiris, I was interested in your statement on page five where you give the example–at the top of the page, it looks to me like you were working in this area and you say, after a day of lip service, the release of the funds, one of the Mexican officials in charge took me aside and expressed his appreciation for my efforts and then told me, quote, "Of course the banks won't let us do any of this," unquote.

This was not a surprise. Why would anyone want to give up a subsidy if they have political influence to maintain it? So far, nothing has been done to introduce market discipline into the Mexican banking system; there is no reason to believe anything will be done. And furthermore, I think on the previous page, you mentioned all deposits are 100 percent insured in Mexico.

Mr. Calomiris. All debts, basically, not just deposits, not just of banks, but of pension funds. It has been a virtually completely insured financial system.

Representative Ganske. So your point is that, regardless of what -and this ties in with what your statement was before on the plywood, which was recently reported in an issue of the *Wall Street Journal*, a lot of these countries will make an agreement with the IMF to do certain things to open up their markets, et cetera, but the leverage is only there as long as the IMF is giving the money and, many times, temporarily; and once that is over, then it is your opinion that there is a reversion back to practice as usual.

Mr. Calomiris. I think that is right, but I really want to make the distinction between macroeconomic reforms and microeconomic reforms. If the goal is to change something about the fiscal policy in a country, the IMF can sometimes be very successful. That doesn't entail a lot of money

47-557 O - 98 - 3

from the IMF, it entails advice, coordination, and it is something that can be done in fairly short order.

The reason the IMF is starting to get interested in banking reform is that their assistance has become microeconomic bailouts of banks. The problem is that IMF conditions for banking reform aren't going to work because you can't turn a banking system around on a dime the way you can change a fiscal policy around. It is that simple.

Representative Ganske. Let me ask the panel one question, then I think I will be done.

Recently it has been reported that Indonesia was looking at a currency board, and it has been reported that both the Administration and the IMF have been vehemently against that. Can you tell me why you think the IMF and the Administration have been against a currency board in Indonesia, when it seems to have worked effectively in other areas; and is, in fact, a currency board a legitimate idea for Indonesia to be looking at?

Mr. Calomiris. Having worked in Argentina with the central bank there for the last four years, I have become much more a fan of currency boards than I was prior to that. Still, I agree with the Administration, and with the IMF, that Indonesia, at this point, is not ready for a currency board.

Currency boards can work very well if, prior to instituting them, you have already put into place the fiscal reforms that will make the currency board feasible. I think there are very legitimate objections to Indonesia putting in place a currency board because it hasn't done that; and in fact, within the institutions-the World Bank, the IMF, the people I talked to -there are real concerns that the goals in Indonesia, of Suharto, to put a currency board into place, are potentially, let's just say, not goals that involve the best interest of his country.

Mr. Bergsten. We did a thorough study of currency boards at my Institute a couple of years ago that I would like to submit to you. It looks at all the historical cases and concludes there are two cases where they work. One is where you have very small countries that are heavily dependent on trade; they don't have really an autonomous exchange rate policy anyway. That is a case like Hong Kong. The second is where you are coming off hyperinflation and you need some kind of anchor to restabilize, and the public is willing to pay almost any price to do it such as high interest rates or high unemployment. That was the case of Argentina. Indonesia meets neither criteria.

In addition to the problems Professor Calomiris stated, I think Indonesia is more like Mexico. People who now want currency boards in Indonesia recommended them in Mexico three years ago. Mexico rejected it; it did not meet the criteria. It has done quite well with its recovery, under the guidance of the IMF, and Indonesia today is much more like Mexico three years ago than like Argentina or Hong Kong. I share the view it would be a bad mistake for Indonesia to go that route at this time.

Mr. Meltzer. May I just say one bit on that question.

I am not a great proponent of currency boards in Indonesia, but I think, in fairness to Mr. Suharto, there is another side to that problem. Food prices are going to go up three to four times. Every company that has debt in Indonesia is about to fail, because the debt now becomes extraordinarily burdensome when they have to pay four times or more the price at which they contracted the debt, just to keep the thing afloat. There is a real crisis. The IMF program failed in Indonesia.

Now, a currency board that could back an exchange rate at 5,500 rupiah is a risky gamble, but what is it to be compared to? Is it to be compared to the present crisis in which people are rioting in the street, where there is very great difficulty in buying food, where there is a real threat to the indigenous Chinese population in the country, where every company is about to fail? It is a gamble. If the IMF backed it with the $40 billion it has promised to Indonesia, I can't say it is a guarantee it is going to work, but it certainly is better than the program which is now there, which is doing nothing.

Mr. Lindsey. One of the fundamental criteria for a currency board would be that they actually have the money in the bank, the foreign currency in the bank, to back the rupiah.

Mr. Meltzer. The 40 billion?

Mr. Bergsten. $60 billion or more, according to most analyses.

Mr. Lindsey. Let me proceed. Okay, thanks, Fred.

What you have to do is, you have to take the Indonesian money supply, divide it by whatever number you want to have as the exchange rate, then you have to have that amount of money in the bank. There is no indication that Mr. Suharto did that before proposing the currency board. As a result, his actual proposal would be doomed to failure; it didn't meet the first prerequisite.

But I think Mr. Meltzer had an excellent point. The question is, compared to what? When countries choose different monetary regimes -and I think Fred Bergsten's book would point this out also-they often completely give up their own ability to run their monetary affairs, and so they say, well, let the Federal Reserve do it, which is what Hong Kong and Argentina have done, because there is no one indigenously who can. So I don't think you can necessarily condemn a currency board.

I agree with the IMF and the Administration that Mr. Suharto did not do his homework before proposing this one, but I think it depends on a case-by-case basis whether or not you really want to have one.

Representative Saxton. Let me change the subject. When we debate tax policy in this country, we try to be very careful not to make the rich richer and the poor poorer. Last night on the train as I was coming back to Washington, I was reading the testimony I had available. And Mr. Calomiris' testimony was one of the sets of papers that I had. I would like to read something from his testimony and then ask each of you, beginning with Mr. Calomiris and then going across the table, to respond to it.

Mr. Calomiris writes, "While bailouts entail loans from the IMF and foreign governments and subsidize interest rates to developing countries' governments, taxpayers in the United States and other developed economies who pay the subsidies associated with these loans are not the biggest losers in the bailouts. The IMF and the U.S. Treasury in most cases are repaid.

"Loans from the IMF and the U.S. Treasury, however, provide powerful justification for increased taxes to repay the loans. When the crisis is past, the big winners are the wealthy, politically influential risk-takers and the big losers of the taxpayers in countries like Mexico and Indonesia.

"Thus, in addition to bailing out foreign and domestic bankers who had lent funds to Mexican firms prior to the crisis, the likely result of the Mexican bailout will be the transfer of some $45 billion from Mexican taxpayers, collectively, to the country's wealthiest and most politically powerful enterprises and individuals."

Would you like to comment on that, Mr. Calomiris? I find that quite astounding.

Mr. Calomiris. I will only comment on it by clarifying where the $45 billion comes from.

When the Mexican government decided to bail out the banks, effectively using the assistance it was getting internationally to bail out the banks, it did it by purchasing $45 billion of bad debt from the banks with the statement that it would prosecute or sell those debts to get as much repayment as possible. And roughly 23 billion of those are corporate debts to the largest corporations, which are part of this whole conglomerate mechanism; they have done nothing to move in that direction. And the people that I talked to at the World Bank who are handling the Mexican economy tell me they currently have no expectation that will happen, so that is the basis for the discussion.

Mr. Lindsey. I think the analysis is a correct one, and I think the reason that it works that way is that you have to realize that the people who are doing the negotiating tend to represent themselves; and in a sense, the money was already lost when it was lent. The question is, who then makes up the money? Is it the lender, i.e., the bank, or is it the government? If the government chooses to make it up, the government is nothing more than the taxpayer; and that is the description Mr. Calomiris had in mind, and I think it is quite straightforward.

Mr. Meltzer. I agree with what Mr. Lindsey just said. Think back to our own experience with the savings and loan problem. We had all the bailed-out banks. We later sold off the assets that could be sold to the market, and the rest–the $150 approximately billion–is a charge to the taxpayers.

There are only two places you can go. You can sell the bank for whatever it is worth and get as much out of it as you can. The residual is what is guaranteed by FSLIC or the FDIC or the Mexican government; that is essentially what Mr. Calomiris' argument says.

Mr. Bergsten. I agree with Mr. Meltzer. But it is worth remembering that we all agree, I think, when you are faced with a financial crisis of that type, be it our S&L crisis or the Mexican position in 1995 or the Korean position today, you have to get the bad loans off the books in order to restabilize the financial system and enable it to go back to playing its role in the economy. That is going to require a big hit to the taxpayers of the country as a group.

Then comes the crucial question of how you distribute that tax burden. That is a question of the country's fiscal policy rather than anything directly related to the banking system per se.

Mr. Calomiris. Just a little addition.

The thing that is so different, though, from the way we think about this in the U.S. is that the owners of the banks are the borrowers from the banks; that is what makes it such a, if you like, "seedy proposition." What is really happening is the recapitalization of the banks is accomplished, and then the decision is made that the borrowers–who, by the way, just happen to be the owners of the bank–don't have to repay the debt that they had taken out from the bank. That is what makes it a little bit different.

Mr. Bergsten. It is not only seedy, but uneconomic and inefficient. One of those Basel core principles I talked about, that has now been agreed at the international level, is to put strict limits on connected lending by owners to themselves. That is an essential reform in any banking system in the world.

Mr. Meltzer. Let me just say, we don't need the IMF to do those things, and it wasn't the IMF that invented the Basel procedures. The principle began with Chile, which went through a wringer in the 1980s after it got rid of Allende. It had a lot of financial problems following that. It imposed a principle on the banking system: if you get bailed out, every dollar you got from the government you are going to pay back with interest out of future profits. The banks pay it back–that is essentially what we did with the RFC in the 1930s. We said, here is the money; we are going to salvage the banks, but the money has to be paid out of future profits of the bank.

Representative Saxton. Let me just move on to a couple other questions. We have to, unfortunately, finish up shortly because we have to clean the room for someone else who is coming in at 1:00.

Some proponents of additional IMF funding would like to preserve the flexibility of the U.S. Treasury and its access to the Exchange Stabilization Fund. Others have suggested placing limits on this fund. Could you comment on these alternative proposals? Do you have recommendations regarding the Exchange Stabilization Fund?

Mr. Lindsey.

Mr. Lindsey. In my opinion, the Congress would be better served to look at the intended purpose of the Exchange Stabilization Fund. Do you want the Treasury to have the ability to manipulate the U.S. dollar exchange rate on world markets? That is the fundamental issue.

My personal view on that, which I stated also when I was a governor, was that the answer was no; that is, it is a temptation to mischief. If I thought that the very able people we have in New York at our desk, who use the Exchange Stabilization Fund, were better than George Soros and the other hedge funds at taking money out of the foreign exchange market, I would recommend to you that you appropriate money for them to gamble with and enrich the taxpayer and lower our taxes as a result. Unfortunately, I don't think they are as good as Soros and they would end up losing the money.

So I tend to be a skeptic of the Exchange Stabilization Fund, but I would go back to its fundamental purpose. I don't think it is a useful tool to have.

Representative Saxton. Should it be liquidated?

Mr. Lindsey. Yes.

Mr. Meltzer. Yes. May I say two things about that?

The first is, when you talked about transparency, there is no transparency in the Exchange Stabilization Fund. Congress doesn't have a clue about what they do with the money. Once in a while you may be able to get some records from them.

Second, how does the fund finance itself? By a system, most of the time, called "warehousing," by which the Federal Reserve makes a loan directly to the Exchange Stabilization Fund, off the budget.

Now, it seems to me to be absolutely violating every principle we have of democratic government to say that administrative agencies can, between themselves, under whatever name or arrangement they make, allocate monies without the Congress voting for them. And that really is a fundamental principle which needs to be corrected–has needed to be corrected for a long time.

The Exchange Stabilization Fund started when we devalued the dollar; it was there to protect us against foreign predators who might try to appreciate the dollar. Now, it has been used for all sorts of purposes, like Mexico and other purposes, which have nothing to do with its original purpose and which constitute a direct violation of democratic principles–namely, using unappropriated funds for a purpose which Congress has not approved.

Representative Saxton. Dr. Bergsten, would you like to have a very quick response?

Mr. Bergsten. I believe we should maintain the Exchange Stabilization Fund. The fundamental reason is that private markets often diverge very sharply from underlying economic fundamentals. There are what economists call "externalities" to be taken into account by official entities like the Fed and the Treasury. The U.S. Government has to be in a position to deal with adverse effects on our national interest caused by excesses and errors of the markets, errors which everybody on the panel has agreed frequently happen and can be very large.

Representative Saxton. I'm sorry. Mr. Lindsey.

Mr. Lindsey. I'm sorry. I would take too long. I just get hot under the collar when I hear that.

I'm sorry. I will learn to be quiet.

Representative Saxton. As you know, the U. S. Government levies taxes to exact resources from the private sector and transfer them to the public sector. In the case of the IMF, some of these resources extracted from the U.S. may be transferred to the IMF and then loaned to others. We get a paper, an IOU, from the IMF that represents the value of resources transferred to the IMF.

In the foreseeable future, what is the probability that a significant amount of these IOUs will be cashed and returned to the United States?

Mr. Lindsey. I think this gets to the disagreement that Fred Bergsten and I have: Is this really a cost to the taxpayer? If it worked, then I would recommend not $18 billion, but $100 billion or a trillion or $2 trillion. I mean, $18 billion is not going to solve the problem. I don't think Fred would recommend that.

The reason that it is not costless to the taxpayer, I think is threefold. First, there is an opportunity cost involved to the U.S. economy. The money is being borrowed at the risk-free rate available to the U.S. Government. We are borrowing more than we would otherwise borrow. That money is therefore not available to other public sector uses. It goes from the U.S. Government, at the same rate to the IMF, at the same rate to the foreign borrower.

We agree the foreign borrower is paying too little, which means we are introducing a distortion into the system, so it is simply not costless because of the opportunity cost involved. A better test of whether this is costless or not would be the dissolution test.

If we were to announce that we were withdrawing from the IMF, would we actually get our money back? I don't believe so, but I think that would be the real test as to whether the loans to date have been costless.

Thirdly, prospectively, I again think the right comparison is with the FDIC or with FSLIC prior to the banking meltdown in the late 1980s. I think you can find statements by Treasury officials that the FDIC was a costless institution, that it never–that we never incurred a loss in all the bank resolutions we ever had. I am sure there was a date at which that was true, not in the last 10 years, but this is exactly the same.

When you have a major meltdown–and one will come at some point in time–the IMF and the resources available to it will be swamped; and we should face that and we should make sure we have other mechanisms in place to deal with that eventuality.

Mr. Bergsten. I would just add that there are dissolution provisions in the Articles of Agreement of the IMF. They do provide for the member countries to be repaid. I am confident they would be and could be.

May I add a point about the so-called subsidized interest rates? The reason why those interest rates are provided is because the IMF's purpose is to achieve a public good–less global recession, less competitive depreciation, less import controls and less deviations from market practices. Those are what economists call "externalities"; they justify submarket interest rates or prices for individual products that may deviate from a pure market consideration. That is the concept.

Since I happen to believe the IMF serves those public purposes effectively, I support the notion of the externality and, therefore, the submarket cost in the sense that it is being used here. Since my colleagues on the panel disagree that there are positive externalities, they quite logically want to see a pure market rate in terms of rates in the borrowing country.

But that is the difference. If you believe the IMF serves a public purpose, which is why it was created in the 1940s, which is why we supported it for so long and do now–and I believe that strongly as indicated in my statement–then you have a clear economic rationale for the interest rates they charge.

Mr. Lindsey. That is a little different than what you said initially, because what you just said I agree with, which is, it is a matter of cost-benefit analysis. There is a cost, but the benefit is higher. That is different than saying, this is a costless program that should only be rejected if the net benefits are below zero.

Representative Saxton. Mr. Calomiris.

Mr. Calomiris. That is exactly what I was going to say. It has been bothering me since I discovered that Secretary Rubin has been spreading it around. It bothered me in Mr. Bergsten's written testimony, the statement that the American taxpayer doesn't pay a penny.

Well, I worked at the IMF for a summer. I made a salary. Someone paid it. I don't think it was the tooth fairy; I think it was the taxpayers of the member states of the IMF who paid the salary. So there must be a gross cost involved in running the IMF. Borrowers don't pay it. In fact they receive interest rate subsidies.

Another thing that is wrong with what I believe Mr. Bergsten said is, he said if it is just a credit cooperative, in some sense we all have this option to borrow, so we are all gaining; so even if there are interest rate subsidies, we all get subsidized, so in net there is no subsidy. That is not right because the probability of using it is not equivalent across the countries.

The IMF has become very different from what it was in the 1960s. In the 1960s or early 1970s, it was a fairly mutual arrangement where countries equivalently used it; now it has become a mechanism for transferring loan subsidies from the group of developed countries to the group of less developed countries.

So irrespective of whether you think that the benefits justify the costs, let's be honest; let's stop saying things like this doesn't cost us a penny, because if anyone believes that a loan subsidy doesn't cost him a penny, I would like to borrow some money from him at zero interest.

In fact, Fred, maybe we can meet outside.

Representative Saxton. Thank you very much. I thank all of you very much for being with us today. As you probably know, in Congress there are individuals who would like to have the Administration's proposal passed and the appropriation passed as proposed. There are others at the other end of the spectrum who would like us to withdraw from the IMF. Probably neither of those things is going to happen.

And so to the extent that we can understand these issues and perhaps in the future pass legislation which will address some of the concerns that many have and form a consensus among Members of Congress in both Houses and, obviously, the administration as well, then we will hopefully move forward to do, as Fred Bergsten suggests, make life a little better for some people around the world who do need it.

I want to thank all of you, for being here and for your written testimony, as well as your presence here today. Thank you, and the hearing stands adjourned.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome the distinguished economic experts testifying before the Committee this morning. This hearing has been called to review the Administration's request for $18 billion for the International Monetary Fund (IMF).

Over the last several weeks there have been a number of hearings on the Asian crisis and the IMF. Much of the focus has been on Asia instead of fundamental issues regarding the IMF itself. This is understandable given the circumstances, but more facts concerning the IMF are needed before Congress can make an informed decision on the IMF appropriation.

For example, in presenting a case for increased resources for the IMF, little Administration testimony to date has presented basic financial information such as the current level of quotas, amount of outstanding loans, the interest rate paid on the quotas, and cost of overhead and related expenses. Furthermore, the Administration case relies heavily on the Asia crisis even though the IMF has sufficient funds to complete the announced Asian bailouts.

This hearing has been called to focus on the IMF, its financing, procedures, administration, and economic impact. This is entirely appropriate in light of the Government Performance and Results Act. Under this bipartisan legislation, Congress is to review programs based on measurable and objective performance criteria.

This Act fundamentally changes the way Congress and the Administration evaluate programs. Even if it is argued that the Act does not technically apply to the IMF, the IMF appropriation should be evaluated in the same spirit. This will require more transparency and responsiveness to Congress from the IMF in the future. As Sabastian Edwards, a former Chief Economist of the World Bank, has said, the pervasive secrecy of the IMF makes evaluating its performance extremely difficult if not impossible.

The key question before Congress is whether the IMF should be significantly expanded into the future. The current quota increase before Congress is somewhat smaller than that favored by the IMF. The IMF has signaled that the U.S. should be prepared for an additional quota increase fairly soon. This indicates that the IMF expects rapid growth in its operations in coming years. The desirability of such a permanent structural increase in the IMF is the key issue before Congress.

However, a convincing case for such IMF expansion is not at all clear and, in fact, has not been made. The IMF budget projections are not available because apparently the IMF does not produce such projections even for internal use. Thus, a case for future IMF growth cannot be substantiated by quantitative estimates of future IMF activities. Measurable and objective criteria for IMF functions are not available. Presumably, the growth of international capital flows in recent years might be used to justify an expansion of the IMF, but an alternative explanation might be a growing moral hazard problem associated with the bailouts of recent years.

Aside from the specifics of the budget request, there are several major problems with existing IMF lending practices. These include moral hazard, lack of IMF transparency, excessive taxpayer exposure, subsidized interest rates, and counterproductive conditions attached to IMF loans. These are issues on which reasonable people may disagree, but they cannot be ignored. Meaningful structural reform of the IMF is needed whether or not an IMF expansion is financed in 1998.

PREPARED STATEMENT OF TIMOTHY F. GEITHNER, TREASURY ASSISTANT SECRETARY, DEPARTMENT OF THE TREASURY

Mr. Chairman, thank you for giving me the opportunity today to discuss the International Monetary Fund, its role in the world economy and financial system, and why we believe it is important to act now to strengthen its financial resources.

New Risks in the Global Financial System

This hearing today takes place in the context of two developments of great importance to the United States and to this debate over funding for the International Monetary Fund (IMF).

The first is the emergence of a global financial market that has brought significant benefits to the world economy, but also new risks. National financial systems are now more closely integrated than ever before. Capital now flows across markets on an extraordinarily large scale. And technological innovations in telecommunications and finance make it possible for finance to flow much more quickly in response to events.

These developments have made it possible for private capital to finance an extraordinary improvement in living standards across many countries. But they also have increased the scale, force, and speed with which financial crises can occur.

These risks are illustrated clearly in the financial crisis in Asia, and this is the second development which makes these hearings on the IMF so important. The crisis that began this summer in Thailand and then spread throughout Southeast Asia and to Korea presents serious potential risks to American interests.

Our economic interests are at stake because large and sustained depreciations in the currencies of our trading partners and deep recessions in their economies will reduce the competitiveness of American companies, reduce demand for American exports, reduce the earnings of American firms, and reduce the value of pension funds across the country, all of which, of course, will affect American families and American workers.

Even if the crisis is contained to its current dimensions, the impact on the U.S. economy could be significant. While it is too early to offer a precise assessment of the overall impact of the Asian crisis, preliminary assessments by the OECD and a number of private forecasts have estimated that the impact on the U.S. economy may be around half a percentage point (0.5%) of U.S. GDP. If the crisis is not contained, the impact could be significantly greater.

Our security interests are at stake because economic instability, when it is acute and sustained, can threaten political stability. This risk is real, not just in those places where we now have American troops on the ground. It can be significant in any country where the basic institutions of the state are untested in crisis or where there does not exist an established pattern for stable governmental successions.

U.S. Policy

In response to these developments and in an effort to limit the risks they present, we have led a major international response to help reestablish financial stability in Asia and to help strengthen the architecture of the international financial system. The International Monetary Fund is at the center of these efforts, and it will remain critical to any effective U.S. response to protect our interests in this crisis, as well as future international financial crises.

Our strategy to protect U.S. interests in the immediate crisis has the following major elements:

- First, we have worked to encourage the countries in crisis to put in place strong programs of reform, and supported these programs with temporary financial assistance from the international financial institutions.
- Second, we have encouraged countries in the region and outside the region to take preemptive policy actions to reduce their vulnerability to contagion from the crisis.
- Third, we have worked to encourage Japan and the other major industrial countries to pursue policies to strengthen growth and open their markets, and thereby contribute to recovery in Asia.
- And, finally, we have taken steps, led by the U.S. Eximbank, to protect U.S. exports to the region, by mobilizing trade finance for the countries in crisis.

Restoring Financial Stability in Asia

The centerpiece of our approach has been to support strong programs of reform, backed by temporary, highly conditioned financial assistance, led by the IMF, as a bridge to recovery.

Policy and Reform

These programs of economic reform are designed to address the specific causes of the crisis in each country and to create the conditions necessary for stronger and more stable exchange rates and for a quick return to rising living standards.

To accomplish this, the programs focus on the types of reforms necessary to restore confidence, so that the people of these countries are willing to keep their savings in the currency of the country concerned and so that new flows of private capital will be available to finance recovery.

Although the specifics have necessarily varied across countries, the principal elements of each program include:

- Measures to strengthen the financial systems by closing weaker institutions, reinforcing stronger ones, and improving the supervisory system.
- Structural reforms to make the economy more market-oriented, better able to allocate capital efficiently, and less vulnerable to corruption.
- The liberalization of restrictions on trade and investment.
- Improved transparency and disclosure in the financial accounts of the government and central bank, and in the balance sheets of private banks and corporations.
- Measures to reduce the impact on the poorest segments of society by protecting health and other social expenditures from budget cuts.
- A supportive framework of monetary policies to help stabilize the exchange rate and contain the inflationary effects of depreciation, and fiscal policies to promote the necessary reduction in external deficits and to finance the costs of financial sector restructuring.

These programs are essentially programs of growth-oriented structural reforms. They are not austerity programs. Despite popular perception, the degree of fiscal and monetary tightening in these programs in Asia has been modest by comparison with the stabilization programs the IMF has employed in different circumstances.

It may be unavoidable that the reform programs and their architects get associated with and blamed for the economic distress that comes with financial crisis. But it is the crisis–not the programs–that induces the distress. And it is the programs that help cushion the decline in growth and living standards and help create the conditions necessary for recovery. Countries that have tried a different path of delayed adjustment and less comprehensive reform have normally found that by doing so they simply lengthened the crisis and delayed recovery.

The other common element in these programs is that they can be adjusted in response to changing circumstances. When growth slows more sharply than expected, for example, the IMF can move, as it has in each of the cases in Asia, to modify the fiscal targets in the programs so as not to impose excessive contraction on weakened economies. And when problems in the banking system become more acute than originally estimated, the IMF can act, as it has in Thailand and Indonesia, to strengthen the programs in response.

Temporary Financial Assistance

In support of these programs of reform, we have mobilized temporary financial support, led by the IMF and other international financial institutions, to rebuild reserves and help provide confidence.

The U.S. has also joined with other countries in being prepared to provide contingent supplemental resources that could be made available to augment these programs. We have a moderate share of these supplemental lines, and have not yet disbursed any funds.

This financial assistance by the international community is an essential part of the solution to these crises and a necessary complement to the programs of reform. It is necessary to provide confidence, to induce stronger reform programs, to provide some breathing space for the reforms to take hold, to supplement the countries' official reserves, and to help ensure that these governments can meet their international obligations and can stand behind their financial systems.

There is no amount of official money available in the world that could substitute for or compensate for a lack of commitment to reform in these countries. But even the most virtuous, most credible, most committed government could not successfully confront problems of this scale without temporary financial assistance. It's useful to recall that the United States drew a substantial amount of our reserve deposits from the IMF in 1978–largely financed through the General Arrangements to Borrow (GAB)–when we faced a major decline in the value of the dollar.

The IMF reform programs are structured carefully to help ensure it works, to help limit the moral hazard risks that are inherent in any provision of official finance, and to maximize burden sharing. Several of these features are worth highlighting:

- Disbursements are tied to strict compliance with very detailed, concrete, time-specified policy commitments. They are tranched or phased to help induce both early up-front actions and sustained follow-through. The money does not flow unless and until the policy commitments are carried out.
- The assistance is in the form of temporary loans, not grants, at market-related interest rates. In fact, after the establishment of a new IMF facility at our initiative in December, much of the assistance for Korea is being made available for short maturities at a substantial premium to minimize use and to maximize the incentive to repay early.
- The assistance comes with strict limitations on the use of the money, with restrictions on support to private corporations, and with limits and conditions on liquidity support to banks.
- The assistance is led by the international financial institutions–the IMF, the World Bank, and the Asian Development Bank–which ensure that conditionality is maintained and that we leverage substantial contributions from the international community for any U.S. participation (direct or indirect).

Not providing this assistance, however appealing that might seem as an option, would risk more acute instability, with a greater and more protracted loss of economic output, deeper, more sustained depreciations in the currencies of our trading partners, and greater contagion, with all the attendant risks to the United States.

The Critical Role of the International Monetary Fund

The IMF is absolutely central to this effort. If it did not exist, we would have to invent it. We have a huge stake in making sure it has sufficient resources to respond to any intensification or spread of the current crisis and for any future crises.

- Without the IMF, there would be no multilateral mechanism for providing apolitical advice to shape strong reform programs.
- Without the IMF, at times of crisis, there would be greater depreciations in the currencies of our trading partners and sharper adverse impacts on the US and world economies.
- Without the IMF, at times of crisis, there would be greater pressure on the United States to act unilaterally with taxpayer resources to protect our interests without the global leverage the IMF provides.

Today, as much as when it was established with U.S. leadership more than 50 years ago, the IMF acts as a forward defense of American interests. It has played a critical role in supporting reform and growth in the transition economies, bringing Russia back from the brink of hyperinflation, and Poland from near collapse to one of the fastest growing economies of Europe. In Uganda it has helped underwrite ten years of remarkably successful economic reforms which have generated average annual growth rates, in real terms, of over six percent a year. And in Argentina, the IMF has supported–including during the 1995 "tequila crisis"–Argentina's deep economic transformation from a country characterized by anemic growth and hyperflation to one that enjoys strong growth (8% in 1997), near zero inflation, declining fiscal deficits, and a more private-sector oriented economy.

The IMF has been successful in so many cases because it promotes the core American economic values of sound money, respect for market forces, and free trade.

I thought that it may be helpful for me to say a few words about the financing structure of the IMF. In some ways, the IMF operates like a credit union. We extend a credit line– most of our quota subscription and for our GAB or NAB commitment–which the IMF can draw on. Any drawing by the IMF gives us a sort of deposit in the IMF, which is of equal value, pays interest, is supported by over $30 billion in gold, and which we can withdraw essentially on demand if necessary. For these reasons, U.S. participation in the IMF is treated as an exchange of financial assets. U.S. transfers to the IMF are not scored as budget outlays, and do not come at the expense of domestic programs.

Chairman Greenspan and Secretary Rubin have testified several times over the past few months about the risks in the current crisis and the importance of action by the Congress to strengthen the IMF's resources.

As you know, the President's request has two components:

- The first component is to authorize our participation in a facility to provide expanded emergency resources to the IMF called the New Arrangements to Borrow. Proposed after the Mexican financial crisis and modeled on the General Arrangements to Borrow (GAB) established by the G-10 more than three decades ago, these arrangements would make available an additional $23 billion from some 25 countries to supplement the IMF's normal lending resources in the event of a serious threat to the stability of the international financial system. The GAB was last increased in 1983 in response to a request from President Reagan, and also in conjunction with a normal quota increase. In the ensuing 15 years, the growth in the world economy, trade, and, most importantly, global capital flows have left these arrangements too small to deal effectively with the challenges of today's capital markets–for instance, IMF resources as a percentage of private capital flows to developing countries are now one-twentieth as large as they were 15 years ago.

- The second component is to authorize our participation in a normal periodic increase in IMF quotas, which are the normal lending resources of the institution. These resources have been increased on average every seven years in an attempt to keep up with the growth of the world economy and the global financial system. This latest proposal, which would increase the overall quotas of the IMF by about 45 percent and provide roughly $65 billion in additional loanable resources, was negotiated last year, in consultation with the relevant committees in the Congress.

The IMF's recent stabilization programs for Asian countries have depleted its resources to levels approaching historical lows. Although the IMF has $45 billion in uncommitted resources, only $10-15 billion are now available for lending, because the IMF needs to reserve the remainder in cash balances to accommodate possible unconditional withdrawals by members. This is neither a sufficient cushion of resources to enable the IMF to perform its basic mission nor is it sufficient to ensure the IMF could respond effectively if the Asian crisis deepens or spreads to other markets. We believe it is extremely important that the Congress move quickly to approve both the NAB and quota requests, so that the IMF has sufficient resources to help protect U.S. interests in the event of unforeseeable but potentially very damaging financial emergencies over the near term.

Strengthening the Architecture of the International Financial System

At the same time that we have worked to confront the immediate crisis in Asia, we have worked to build consensus on reforms to help strengthen the architecture of the international financial system. We have a strong interest in trying to identify changes to the system that could help reduce the risk of, and make the system more resilient in the event of, future financial crises of this magnitude.

President Clinton began this effort four years ago at the G-7 Summit in Naples. At the Summit that followed in Halifax in 1995, we launched a major international effort to help make the international financial architecture, in Secretary Rubin's words, "as modern as the markets."

This initiative produced an international program to strengthen transparency and disclosure, the development of core principles for banking supervision in emerging markets, the establishment of an "Emergency Financing Mechanism" to accelerate the IMF's capacity to respond in crisis, and an expanded emergency facility for the IMF, the New Arrangements to Borrow.

Building on these steps, we have supported a number of additional reforms over the past few months. The most significant of these are the following:

- We launched a new effort to strengthen transparency and disclosure standards to help reinforce market discipline, by improving the quality of information available to the markets on the liabilities of central banks, the balance sheets of the banking system, and the external debt of the government and private institutions.
- We have won support for a number of steps to improve transparency in the operations of the IMF, including the release of Letters of Intent with respect to each of the three large Asian programs and summaries of the IMF annual reviews of countries, and new efforts to use independent, external evaluators to gauge the effectiveness of IMF programs in a number of areas.
- We have changed the policies and operations of the IMF and the World Bank to make it possible for them, when necessary, to mobilize the types of large-scale, front-loaded, and more innovative programs of temporary financial assistance more appropriate to the challenges of today's capital markets. Most important among these changes is the establishment of a new facility in the IMF, the Supplemental Reserve Facility, which will result in much of the resources provided in exceptional circumstances being extended at shorter maturities and at a substantial premium over the IMF's normal lending rates.
- We established a new forum for mutual surveillance and cooperation in Asia, to help deal with risks that might precipitate future crises.
- And we have encouraged greater participation by private financial institutions in the resolution of these crises, with a global effort by the

major banks to refinance their short-term claims on Korean financial institutions.

We are now in the process of a more comprehensive review of changes to the international financial system that will help ensure we have effective institutions to manage the risks that accompany all the benefits of the global capital markets, and help deal with a world in which we are all more directly affected by the failures and successes of other economies and other governments. But we do not yet have solid and convincing means to induce sovereign states to take actions that would prevent a crisis, or to induce investors to make judgements about risk and return that overcome the more powerful forces of fear and self interest that drive markets.

These challenges will be the subject of a meeting of finance ministers and central bank governors from key countries around the world that we will convene later this year as a first step to try to build a global consensus on reforms to the architecture of the international financial system. We held a preparatory meeting of senior officials from the finance ministries and central banks of 22 countries in Washington last week. And the G-7 Finance Ministers and Central Bank Governors last weekend endorsed a framework of new initiatives in several areas.

This will be a complicated and difficult process, with lots of interesting, compelling solutions to be explored. The temptation will be to try to stop the clock somehow and suspend the reality of the global financial market while we try to figure out the best way forward, but that is not a tenable approach given the risks we now face.

Conclusion

The United States is central to this effort to contain and resolve the Asian crisis and to strengthen the architecture of the international financial system.

Our role is critical because the IMF cannot strengthen its financial position without us. If we do not act, the NAB will not come into force, and the quota increase will not go into effect. Our role is important because no other nation has the capacity to lead the global effort necessary to deal with a crisis of this magnitude. And our role is fundamental because our perceived willingness and capacity to support an effective international response is critical to confidence at what is a rather delicate moment for the global financial system.

We cannot guarantee that, by acting, we can turn things around and successfully limit any fallout for the U.S. economy and our strategic interests. Most of the solutions to these problems have to come from the countries themselves. But we have a responsibility to do what we can to protect our interests in this crisis. And strengthening the IMF is essential if we are to have the tools necessary to protect those interests.

Statement by

Charles W. Calomiris

Paul M. Montrone Professor of Finance and Economics

Columbia Business School, and

Director, American Enterprise Institute Project on Financial Deregulation

before the

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Throughout history, financial collapses have been defining moments for public policy. Crises promote action, embodied in new financial institutions or policy doctrines. The motives that underlie such policies are sometimes short-sighted – driven by short-run pressures rather than long-run principles – and it is easier to enact unwise policy in the midst of crisis than to reverse course after the crisis has passed, after policies become embodied in institutions or statutes.

The responses by the IMF and the U.S. government to the Mexican crisis of 1994-1995 and the recent Asian crises are examples of dangerous short-sightedness. In the wake of these crises, the Clinton Administration is promoting a new doctrine of global financial bailouts, administered through IMF largesse and conditions. If the IMF and U.S. Treasury are permitted to prevail, the efficiency of global capital markets will suffer, and the incidence and severity of financial crises will grow.

The Mexican and Asian collapses follow a pattern dating back to 1982, and are the byproduct of fundamental flaws in the incentives facing bankers in developing countries. Incentives to assume excessive risk result from the unhealthy partnerships between government and business in many countries, which manifest themselves in taxpayer bailouts of insolvent banks. International support for bank bailouts will deepen that unhealthy partnership, and thus make the preexisting problems in these countries even worse.

The uses of IMF assistance and the U.S. Exchange Stabilization Fund to bail out insolvent emerging market creditors and banks are not only improper (in the sense that these sources of funds were not designed to be used in this way); such assistance and the doctrine that underlies it are a threat to the stability of the world financial system.

The suggestion that the IMF's capital and facilities should be expanded to permit it to engage in more such activity in the future is troubling. The principal lesson of the recent bailout programs managed by the IMF and the U.S. government (and the longer history of generous domestic bailouts of banks in developing economies) is the vital need for all parties (including host governments, the IMF and the U.S. government) to find a way credibly to commit *not* to sponsor such counterproductive bailouts.

Why Are Bailouts Misguided?

A guiding principle of a well-functioning market economy is that those who undertake risks should either lose or gain according to the outcomes produced by those decisions. The idea that government, or governments acting through the IMF, should absorb losses when risky decisions turn out badly is fundamentally contrary to this guiding principle of a free-market economy. This is, regrettably, precisely what the IMF and the U.S. government are doing. While assistance is often couched as "liquidity" assistance to resolve "balance of payments" problems, in fact assistance is 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.

What have been the costs of government absorption of financial losses? Three kinds of cost figure prominently: (1) undesirable redistributions of wealth from taxpayers to politically influential oligarchs in developing economies; (2) the promotion of excessive risk taking and inefficient investment; and (3) the undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote. I will explain each of the three categories of cost in turn.

Bailouts Benefit the Politically Powerful at the Expense of Others

The first undesirable consequence of these bailouts is the massive redistribution of wealth away from taxpayers in emerging economies, and toward the wealthy political cronies who control their countries' industries and financial institutions, and whose imprudence precipitates financial collapse.

While bailouts entail loans from the IMF and foreign governments at subsidized interest rates to developing country governments, taxpayers in the United States and other developed economies who pay the subsidies associated with these loans are not the biggest losers from the bailouts. The IMF and the U.S. Treasury in most cases are repaid. Loans from the IMF and the U.S. Treasury, however, provide powerful justification for increased taxation to repay the loans. When 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 or Indonesia.

Mexico's financial crisis of 1994-1995 – often seen as a "success story" by the Clinton Administration – provides a case in point. During the resolution of the Mexican banking collapse, the Mexican government (through its deposit insurance agency) purchased more than $45 billion of bad debts from Mexican banks, half of which are the debts of bank-related conglomerates. The government promised (at the time) that it would not absorb those debts permanently, and that it would hold debtors responsible for paying their obligations. So far, it has done virtually nothing to retrieve funds from borrowers liable for the debts ("Debt Burden Drags on Economy," *Financial Times*, December 16, 1997, p. II). Thus, in addition to bailing out foreign and domestic bankers who had lent funds to Mexican firms prior to the crisis, the likely result of the Mexican bailout will be the transfer of $45 billion from Mexican taxpayers collectively to the country's wealthiest and most politically powerful enterprises and individuals. The economic result of these taxes is more than a pure transfer to the rich; taxation has also slowed recovery from the recession.

The bailout and redistribution of wealth in Mexico – like those currently underway in Asia – was blessed by the IMF and the U.S. government. In addition to lending money, the IMF and the U.S. Treasury effectively lend respectability and external political imperatives to tax-and-transfer schemes to benefit the rich.

Some proponents of IMF bailouts argue, however, that by intervening the IMF is able to promote fundamental structural reforms (in particular, reforms to domestic banking systems) that reduce the likelihood of future bailouts. The 1994-1995 intervention in Mexico, however, provides contrary evidence. In 1995, I was a member of a World Bank team which provided advice to the Mexican government to assist it in implementing its promised reform of the deposit insurance system, which was part of the package of proposed IMF-U.S. Treasury-World Bank reforms. All deposits are 100 percent insured in Mexico, and this complete insurance has effectively subsidized high-risk bank lending to powerful risk-taking conglomerates. (Insured depositors have little incentive to question the use of their funds, which leaves bankers free to make whatever use of the funds they please.) In November 1995, we presented a detailed plan for reform to the Mexican government that would have introduced a small element of market discipline into the system and thus would have partially removed some of the government subsidies enjoyed by the Mexican banks.

Ostensibly, as a vaguely worded condition for the World Bank to release $500 million in funds to the Mexican government, the government had to agree to consider some version of the reforms we were advocating. After a day of lip service (and the release of the funds), one of the Mexican officials in charge took me aside and expressed his appreciation for my efforts, and then told me that "of course, the banks won't let us do any of this." That was not a surprise; why would anyone want to give up a subsidy if they have the political influence to maintain it?

So far, nothing has been done to introduce market discipline into the Mexican banking system, and there is no reason to believe that anything will be done to limit the current system of subsidizing the risks of the industrial conglomerates and the banks they own. That experience has made me suspicious of IMF "conditionality."

I expect similar results from the current conditions being attached to IMF assistance in Asia. It is very hard to undermine the corrupt partnership between powerful industrialist-bankers and governments by giving them both money in exchange for promises to reform in the future. It is even harder to do so when those conditions are specified in secret agreements – such secrecy makes it impossible for any outside observer to evaluate the wisdom of the conditions, or gauge a country's eventual compliance with them, which further weakens the incentives of recipient countries to comply.

That is *not* to say that IMF conditions of *all kinds* always fail. The IMF has been somewhat successful in getting countries to change tax or expenditure policies, foreign trade policies, and monetary policies. Banking policy is fundamentally different, however, for two reasons. First, real reform in the banking system takes years to accomplish because it entails new ways of measuring and managing risk, new regulations, and new supervisory procedures. These changes are both politically difficult (because the politically powerful must forego subsidies) and technically challenging. The time horizon necessary to implement successful reform is at least five years (judging from the successful examples of Argentina and Chile, which did so very aggressively and without IMF pressure). Building effective financial institutions, and reforming the legal and regulatory environment in which they operate, is a protracted and difficult learning process, even when countries have the political will to do so. The horizon of IMF crisis assistance and conditionality (typically two years or so) is simply not suited to achieve true reform in the banking system.

Second, banks are controlled by powerful and concentrated vested interests who are willing to fight hard to maintain their access to subsidized credit and block those reforms. A basic principle of political economy is that powerful minorities (in this case, a handful of conglomerate-controlled banks) generally will be successful in obtaining political favors paid for by fragmented majorities (the average taxpayer).

Thus in practice, crisis countries will always find it easy to promise (but never deliver) true banking reform. Instead, they will tax quickly and deeply, pay back their loans to the IMF, replenish the poker chips of their risk-loving conglomerates, and return to business as usual.

Another criticism of IMF conditions in Asia (put forth by Martin Feldstein 1998) is that they are inappropriately detailed and microeconomic. Feldstein argues that it is inappropriate for an international agency to intrude so deeply into domestic economic policy, especially since its charter provides no mandate to do so. I agree with that view, but I would hasten to add that that the lesson is not that the IMF should provide bailouts with fewer conditions. Rather, I would characterize the new tendency of the IMF to intervene too deeply into the structure of borrowing country economies as the natural result of overstepping the proper limits of providing assistance. The new intrusiveness reflects an unwise new goal (providing massive bailouts for insolvent financial institutions and international lenders), a noble hope (to restructure the economies of recipients to prevent future dependence on bailouts), and an unrealistic belief in the ability of such conditions to succeed.

The Expectation of Bailouts Increases the Fragility of the World Financial System

The predictable failure of government to allow losses to fall on risk takers after financial crises not only produces a one-time wealth transfer, but encourages behavior that will lead to a repeat of the same problem in the future, which brings us to the second category of costs resulting from bailouts.

If the risk-taking bankers know that future gains from taking on risk will be private, but losses will be borne by taxpayers (again), that amounts to a government subsidy for risk, which thereby encourages excessive risk taking (the so-called "moral-hazard" problem).

In the United States, we learned during our Savings and Loan debacle that subsidies for risk taking could lead to large losses from unwise, high-risk investments. The losses to taxpayers from that experience (roughly 3% of 1990 GDP), however, were small compared to what has been happening in developing economies over the past 15 years – an era that has seen an unprecedented epidemic of high-cost bank insolvency.

Studies by the World Bank and the IMF have documented some 90 episodes of severe banking crisis since 1982. In more than 20 of those cases, the bailout costs to developing country governments have exceeded *10 percent of GDP*. In roughly half of those cases (including the estimated losses of some of the current Asian-crisis countries) losses have been in the range of 25 percent of their GDP (see Caprio and Klingabiel, 1996a, 1996b, and Lindgren, Garcia, and Saal 1996).

These facts warrant emphasis. This string of enormous losses is unprecedented, and is occurring during a relatively stable period of positive global economic growth. Losses to depositors in the United States during the Great Depression, for example, were comparatively small. National banks (the only banks for which depositor loss data are readily available – from FDIC 1940, p. 66) issued 47 percent of U.S. bank deposits. Losses to national bank depositors from bank failures during the worst four years of the Depression (1930, 1931, 1932, and 1933) together amounted to only 1.9 percent of average U.S. GNP over those years (GNP data are from *Economic Report of the President*, 1968, p. 218). Assuming similar loss rates to depositors of national and state-chartered banks would imply an estimated loss on all deposits of roughly 4 percent of GDP. Losses during other historical periods of the most severe economic crises – the 1830s, the 1850s, and the 1890s – also pale by comparison to the experience of the last 15 years. Indeed, in many countries historically, severe recessions have not been associated with any significant losses to depositors (Bordo 1985, Calomiris 1993).

What can explain the enormity of loss since 1982? Surely not "shocks" of unprecedented magnitude (like oil price hikes, wars, or global downturns in demand), since such influences have been absent during this period. The explanation for the new epidemic of worldwide banking instability is the roller coaster of risk produced by the choices of banks in developing economies – choices that are the byproduct of government subsidies for risk-taking.

Why are banks behaving so differently now from the way they behaved previously? The answer is simple. Prior to the 1980s, banking systems did not subsidize risk nearly as much as they do now. The wave of partial economic and financial liberalization that swept through the developing world in the 1980s and 1990s has been enormously beneficial in many ways, but it should not be confused with *true* economic liberalization. While many countries have opened themselves to world trade, have privatized many important sectors of their economies (including their financial sectors), and have moved away from direct governmental control of domestic credit, a key flaw in the new era of liberalization has been an expanded, and unhealthy, partnership between government and private business.

Private business in many developing economies is dominated by oligopolistic conglomerates, often controlled by a small minority of wealthy, politically influential families or corporations. At the center of the unhealthy partnership between government and business in many developing countries is a new kind of bank – what I call the *quasi-public bank.* Quasi-public banks (typically owned and controlled by conglomerates) are private institutions with an implicit claim to public resources (which pay for their losses). They are a key instrument of domestic economic control for conglomerates, and a key vehicle for the transfer of political patronage from the government to these conglomerates.

Prior to the 1980s, banks in developing countries were often state-owned institutions, or private banks subject to strict controls that limited private allocation of credit. That system was highly inefficient and limited private sector access to funds. It was replaced by a "privatized" banking system with a different set of inefficiencies – an unnaturally risky form of bank "privatization" that brought freedom without responsibility. When quasi-public banks (and their parent conglomerates) make profits, they keep them; when they suffer losses, the public pays for them (through bank bailouts). That is a formula for encouraging banks to take on extreme risk.

Quasi-public banks don't always choose to take extreme risk, however, and that explains why they sometimes can survive successfully for years before imposing such large costs on taxpayers. But they are extremely fragile institutions, and they magnify risk for the rest of the economy, particularly during recessions. These banks turn normal economies into a house of cards – one which collapses in the face of even moderate-sized adverse shocks.

The key to understanding how quasi-public institutions magnify economic risk is to consider how they respond to initial losses produced by adverse shocks to their borrowers. Normal private banks experiencing loan losses tend to reduce their portfolio risk to restore the confidence of their depositors and limit the risk of bank failure. But quasi-public institutions need not concern themselves with the risk of failure, since bank depositors and stockholders are all insured against loss by taxpayers. In the wake of losses, these banks face opposite incentives – to channel ever riskier loans to their conglomerates.

Financial crises in these economies tend to go through three stages: (1) initial losses, followed by purposeful increases in bank lending risk; (2) consequent increases in the probability of devaluation, followed by purposeful increases by banks in their currency risk; and (3) large devaluation, followed by enormous losses to banks and taxpayers. The consistency of this pattern in uncanny. It was first visible in the Chilean collapse of 1982-1983 (that experience has been described in detail by the former Chilean minister of finance in de la Cuadra and Valdes 1992). The same pattern was followed in Mexico in 1994-1995, and in Thailand, Indonesia, and Korea in the recent crisis.

The sequence is disturbingly predictable: (1) As initial losses of borrowers and their banks mount, banks and their borrower-owners increase credit and thus pursue higher-risk resurrection strategies. The initial recessionary shock that hits these economies raises the probability of devaluation (slightly, initially). The resultant increase in bank risk makes devaluation more likely because of the link between expected bank losses and future government money supply increases.

(2) Increased risk of banking collapse means a greater chance of a government bailout of bank losses. Since those losses are often in the range of 10 or 20 percent of GDP, the implications of these potential losses for government expenditure and money supply increases make drastic devaluation a real possibility.

The high probability of devaluation provides banks and their borrower-owners a new opportunity for profitable risk taking in the form of currency risk. As the risk of devaluation grows, the interest rate difference between local currency-denominated debt and dollar-denominated debt rises (reflecting the expectation of a devaluation). Now banks and their borrower-owners face the choice between domestic-denominated borrowing – which has a high current cost, but no currency risk – and foreign-denominated borrowing – which has a low current cost, but a risk of loss following a devaluation (when the value of hard-currency debts can rise astronomically). Because the banks and their owner-borrowers know they will be bailed out by the government if a devaluation occurs, they prefer to borrow via low-interest rate, dollar-denominated debt, and need not worry about the enormous losses they will suffer from a devaluation.

(3) Of course, the more the economy increases its dollar-denominated borrowing, the more likely it will be unable to meet those hard-currency obligations. Thus devaluation becomes more and more likely over time.

That, in short, is how quasi-public banks have turned many developing economies into the riskiest financial systems the world has ever seen. Indeed, several former government officials in these economies have issued what amount to "public confessions" that document exactly this pattern (notably the central bank president of Venezuela, Ruth de Krivoy 1995, and the finance minister of Chile, Sergio de la Cuadra). Consider de la Cuadra's discussion of the Chilean collapse.

As in many other countries, the adverse macroeconomic consequences of the initial exogenous shocks to the Chilean economy made it politically difficult to impose the necessary discipline on banks. As de la Cuadra and Valdes (1992, p. 75) argue:

> In a nutshell, we argue that the superintendency could not include in its loan classification procedure a truly independent assessment of the exposure of bank debtors to foreign exchange and interest rate risk because such an assessment would have interfered with official macroeconomic policies.

De la Cuadra and Valdes go on to trace how excess risk taking by banks and firms, and eventual losses from those risks, produced economic devastation by 1982 and increasingly perverse incentives for lenders (pp. 79-80). Their discussion warrants recounting in detail.

> In 1981 most banks saw their effective capital plummet further as soon as optimistic debtors became less willing to pay when the net worth of their corporations fell. This reluctance reinforced the previous perverse incentives to banks, so that banks became even more willing to assume credit risks derived from exchange rate and interest rate risks.
>
> By 1981 financing decisions by Chilean firms and banks reflected a *de facto* government guarantee to the private sector for foreign exchange risk. Our analysis has identified the superintendancy's lack of penalization of credit risk in its loan classification criteria as the channel for the guarantee.
>
> The outcome of this structural contingent subsidy was that many small and medium-sized businesses got deeply into debt in 1981. Debts to banks increased during 1981 from 37.6 percent to 50.4 percent of GDP in response to the rise in real interest rates...
>
> By mid-1982 the fall in GDP was so steep that it took on the character of a depression. In June 1982 the government finally decided to devalue the exchange rate by 14 percent...By the end of 1982 the losses that the devaluations had inflicted on the holders of dollar-denominated debts had created insolvency among firms of all sizes....
>
> The sorry state of most debtors caused delinquent loans to rise from 2.34 percent of loans in December 1981 to 3.83 percent in February 1982 and 6.31 percent in May. Most delinquent loans turned out to be 100 percent losses, so they reduced the net worth of banks...
>
> ...On July 12, 1982, the central bank decided to allow banks to defer their losses over several years, so it began to buy the banks' delinquent loan portfolios at face value. The banks, however, had to promise to repurchase the portfolios at face value over time with 100 percent of their profits, so the scheme did not improve bank solvency by itself. It solved a liquidity problem but also set the stage for making good the implicit contingent subsidy that the government had offered to speculators in 1981.

De la Cuadra and Valdes emphasize that loans to industrial firms that were linked to banks via conglomerates were especially forthcoming from banks as a consequence of the government subsidization of risk. Thus despite its free-market orientation and stated commitment to private discipline in banking, Chile ended up insuring "uninsured" claims on banks, subsidizing high-risk resurrection strategies on the part of its banks, and passing on enormous risk-encouraging credit subsidies to large industrial firms with close links to banks.

The Chilean pattern was repeated in Mexico in 1994-1995. Initial bank loan losses were aggravated by currency devaluation's effects on Mexican firms that had undertaken dollar-denominated debts. Furthermore, Mexican banks, like those in Chile in 1982, had bet heavily against devaluation. Despite the fact that Mexican banking regulations prohibited banks from assuming currency risk, as the peso devalued Mexican banks suffered large losses from illegal "structured note" agreements they had entered into with American banks (discussed in Garber 1997).

In the recent Asian crises, Thailand, Korea, and Indonesia also have seen enormous increases in their dollar-denominated debts over the past year – after recessionary shocks and bank losses were widely known. The devaluations of recent months (in combination with the prior pursuit of low-interest dollar-denominated funds) have produced an enormous burden on the taxpayers of these countries who now must repay the dollar-denominated debts at inflated exchange rates.

Ironically, some supporters of international bailouts – notably, Jeffrey Sachs – see the high dollar-denominated short-term debt burdens of developing market economies as the "cause" of "unwarranted" runs on their currencies which they claim produce financial crises. According to that view, large amounts of short-term foreign debt expose countries to the fickle preferences of foreign speculators. That view is misleading for at least three reasons.

First, the run-up in short-term foreign debt is a *symptom* of weakness (a characteristic of an economy that cannot attract long-term debt) and indicative of the perverse risk-taking incentives of banks and conglomerates that are willing to absorb massive amounts of foreign currency risk at taxpayers' expense.

Second, fickle foreign speculators are not the source of devaluation pressure. Developing economies in which government and business are too closely linked tend to suffer two kinds of fundamental problems which underlie devaluation pressures: low productivity growth, and off-balance-sheet fiscal pressures resulting from weak banking systems. Because crony capitalism is highly inefficient, it produces low factor productivity growth, which makes the long-term maintenance of a fixed exchange rate against the dollar very difficult. As Paul Krugman noted of the "Asian tigers" two years ago, their growth resulted from combining large amounts of savings with inexpensive unskilled labor. Relative to the U.S., the Asian tigers have enjoyed little factor productivity growth. Relatively low-productivity economies must suffer real exchange rate depreciation over time, and consequently either have to devalue or experience price deflations.

Fiscal pressures are also important. The off-balance-sheet liabilities associated with costly bank bailouts imply the need to monetize government debts. Because these potential costs and their monetary implications are anticipated by markets, they can undermine the credibility of the fixed exchange rate. A common error of many macroeconomic analyses of exchange rate collapses in Asia and Mexico is the tendency to focus only on the *official* government deficit, ignoring the enormous costs of bank bailouts.

The Sachs view is also wrong to identify foreign funds as the primary sources of balance of payments outflows. In many cases (as the IMF's report on the Mexican crisis made clear) foreigners are not the ones who initiate the run on the currency. Well-informed domestic market participants often are the first to flee once it becomes clear that devaluation is imminent.

To What Extent Are the IMF and the U.S. Government Magnifying Moral Hazard?

My review of the moral-hazard consequences of bailouts over the past 15 years has emphasized that domestic governments have often been the most important source of perverse incentives for their banks. Where does the IMF fit in? The main influences of the IMF and the U.S. government in the 1990s have been to aggravate the problem in two ways: (1) to lend legitimacy to (and thus facilitate) 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 (2) to insulate foreign creditors from losses during these crises.

Of the two influences, the second is the more pernicious. Insulating foreign investors from loss (by ensuring that bailout packages also rescue them) removes the incentive for foreign investors to avoid lending to high-risk countries. That aggravates the moral-hazard problem by promoting the flow of dollar-denominated "hot money" during the second and third stages of the financial crises outlined above.

In this regard, consider the contrast between what creditors learned from the Mexican crises of 1982 and 1994. In 1982 (in the wake of a decline in oil prices and the rise in U.S. interest rates) foreign lenders to Mexican firms suffered enormous losses as the peso depreciated to 1/3 of its pre-crisis value, making foreign-denominated debt unsustainable for many firms. For example, the workout of one of the largest Mexican conglomerates, Grupo Alfa, entailed eventual losses to its creditors in excess of 50 percent. Painful lessons were learned by some of these creditors, including some of the largest U.S. banks operating in Mexico. Citibank in particular learned important lessons about managing risk on its commercial lending in Mexico, and managed its exchange and credit risk much better during the 1980s and 1990s. During and after the crisis of 1994-1995, its losses were far smaller than in 1982.

What will foreign lenders learn from the 1994-1995 Mexican crisis, or the recent Asian crisis? I fear they are learning that they can lend without fear of default because of the implicit protection of the IMF and the U.S. Treasury. And it does not help matters that the IMF and the Treasury are signalling their intent to provide future bailouts by calling for ever-increasing amounts of IMF capital and new IMF lending facilities. That, of course, will add fuel to the fire of risk-taking in developing economies.

Undermining the Process of Economic Reform in Developing Economies

The cost of insuring foreign lenders against loss runs even deeper, however, which brings me to the third category of costs from bailouts. By insuring foreign creditors who fuel developing economy risk taking, the IMF and U.S. government are undermining the natural process of reform in many emerging economies.

For developing economies true reform is a big step – one that requires the fundamental political transformation from a domestically-oriented "rent seeking" society to one willing and able to participate in the competitive global economy. Powerful local oligarchs often can successfully block liberalization if they choose to do so. But the oligarchs may prefer true liberalization if they profit from it. The attraction of participating in the competitive global economy is that globalization offers greater access to foreign markets and foreign sources of capital. That may lead powerful special interests to permit true liberalization if it is the necessary path to globalization. Entrenched oligarchs may choose to liberalize in order to trade a large slice of a small pie for a small slice of a much larger pie.

The incentives for oligarchs to liberalize can be strong if foreign sources of capital are only willing to provide funds to economies with appropriate capitalist infrastructures – that is, those which are based on the rule of law, the protection of creditors and stockholders rights, a predictable means of laying claim to title, an orderly bankruptcy procedure, an intelligible system of accounting principles, a non-confiscatory tax system, and fair competition in markets.

But IMF and U.S. government assistance can undermine the incentives that encourage the liberalization process. If oligarchs can avoid true liberalization but still maintain access to foreign capital, 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? If foreign investors are protected by the IMF and the U.S. government, foreigners will be less discriminating about where they place their funds, and thus provide less of an incentive for reform in developing economies.

Thus bailouts undermine the natural process of reform that global competition would otherwise promote. They do so not only by taxing (and thus weakening) the emerging middle classes in developing countries (the segment of society most likely to push for real reform), but by undermining the incentives of the existing oligarchs to permit liberalization.

From some quarters one hears praise for IMF bailouts as a means to political "stability" in developing economies. If the pursuit of stability means tilting the balance to preserve corrupt rulers and undermine democratic forces within developing economies, it becomes harder to defend policies solely on the basis of the political stability that accompanies them. I for one am very thankful that stability was not the overriding objective of Americans in 1776.

Distinguishing Liquidity Crises from Solvency Crises

Supporters of the IMF sometimes refer to its assistance as an infusion of "liquidity." While liquidity has nothing to do with financing bank bailouts, liquidity assistance was the motive that gave rise to the IMF as part of the Bretton Woods system. Traditionally (under the pre-1973 Bretton Woods system) IMF intervention was supposed to help bolster central bank reserves to preserve a fundamentally sound exchange rate regime buffeted by "destabilizing speculation."

After the collapse of the Bretton Woods system and throughout the 1980s, the IMF's role changed. It assumed the role of helping mainly developing countries devalue in an orderly way, and establish credibility in private markets. The IMF offered technical advice, and monitored compliance with macroeconomic policy objectives. During that period, one could argue that the IMF provided "liquidity" assistance (rather than simply wealth transfers) in the sense that its policies sometimes helped to restore credibility by reversing adverse trends in the fundamental macroeconomic determinants that drove exchange rate depreciation.

In the 1990s, the IMF has stretched the notion of "liquidity" assistance beyond any reasonable definition. IMF programs in Mexico and Asia are now *microeconomic bail outs that restore the solvency of clearly insolvent financial institutions.* That objective has nothing to do with bank or government liquidity, or with temporary imbalances in the balance of payments.

These bank bailouts also have nothing to do with "panic prevention." In particular, there is no connection between current IMF programs and the historical interventions by central banks or private coalitions of banks to stem banking crises. (The history and theory of banking panics, and the proper role of the lender of last resort, are reviewed in Gorton 1985, Bordo 1990, Kaufman 1991, 1994, Calomiris 1990, 1993, 1994, 1997, Calomiris and Gorton 1991, Calomiris and Schweikart 1991, and Calomiris and Mason 1997.) The current IMF bailout policies are bridge loans in support of the large wealth transfers from domestic taxpayers to recapitalize clearly insolvent financial institutions and related parties. Historical lender-of-last-resort assistance during banking panics, in contrast, was geared to prevent the failure of *solvent* banks which were temporarily in need of cash to prevent their unwarranted failure.

Given some of the recent concerns of a threat from "irrational financial contagion" voiced by policy makers in the popular press, it is worth emphasizing that the literature on the history and theory of banking panics (cited above) demonstrates that panics have been "rational" phenomena. Bank panics result from reasonable concerns on the part of bank depositors, and are *predictable historical phenomena.* Random, irrational attacks on financial systems are not evident in financial history. Thus concerns of "irrational contagion" spreading from one country to another without any fundamental explanatory link connecting the countries are unwarranted. Such concerns should not be used to justify financial bailouts. For example, there are clear *fundamental economic* connections (notably export product competition) that have produced "spillover" effects across countries within Asia during the recent crisis. As during the Mexican crisis, not all countries suffer from the fallout; the spillovers can be traced to economic and financial linkages, not irrational contagion.

IMF bailouts cannot be justified by panic prevention, as that term is properly defined. Nor could the IMF serve as an effective lender of last resort to the banking systems of developing economies. A lender of last resort (whether private or public) must be in the position to observe and control the uses of the funds it provides. Historically, bank clearinghouse coalitions or central banks have been the lenders of last resort.

There is no reason to believe that legitimate lender of last resort protection to stem financial panics would be best achieved via IMF or U.S. government intervention. Runs on banks are either the consequence of fears of impending devaluation (which central banks control via monetary policy), or the consequence of confusion about default risks within the banking system. In both cases, local authorities are the proper institutions to deal with the problem (by resolving the exchange rate uncertainty in the former case, or by deciding on the appropriate lender-of-last-resort policy in the latter case).

In cases where lender-of-last-resort assistance is warranted, the local central bank (unlike the IMF) has the information and legal authority to enforce the necessary conditions on the behavior of banks receiving such lending. Furthermore, those conditions may involve long-run reforms of banking practices. As I argued before, the brief time horizon of IMF involvement makes any attempt by the IMF to achieve meaningful reform of the financial sector, as a condition for assistance, virtually impossible. Financial sector reform is a process that requires many years to design and implement. Countries that have achieved successful banking reform have done so over many years and as the result of a strong domestic commitment to improve banks' incentives, not in response to IMF conditions (Calomiris 1997).

The Current Asian Crisis and the Proposed Increase in IMF Capital

If there is no respectable intellectual justification for the current direction of IMF policy (as illustrated in Mexico and Asia), then why are so many people coming out in support of expanding the IMF's capital and lending facilities? If IMF-sponsored bailouts are weakening democracy, strengthening corruption, aggravating inequality and poverty, and fostering systemic financial instability and industrial inefficiency, why are they so popular?

I think part of the answer lies in the short-run fears of American banks and businesses, which have led them to equate support for expansion of the IMF with support for its programs in Asia. Many U.S. banks and businesses would stand to lose if the current IMF Asian bailouts were undermined. For many, the "long-run" appropriateness of IMF policy is not the issue; their current exposure in Asia is their overarching concern.

Of course, deciding not to expand the IMF's capital would not in any way undermine the IMF's existing commitments in Asia. Rather, it would only limit the IMF's ability to expand such commitments in the future, in Asia and elsewhere. Thus I think much of the support demonstrated for the IMF on the part of U.S. banks and businesses is not only myopic, but misguided. There is no immediate threat to Asia from limiting the ability of the IMF to expand in the future.

Policy Recommendations

The following are four specific recommendations that follow from my analysis.

First, policy makers should recognize that IMF bailouts like those provided in Mexico and Asia are counterproductive. The IMF can best contribute to global financial stability by committing not to insulate foreign or domestic creditors from loss. The more that developing countries are forced to handle their own financial insolvencies, and the more foreign investors are forced to bear the costs of their investment decisions, the more developing countries will be attracted by the benefits of true liberalization. International "coordination" of assistance to insolvent creditors is counterproductive to the stability and efficiency of the global financial system.

Second, consequently, there is no reason to expand the IMF's capital or to develop the new proposed lending facility to provide bailouts to financial systems in distress. Indeed, an expansion of IMF capital or facilities would do real harm by signalling an intention to strengthen and expand the IMF's commitment to provide bail outs in the future. The U.S. government should do all within its power to encourage the IMF to revert to its pre-1994 goals of advising countries on their macroeconomic policies (to improve exchange rate stability) and serving as an international delegated monitor charged with tracking those policies and providing credible information to global capital markets.

The IMF and World Bank sometimes have been successful in helping to identify and give credibility to regimes that are honestly pursuing the path of reform. In my view, their expressions of support for these regimes have been more important than the funds they have contributed in support of those reforms. Both institutions could operate successfully with far less capital than they currently have.

The IMF does not need to use funds to bribe countries to restore balance to their macroeconomic accounts or proper incentives to their banks. The IMF should place its trust in global competition, which gives the most reliable encouragement to true liberalization. Wise economic policies will be rewarded by prosperity, and by global inflows of "unprotected" capital. In the case of banking reform, bribery is not only unnecessary but ineffectual. The IMF should recognize that it cannot control (and should not try to control) the banking regulations of developing economies.

Third, denying the IMF its desired increases in capital and facilities, and working to restrict its purview, are not enough to stop the trend toward unwise expansion of global bank bailouts. Other means of promoting bailouts must also be forsworn. Along with refusing to expand the IMF's capital, Congress should abolish the Exchange Stabilization Fund – a legacy of the Great Depression which has no legitimate role in U.S. monetary policy today. The Exchange Stabilization Fund – originally created to "stabilize the exchange value of the dollar" (Schwartz 1997, p. 135) – was the source of a $12 billion loan to Mexico in January 1995. No one could plausibly argue that the loan to Mexico was a form of exchange intervention in support of the dollar. This was not the first time the Exchange Stabilization Fund was used inappropriately. Indeed, as Anna Schwartz (1997) documents, the history of the Exchange Stabilization Fund – contrary to its stated purpose – is rife with similar examples of abuse by previous Administrations.

The World Bank – which has been somewhat successful in advising countries on long-term financial sector reform – should also be prevented from serving as a substitute vehicle for bailouts. It should limit its influence on financial sector reform to advising and tracking long-term progress. Private financial markets have the ability and the incentive to reward viable economic reforms with all the funding needed to promote development.

Fourth, IMF secrecy is contrary to its proper role as a source of independent, objective, and informed opinion about the economic performance and financial risks of member countries. In pursuit of its appropriate mission, any policies or conditions for assistance advocated by the IMF should be revealed publicly. That will encourage a lively debate about their merits, and permit critical evaluation of their effectiveness.

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The International Monetary Fund

Statement by

Dr. Lawrence B. Lindsey

Resident Scholar

The American Enterprise Institute

before the

Joint Economic Committee

Congress of the United States

February 24, 1998

Thank you Mr. Chairman. It is my pleasure to be here today to discuss the desirability of increasing the size of the International Monetary Fund at this time, as well as potential actions to improve international economic policy. 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 believe that there are three salient points that have not been adequately addressed to date by the Administration in its request to the Congress for funds to support an IMF expansion.

First, I believe that the prospective cost to the American taxpayer of our IMF contribution is greater than the Administration has suggested to date. It has been described as an essentially riskless investment, like putting money into a credit union. This is not the case.

Second, an expansion of the IMF has been described by the Administration as essential for our macroeconomic stability. It has been suggested that millions of American jobs are at risk if this increased IMF funding is not approved. Again, I do not believe that this is the case.

Third, and I believe most important, an enlarged IMF is simply not the best way to advance a sound international economic policy for the 21st century. The IMF is a relic of the Cold War and, while potentially advantageous to the global situation in the second half of the 20th century, is not central to a sound global economic strategy for the next century. Congress should seize this opportunity to carefully consider how we would like to shape the United States' global economic policy for the decades ahead.

Let me begin with the nature of the U.S. contribution to the IMF. In recent Congressional testimony, a senior Administration official likened American contributions to the IMF to deposits in a credit union. Consequently, he argued, the money involved was not really an expenditure. He 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 <u>not</u> 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 was 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 roughly 20 percent of its value in recent months. 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.

I really think that is the rationale behind the IMF request for a quota increase and the observation of Chairman Saxton that a further quota increase is likely in the foreseeable future. Due to a variety of reasons, not the least of which involves the concept of moral hazard, the IMF considers an ever larger quota necessary to cover the risks involved in ever larger international lending positions. The question the Chairman asked therefore is a good one. If this really is the equivalent of 1980 and we are dealing with the equivalent of the FDIC, we desperately need to reflect on whether we want to make the institution ever larger, or whether we want to contemplate new arrangements to cover the missions of the institution.

The second fundamental question I would like to address has to do with the supposed necessity of contributing to the IMF for reasons of economic security. We are told that the economic consequences of not approving the $18 billion request are potentially dire. There are two separate arguments which support this claim: one has to do with trade, the other with the banking system. I would like to examine each closely.

But before looking at the details of these arguments, let us consider the big picture for the moment. The same people who are warning of dire consequences if the IMF funding is not approved tell us in other venues that the U.S. economy is in the best shape ever. It would be a truly unusual circumstance in economic history that a record breaking economy would be so fundamentally fragile that it relied on an appropriation equal to one quarter of one percent of GDP for its continued success.

There is one possible link between record setting expansion and economic fragility that needs to be considered. Is the United States economy really just resting on an economic bubble of excess credit expansion? Although I think the answer to this question is on balance, no, I would feel more comfortable with the intellectual consistency of the advocates of this funding if they were to resolve the apparent paradox in their arguments.

But, if this link between expansion and fragility were in fact the result of a financial bubble, an $18 billion appropriation for the IMF is at best irrelevant. There are other actions we should be taking and other questions we should be asking. Why are we effectively easing bank supervisory standards in the midst of a financial bubble by telling lenders to roll over loans which are officially in default? Why are we not gradually trying to deflate the bubble through a slightly more restrictive monetary policy? Why is the Administration advocating $40 billion in new spending programs rather than pursuing a more contractionary budget policy? Shouldn't public officials be trying to "talk down" the stock market and warning investors of the risks ahead?

Again, my own judgment is that the U.S. economy is not so fragile at this point in time that failure to approve this money would lead to an economic recession. However, I do believe that we may be at risk of encouraging a future financial bubble to develop through the actions now being proposed. Increasing the capacity of the IMF is not helpful in this regard as it sends a signal to borrowers and lenders alike that a U.S. taxpayer funded safety net is being expanded to rescue them, should they engage in imprudent lending. I also worry somewhat about the regulatory treatment of the bad debts associated with Asian lending. This is not 1991. The banking system is not fragile. Regulatory

47-557 O - 98 - 5

forbearance at a time of record setting bank capital and profits and a robust economy is simply not appropriate.

Now let us consider the two detailed mechanisms which supposedly link our economic security to the need for an IMF funding package. The first I would call the "trade" argument. The Administration is pursuing a lobbying campaign claiming that jobs would be lost in various members' districts if the IMF package is not approved. I can well understand the need for this from a political point of view. But a careful examination of the claim suggests it is not well constructed.

My personal favorite "trade" story comes from recent IMF hearings before a committee of the other house of Congress. There, one Senator from Nevada noted that the entertainment facilities in his state had been emptied since the Asian crisis began. State revenues were particularly threatened. While the Senator was not explicit, the supposed logic followed that we needed to replenish the IMF, so that it could bailout Asia, so that Asian high rollers could return to Las Vegas and lose the money back to us.

While one might chuckle at the details, I am sorry to say that the fundamental logic of this argument is exactly the same no matter what industry and no matter what state is involved. The notion that you can indirectly channel money to someone to repay a bad debt and then expect him to buy (on net) more goods from you than your initial gift is plainly fanciful. I do not believe that the act of creating jobs in one's district should be the sine qua non of a Congressman's decision making. But the Administration, by making this argument, is advancing a logic which is false: The IMF quota increase is not a net job creator in the United States economy. Congressmen who base their vote on the argument that it is are doing their constituents a disservice.

The other detailed link between the IMF package and the health of the American economy has substantially more merit. It involves the well-being of the banking system. Chairman Greenspan has testified that the risks from the current crisis pose a "small but not negligible probability" of placing the global banking system in jeopardy. I concur with Chairman's Greenspan's evaluation. The question is what the best ways are to deal with this risk.

As Chairman Saxton pointed out in his opening remarks, the money for the IMF now under consideration is not related to the current commitments the IMF has made to Asia. Frankly, if approved, this additional funding would be used if events in Asia produce a much bigger debt problem than the IMF now expects or if those problems were to spill over to other regions: Eastern Europe, the nations of the former Soviet Union, or Latin America. In practice, the small but not insignificant risk to our banking system that Chairman Greenspan alluded to would involve one of these eventualities. I do not believe that either the Fed or the IMF believes that the Asian crisis, if contained at current levels, poses the kind of risk we are talking about.

I believe that if the Asian crisis were to worsen, or if financial problems were to spread to other regions, the IMF would be of only limited usefulness in stemming it. Of much more importance would be actions already taken over the past decade in the United States to improve the quality of our financial system . As a result of these actions, our financial system is far better able to weather the current difficulties than it was 10 years ago and is far better positioned than any of our competitors.

This involved a lot of hard work by our Nation's regulators and its banks. And we paid a price. The economic headwinds which afflicted the United States economy in the early years of this decade were, in large part, a result of the actions taken to strengthen the banking system so that it can be healthy today. Let me stress two particular changes. First, our banks built substantial capital and loan loss positions. This was the result of legislative and regulatory requirements to make sure that any bank losses would be carried by the stockholders of the institution and not by the taxpayers. This capital building process was a major cause of the economic slowdown in the early 1990s, but it laid the groundwork for the current economic expansion.

Second, the Federal Reserve, under the leadership of Governor Susan Phillips, worked closely with the major global U.S. banks to develop highly sophisticated computer models of banks' balance sheets. They carefully modeled the complex interrelationships between various components of bank portfolios. This all sounds very technical, but it has had a big practical payoff. Bank managements and the Fed have a much better understanding of the actual risks in the lending portfolios of the banking system than exist in other countries. This has really paid off. Our banks are far less exposed to the Asian crisis than those of Europe or Japan, who did not do the same hard work.

Third, our monetary authority has spent the last 17 years building credibility. This credibility, and the Fed's ability and willingness to use it in a crisis, is the real defense America has to prevent systemic problems in Asia from spreading to our banking system and our economy. Again, this has not been a costless process. The process of building credibility was a major factor in the recessions of 1982 and 1990. It is important to recall that back in the Carter Administration, the monetary and financial credibility of the United States was so low that we were actually forced to issue bonds denominated in foreign currency. Today, the dollar is the undisputed king of the world financial community. As a result, it would take an unlikely series of catastrophic policy errors to produce the kind of crisis in American banks that we fear today.

There are essentially three lines of defense that any economy possesses with respect to trouble in its banking system. The first, and most important, is prudence on the part of bankers. That is why the efforts of the Fed during the 1990s to properly model the exposure of American banks was so crucial. In the U.S., at least bank management has the tools and information at its disposal to prevent excessive risk positions from emerging. The second line of defense is bank capital. Again, U.S. banks are in an unusually strong position in this regard. The third line of defense is the central bank. In my view, the Federal Reserve stands ready, willing, and able to provide sufficient liquidity and, if ultimately needed, regulatory forbearance, to protect the U.S. economy from adverse shocks.

The role of the IMF in protecting our economy from a breakdown of our banking system is negligible. One might even question whether the net effect of the IMF is positive or negative. As I have already mentioned, the primary line of defense for our economy is bank prudence. And there is ample evidence that a further expansion of the IMF would not be helpful in enhancing prudent behavior in the long run. If there were any evidence that the IMF has or could enhance the risk assessment process, I would consider this a favorable contribution. But, the position of the IMF in not releasing its country reports for fear of "destabilizing" markets and the poor advance warning the IMF has given in the current crisis do not give one comfort in this regard. I therefore do not share any part of the Administration's conviction that an expansion of the IMF would provide any net increase in the macroeconomic security of the United States.

Finally, let me turn to the future. It can't possibly be in the interest of the American people to maintain the existing international economic order. We cannot continue to have a situation in which every time a bank in one country tries to foreclose on a loan in another country, an international incident is provoked which threatens a collapse of the world banking system. America has the most to gain from a global economic order in which capital investment -- including equity investments -- can be made anywhere on the planet. It also has the most to gain from a world in which contract disputes, including bankruptcies and insolvencies, can be resolved before a fair and impartial arbiter.

With regard to direct investment, our long term objective should be that a company headquartered anywhere on the planet should be able to invest in a factory anywhere else on the planet and receive the same legal protections as any other company located there. I find it amazing that America has tolerated a situation in which any Korean firm can make any investment it wishes in the

United States, but no American firm was allowed to own a majority stake in a Korean enterprise. We should aggressively use our leverage in the current dispute to end such inequities.

With regard to lending, our long term objective should be to ensure that bankruptcy mechanisms are in place which allow lenders to repossess the collateral which underpins their loans. We need an international bankruptcy "best practices" standard, and we are now in a sufficiently strong negotiating position to bring one about if we act immediately and use the advantages the current crisis affords us. At the same time, it should also be made clear that those who make investments or loans which are not profitable must bear the consequences of their decision. As long as it is perceived that international institutions and the United States taxpayer will bail out imprudent lenders, crises of the kind we are now experiencing are sure to recur.

We have also made a serious mistake in effectively converting loans from various international banks to various Asian companies into loans from American and other taxpayers to the Korean and other governments. A lender should be able to foreclose on a borrower without it becoming an international issue. By effectively nationalizing these economic arrangements, we expend the moral authority and security commitment of the United States in the interests of private parties which may not even be American.

Much has been made of the supposed foreign policy interest of the United States in these matters. While I do not pretend to be a defense expert, I believe that most of this foreign policy concern has to do with the perceived reputation of the United States in the countries involved. Our present policies I believe represent the worst of all worlds. The United States is identified as the effective "puppet master" which dictates IMF policy. America, therefore, gets the blame for the harsh macroeconomic conditions which the IMF demands as conditions for its loans. At the same time, as we all know well, the IMF does not represent American interests, but the interests of its many member states. So, the United States bears a disproportionate share of the foreign policy costs without achieving its share of the foreign policy benefits.

From a foreign policy perspective, a world in which an international bank, even an American owned one, can foreclose on a Korean company in default, must be infinitely preferable to one in which the American government, with or without the IMF, imposes macroeconomic policies borne by the entire Korean nation. By converting the problems of those failing companies into *national* problems, and by converting the cause of the banks into an *American* cause, we are actively weakening our world standing.

We are at a critical juncture where the global economic and security policy interests of the United States happen to coincide with the interests of the great majority of the population of the planet. A free international economic order, in which one doesn't need connections with the government to be able to run a business, is as much in the interests of individual citizens of Asian countries as it is in the interest of American citizens and firms. The sooner we make clear that we are not interested in bailing out crony capitalists and the banks which lend to them, the less likely it is that we will ever face an economic crisis like the present one again.

Prepared Statement of Allan H. Meltzer The Allan H. Meltzer University Professor Of Political Economy, Carnegie Mellon University and Visiting Scholar, American Enterprise Institute

"Asian Problems and the IMF"

Between 1990 and 1996, capital inflows to emerging market countries rose from $60 billion to $194 billion. Mexico's problems in 1995 changed the form of these capital transfers. Equity owners learned from their losses. After 1995, portfolio investment declined, but direct investment increased. Banks were bailed out, so they continued to lend. Bank loans rose with direct investment.

No one carefully monitored these flows. When problems developed in Asia last year, neither the International Monetary Fund (IMF) nor the private lenders knew the magnitude of each country's debt within a large range. Firms borrowed directly and through their subsidiaries. Often the total was not shown on any balance sheet. The provision of the IMF Articles of Agreement requiring surveillance, and the decision to strengthen surveillance following the 1995 Mexican problem, proved to be of little use.

Though important, the IMF's failure to monitor seems small beside the elementary mistakes of private lenders. The lenders ignored three principles of prudent behavior that history has shown repeatedly to be a major reason for financial failure.

First, Asian banks and other Asian borrowers used short-term renewable credits from foreign banks to finance long-term loans. Of course all banks do this to some extent. But the extent matters a great deal. When the foreign loans were not renewed, the Asian banks and corporations faced large defaults.

Second, Asian banks and corporations borrowed in foreign currencies -- yen, marks and dollars -- and loaned in local currency. They accepted the exchange risk without hedging. The reasoning is appalling -- interest rates were lower abroad. None realized the difference m interest rates, after allowing for difference in inflation, included the risk currency depreciation. I suspect that this risk is now apparent.

Foreign lenders shared this myopia. They didn't show concern about making short-term dollar or yen loans to borrowers that financed long-term domestic assets. U.S. and other bankers added a third elementary error.

Many, perhaps most, did not ask to see consolidated balance sheets; they did not monitor the total assets and liabilities of the borrowers.

The banks' behavior is evidence of the pervasive problem of moral hazard. The banks expected to be bailed out again, so they acted imprudently, without regard for elementary banking principles.

What has been the result? Equity investors, debt holders, and owners of claims denominated in foreign currency have taken large losses. By mid-January 1998, stock markets in Indonesia, Malaysia and Thailand had lost about 75% of their value on December 31, 1996.[1] In the Philippines and South Korea the loss was 65%. In the year to mid-January, holders with claims in Indonesian rupiah lost 70% of their value. The Thai baht, South Korean won, and Malaysian ringgit fell 40 to 50% in the same period.

What of the U.S., Japanese and European banks? Their loans are in dollars, yen, and other hard currencies. They want repayment in full. The IMF and the principal governments lend money to the Asian governments so they can pay the interest on their bank loans or repay the principal. It helps the Asian banks to avoid default, but the money goes to the foreign bankers. Instead of taking losses like the holders of currency, stocks an bonds, the banks collect with relatively small losses. And in exchange for extending repayment, the banks collect fees for renegotiating the loans. They demand government guarantees of the loans they made to banks, financial institutions and private corporations.

This policy is the fourth mistake. I believe it is the greatest mistake of all, because it invites a larger financial crisis in the future. The Mexican bailout required $40 billion. This time the IMF and the developed country governments have promised $117 billion to South Korea ($57 billion), Indonesia ($43 billion) and Thailand ($17 billion).

Capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence is the missing element in the Mexican and Asian problems. In its absence, bankers and other lenders have taken excessive risks. They don't concern themselves to learn about how many loans the borrowers have outstanding, how much the borrower has

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[1]Based on "Emerging Market Indicators," *The Economist*, January 17, 1998, p.98.

borrowed short to lend long, how much currency risk has been assumed. The lenders don't care much, because they collect with little or no loss whatever happens.

The IMF's programs drive a large wedge between the social risk -- the risk borne by the troubled country -- and the private risk borne by bankers. This is one source of moral hazard, and one reason we have a crisis-generating system. A common argument in its defense is that Mexico repaid its loans to the U.S. government and the IMF. That argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury - IMF intervention. This is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad. It ignores the effect on the Mexican economy.

Consider the record. The U.S. Treasury and the Federal Reserve have been "helping" Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican governments have learned that if they face a crisis, one or both of these friends will lend them money to make the immediate crisis appear less onerous. Investors have learned that they get bailed out, so they continue to invest. I believe that goes far toward explaining why Mexican policy has been erratic and undisciplined at times. The Bank of Mexico and the government take excessive risk and incur large losses for Mexican taxpayers.

The foreigners don't deserve all of the blame, by far, but they contribute. The results have been disastrous for the Mexican economy and its people. Despite enormous growth in the world economy in the past 20 years, Mexican real income in dollars was the same in 1996 as in 1974. (See Chart 1). The Mexican people have been on a bumpy road, but they have gone nowhere. In the same period, Mexican debt in constant dollars increased from \$40 to \$160 billion. (See Chart 2). Much of this is the price Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would learn to run better policies, would have less debt and, I believe, would have made more progress.

CHART 1

Mexico Per Capita GDP, Converted to Real U.S. Dollar Equivalent on Market Exchange Rate Basis

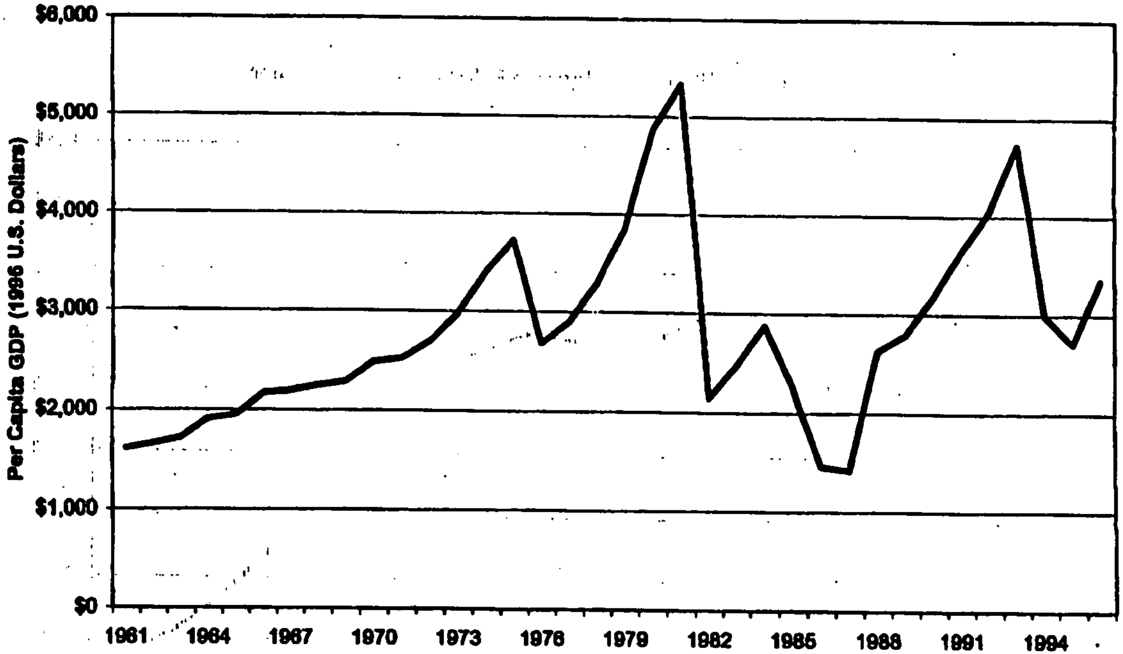
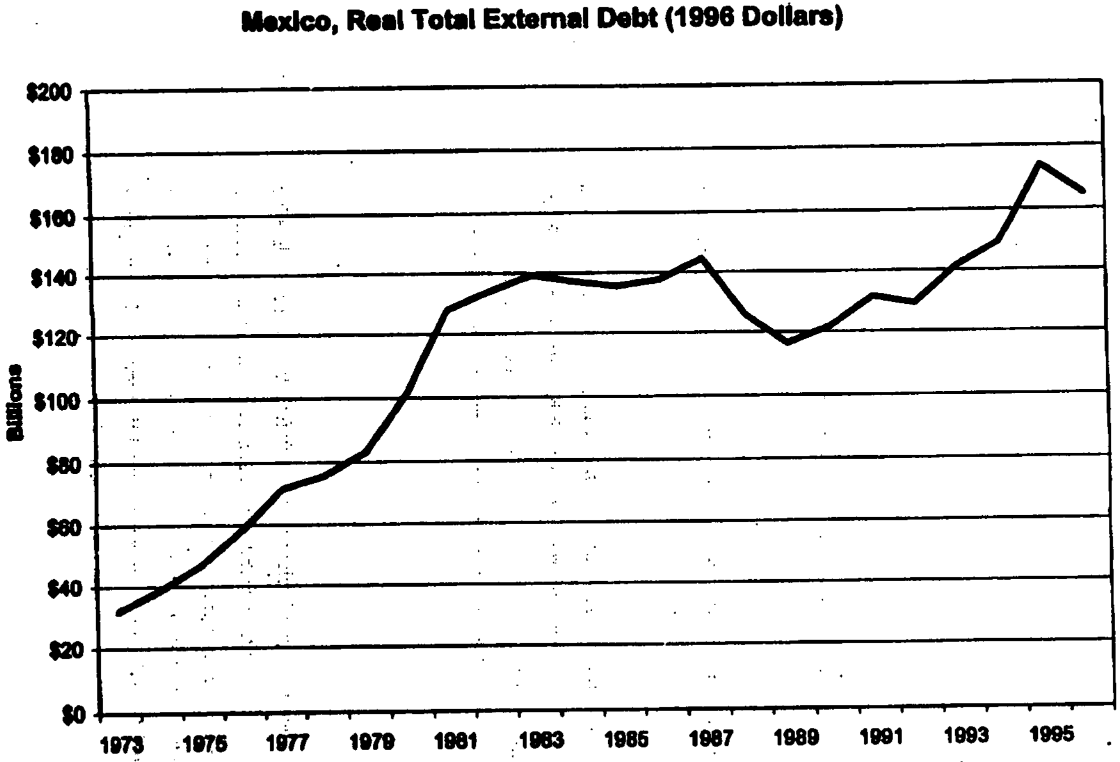


CHART 2



Mexico, Real Total External Debt (1996 Dollars)
$200
$180
$160
$140
$120
$100
$80
$60
$40
$20
$0
Billions
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995

Frequently, the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people to the losses experienced in Latin America in the 1980s, Mexico in 1995, or in Asia now. I believe this is true but irrelevant. The issue does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea and others have face precisely this choice. The government may choose to guarantee the loans by issuing dollar denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea. When the government offers the guarantee, it believes the default risk is manageable or bearable, just as the U.S. government believed that the risk in the saving and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility. The probability may be small at the time the crucial decision is taken. A finance minister faced with this choice will almost always prefer to avoid the crisis now, at the risk of a future larger crisis, than to accept the crisis now when many critics are ready to claim that the crisis is avoidable. And sometimes they are right.

The opportunity to take a (possibly small) risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister having to make the choice I described.

IMF and U.S. Treasury lending to Asian countries continues this dangerous system. The risk of a bigger, future crises increases. Too much of the world has become "too big and too indebted to fail." Neither the IMF, nor the development banks, nor the U.S. and Japanese governments can pay for all the errors, mistakes, and imprudent actions they help to create.

"Too big to fail" was a flawed idea when applied to U.S. savings and loans and to Swedish, Japanese, Latin American and other banks. It is no less flawed when applied to U.S., Japanese and European banks and financial institutions that have lent in Asia.

Secretary Rubin was right when he said in September: "What we don't want to have is a situation where people can do unwise things and not pay a price." But that is the system that Secretary Rubin and the IMF have created and sustained.

Many arguments are used to justify these policies. Some are misleading. Some are based on misunderstanding. Some are simply wrong.

One common argument, repeated many times, is that South Korea is a large country, the world's eleventh largest economy. It sounds impressive and, indeed, growth of the Korean economy since 1953 is a remarkable achievement. But the inference is that a financial collapse in South Korea would be a world-shaking event. In fact, Korea has a GDP about equal to the GDP of Los Angeles County. It may be the eleventh largest economy, but it is less than 5% of the U.S. economy

One of the most serious misunderstandings concerns the role of a lender of last resort. Historically the function of a lender of last resort is to prevent unnecessary financial failures during periods of panic. It functioned at its best in Great Britain after 1866, at its worst in the U.S. during the great depression.

The role of a lender of last resort is not to bail out failed banks. Its job is to assure that solvent financial institutions do not fail because of lack of liquidity. The Asian central banks have the power to stem a domestic, liquidity crisis. The remaining problem is the need for foreign exchange to repay foreign currency loans.

The IMF offers two services. It lends foreign currency on condition of reform, called conditional lending, and it acts as a consultant to troubled countries. Unlike most consultants, it pays the borrower to take its advice by offering favorable terms for its loans. With interest rates in Korea above 20%, the IMF lends at less than 5%.

Asian problems do not require large international loans from the IMF and the developed countries These loans are more likely to delay than to promote reform. The IMF may threaten to withhold payments, but its history shows that the threat is empty. The IMF has a stake in "successful recovery." Client governments understand that. They know that the IMF does not want a failure. They call its bluff, delay reforms, but they get the loan payments. Despite many attempts and much research, the IMF has not been able to demonstrate that countries meet the conditions they promise to fulfill. Some do; some don't, but some would have done more to reform without the loans.

Many critics of the IMF oppose the policies of fiscal stringency and control of inflation. I do not share these criticisms in all cases. In countries with inflationary policies, control of spending is essential.

That is not the problem in Asia. The present predicament was not caused by imprudent spending policies, excessive demand and I-high inflation. Much of the problem arose because one of the principal markets for Asian products, Japan, has grown slowly an because China increased its share of the Japanese market after devaluing in 1994. I applaud the IMF for urging structural reforms to increase competition and reduce local cartels supported by government. However, I believe such reforms would come faster in this crisis without conditional loans.

The IMF errs when it urges Asian countries to reduce demand. What is needed is expanded demand, produced not by inflationary policies in each of the countries, but by increased demand from Japan.

The key to the Asian problem is to end mistaken Japanese policies and reform the Japanese economy. Japan's problems are internal. It should restructure its financial system and end its deflation by increasing money growth. It has the power to do this without international loans. An expansive policy would benefit both Japan and Asia.

If Japan expands; Asian exports to Japan would expand demand in the troubled Asian countries. The principal beneficiaries will be those countries that restructure by breaking up government protected and subsidized industries. As these countries expand, others would benefit, and economic growth would be restored in Asia.

Since 1971, the IMF has been looking for new things to do. It has now solved its problem by creating moral hazard, allowing international banks to avoid the risks they undertake by imprudent lending. The IMF encourages the behavior that creates the problems. It engages in subterfuge by refusing to call the Indonesian cessation of payments a moratorium. To prevent an even larger future financial crisis, we must end this system and create very different arrangements in its place.

If loans denominated in foreign currencies are withdrawn suddenly, solvent borrowers with excellent long-term prospects, are unable to repay their short-term loans on demand. Neither they nor their local banks may be able to obtain sufficient foreign exchange to prevent default.

One solution is to have a true lender of last resort. Unlike the IMF, a true lender of last resort does not subsidize borrowers. It charges a penalty rate -- a rate above the market rate -- and requires good collateral. It offers to lend at a penalty rate to anyone offering proper collateral.

These requirements are not arbitrary. They are essential. The penalty rate means that the lender of last resort will usually do no business. Borrowers will only come when they cannot get accommodation in the market place at market rates. Similarly, the requirement to offer good collateral induces banks and financial institutions to hold such assets. This reduces risk, and encourages safety and solvency. Unlike the IMF, a true lender of last resort does not create moral hazard.

Would such a system work? The system is field-tested. It is the system used in Great Britain after 1866, when London was the center of the world financial system. It worked well through good times and bad.

The second proposal eliminates the maid source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending in local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall lending risk. This reform is not an idealized, textbook solution. Citicorp, in particular, has tried to follow this strategy. Regulations to protect domestic banks in many countries from competition prevents Citicorp and other foreign banks from following this sensible strategy of relating risk to return within a diversified loan portfolio. The financial services agreement, accepted by members of the World Trade Organization last year, is an import move in this direction. In the proposed system, global banks would internalize the risk, or hedge the risk if they choose to do so.

Let me close with an example. The U.S. financial system has experienced many crises and failures. For most of our history, banks were local, often restricted by law to serving a local market. When the corn, wheat or cotton crop failed, the bank often failed because its loans were not diversified. Eventually, after many bad experiences, the U.S. has moved toward a regional and perhaps countrywide, banking system. Loan portfolios are more diversified than in the past. In addition brokers group loans from a diverse group of borrowers and offer securities based on the loan portfolio. This permits banks to hold a diversified portfolio of mortgage, automobile, credit card or other loans that were not previously available to them. Banks are safer because their loans are, at last, more diversified.

In the recent past, when semi-conductor prices fell or, earlier, when its chemical industry posted large losses, Korean banks experienced large losses, much as local banks in Iowa, Minnesota, Texas, or Oklahoma, suffered from a decline in agricultural prices in the 1920s and 1930s, or as Texas banks suffered from a decline in oil prices in the 1980s, or as Swedish and Swiss banks suffered from a decline in local property prices.

The U.S. has now strengthened its financial system by letting banks branch regionally. European banks are beginning to merge transnationally and to operate branches in other countries. The next step is to strengthen the global system. IMF bailouts, and government enforced restrictions on competition, impede this solution.

Financial crises in Latin America in the 1980s, Mexico in 1994-95, and now in Asia should alert governments to the need for fundamental reform. More money for the IMF delays reform of the international system, encourages moral hazard, and subsidizes risk. Fundamental reform begins with global banking and a true lender of last resort.

THE INTERNATIONAL MONETARY FUND
AND
THE NATIONAL INTERESTS OF THE UNITED STATES

Statement by

C. Fred Bergsten*
Director
Institute for International Economics

Before the Joint Economic Committee
United States Congress

February 24, 1998

The national interests of the United States are strongly supported by the International Monetary Fund, as we saw in the Mexican crisis in 1995 and are seeing again in the current Asian crisis. The IMF is in fact one of the best possible deals we could ever imagine: its programs cost us nothing yet it provides enormous benefits for our economy and our foreign policy. Hence I strongly support prompt Congressional approval of both the proposed $3.5 contribution to the New Arrangements to Borrow and $14.5 billion for our share of the internationally agreed increase in Fund quotes.

The Cost of the IMF

It is essential at the outset to clarify the cost side of the equation. Our contributions to the IMF have zero—repeat, zero—cost to the American taxpayer and economy. Every dollar we contribute produces an equal amount of US claims to draw

* Dr. Bergsten was formerly Assistant Secretary of the Treasury for International Affairs (1977-81), Assistant for International Economic Affairs to the National Security Council (1969-71), Chairman of APEC's Eminent Persons Group throughout its existence (1993-95) and Chairman of the Competitiveness Policy Council throughout its existence (1992-97).

yen, DM or other currencies from the Fund ourselves. Hence these contributions amount to an "exchange of assets," with no budget cost or requirement for appropriated funds (an arrangement which, incidentally, I worked out with the Congress in conformity with the new Budget Act of 1974 when serving as Assistant Secretary of the Treasury for International Affairs in 1977-81.

The ability of the United States to draw on the Fund itself is not a theoretical proposition. The United States has borrowed foreign currencies from the IMF on 28 different occasions, more than any other country. We drew about $3 billion of DM and yen in 1978 to help defend the dollar in the exchange markets. The IMF has always been a two-way street for the United States and the Administration's analogy with a credit union is apt.

In addition, the IMF enables the United States to effectively leverage its funding to induce other countries to support internationally agreed programs. Our share in the Fund is less than 20 percent so every $1 we contribute is matched by more than $4 from others. The IMF is thus an extremely useful tool to achieve our perennial goal of sharing the burden of international efforts with countries around the world.

Hence it would be impossible to oppose the proposed IMF contributions on budgetary or cost grounds. The meaningful debate is over whether the Fund effectively promotes US economic and foreign policy interests.

Does the IMF Need More Money?

A second point to clarify at the outset is that the IMF clearly needs more money. The Fund now has about $45 billion in "uncommitted loanable resources." However, $30-35 billion of that total is unconditionally available to member countries and thus could be withdrawn on demand. Only $10-15 billion is clearly available for additional country programs.

In addition, the Fund can borrow about $23 billion from the existing General Arrangements to Borrow (GAB). This credit line has been available to support IMF programs since the early 1960s. Its activation, however, requires unanimous agreement of the GAB member countries and, given differences of views within the group about individual country programs, might not be readily usable.

Hence the Fund has assured access to only about $10-15 billion of additional resources. It is quite possible that another major country, such as Brazil or Argentina or Turkey, could run into a payments crisis at literally any time—especially if the Asian crisis were to erupt again into an additional round of sharp currency declines, which is quite possible. It would then be impossible for the Fund to become involved and the risks of contagion to the rest of the world, and costs to the world economy including the United States, could be multiplied many times.

It is thus clear that the Fund needs additional resources—the quota increases as well as the NAB. Hence we again come solely to the central question: does the Fund effectively promote US economic and foreign policy interests?

<u>US Interests in the World Economy</u>

The United States has two central interests in the world economy. The first is the maintenance of maximum rates of economic growth and employment that are consistent with reasonable price stability. The second is the most widespread possible application of market-oriented policies rather than governmental controls and directives. These goals, incidentally, demonstrably serve our broader national security and foreign policy interests as well as our economic interests.

The IMF plays a crucial role in supporting both fundamental US objectives. When a member country asks the IMF for help to respond to a crisis, the Fund produces two things: financial assistance and policy requirements. Both are central to inducing and enabling the country to (1) adjust gradually to its crisis rather than precipitously and (2) adopt constructive, market-oriented policy measures rather than draconian *dirigiste* controls.

A country, whether Mexico in 1994-95 or Korea in 1997-98 (or, for that matter, the United Kingdom and Italy in 1992), experiences a financial crisis because it can no longer pay its foreign bills and/or faces a sharp fall in its exchange rate. It must enact new policies to put its house in order. But there are also two crucial choices:

1. Must it enact measures, however draconian, that take effect immediately or can it phase in the adjustment over a period of time?
2. Closely related, must it clamp on trade and capital controls or can it alter the market environment in a way that will produce adjustment of a much more economically sound, and thus sustainable, nature?

The IMF plays a critical role in the answers to both questions. An IMF program brings external financing that tides the crisis country over an intermediate period that permits gradual rather than abrupt phasein of the adjustment measures. The conditions attached to that program require the country to employ sound, market-oriented measures rather than "quick fix" controls. In essence, the IMF is an international lender of last resort in the same way that the Federal Reserve is a lender of last resort in our domestic financial crises.

The United States has a huge interest in these IMF contributions. It is far better for us that a crisis country adjusts gradually and constantly—via sound budget and monetary policies, trade and investment liberalization, and needed structural reforms as are required now in Asian financial and corporate governance systems—rather than by instituting import controls, even sharper depreciations of currencies, and even deeper economic turndowns. Our economic and foreign policy interests would be imperiled if major countries, such as Mexico and Korea, were forced to go the latter route because there was no IMF to point them in constructive directions.

One might of course suggest that the United States itself, or somebody else, could provided the needed external funding and policy advice instead of the IMF. We would hardly want to pick up the entire financial costs of significant support programs, however. Moreover, it is likely that any unilateral US attempt to impose adjustment conditions would either fail and/or worsen rather than improve our relations with the crisis country. A multilateral institution, of which the crisis country itself is a member, is the optimal—indeed, probably the only effective—means for carrying out such programs at this point in history. It is literally true that we would have to create the IMF it did not exist.

Some observers who share my assessment of US goals nevertheless oppose the IMF because they believe that, contrary to my arguments, it does not promote those goals effectively. Some even believe that the IMF has counterproductive efforts. We must therefore turn to those critiques.

Criticisms of the IMF

First, some believe the world would be better off without the IMF or any similar institution. They would let the market take care of all crises on its own.

As noted, the IMF promotes market-oriented solutions and the United States strongly supports that approach. The problem, however, is that markets occasionally go haywire and far overshoot the rational bounds of underlying economic conditions. The results can be catastrophic for both the countries involved and the world economy as a whole.

For example, huge amounts of private capital continued to pour into Mexico and the Asian countries until literally the eve of their crises—despite impending signs of trouble and frequent warnings from many quarters. Then the private capital flow totally reversed and drove the countries' currencies down much further than can be justified by any objective analysis. This "roller coaster effect" of the private capital markets was already seen in the runup to, and aftermath of, the Third World debt crisis of the 1970s. It demonstrates why we cannot rely wholly and solely on market forces.

The United States knows about these problems from direct experience. As recently as early 1995, the foreign exchange markets drove the dollar to its all-time lows against the yen and most European currencies despite the stellar performance of our economy and relative stagnation in Japan and Europe. Our own Treasury, despite its strong preference for market solutions, felt compelled to intervene to drive the dollar back up. Since that time, the dollar has risen by 60 percent against the yen and 40 percent against the DM—demonstrating again the "roller coaster" or "bandwagon" effect, and revealing clearly that the dollar had fallen much too far only three years ago.

It would be enormously risky to rely solely on market forces to resolve currency and other financial crises. As noted above, crisis countries would then be wholly on their own and would inevitably have to accept much sharper recessions, much sharper declines in their currencies, and/or draconian trade and capital controls. Such alternative adjustment paths would hardly support US economic or broader interests. The archtypical example was of course the competitive depreciations and trade warfare of the 1930s that helped bring on the Great Depression—and that induced the world to create the IMF after World War II in an effort to avoid ever repeating such a disaster.

A second criticism is that the IMF "doesn't work. Proponents of this view note the continued shakiness of Asian currencies and stock markets, and conclude that the IMF program has failed.

No institution is perfect. Crisis management and recovery are extremely difficult. We should not expect a miraculous recovery in every IMF program country.

But patience is required. It took about six months for the markets to stabilize in Mexico in 1995, which is a dramatic success story whose economy has grown by an average of 7 percent in 1996-97 after suffering only one year of adjustment. Stabilization in Asia will almost certainly take longer because of the regional spread of the crisis and the structural nature of the needed reforms.

Moreover, one can only expect success if countries faithfully implement the IMF programs. Both Thailand and Korea had to navigate political successions before they were able to start applying the needed remedies. Indonesia has not yet begun to do so. Once can hardly charge the IMF with failure until its prescriptions have been in place long enough to be fairly tested.

A third and more nuanced criticism is that IMF remedies are "too extreme" and/or "not tailored to the differing situations in different countries." These complaints are voiced particularly in the current Asian context, where the problems are mainly structural and financial rather than presenting the traditional problems of excessive budget deficits and monetary expansions.

The unique nature of the Asian problem has indeed meant that the IMF has had to "learn while doing." As it moved from Thailand to Indonesia to Korea and now back to Indonesia, and as time has passed, it has been modifying its programs and especially their priorities. Some of the earlier fiscal targets turned out to be too tight, in light of subsequent circumstances, and have been modified with little or no harm done. The overwhelming emphasis of the programs is now on financial restructuring and corporate governance, which is correct.

The most difficult dilemma resides with monetary policy. On the one hand, moderate interest rates are highly desirable to facilitate financial restructuring and to avoid unnecessary economic slowdown. On the other hand, high interest rates help defend the currency and avoid even further depreciations. The IMF strategy is to insist on sufficiently tight money to achieve the latter goal but to approve relaxation as soon as circumstances permit, as they are starting to do in Korea. Judgment calls have to be made on the spot but the basic strategy appears sound.

The most understandable criticism is that the IMF creates "moral hazard" by assuring private investors that they will be bailed out and hence encourages the destructive "roller coaster" efforts described above. Policymakers, including at the IMF, do indeed face an acute dilemma when confronting a country in crisis. Their immediate imperative is to stop capital outflow and restore capital inflows, to finance the (usually sizable) external deficit until it can be corrected, and then to permit gradual and constructive adjustment. This counsels avoidance of hits to existing investors that could scare them off and undermine the whole strategy. At the same time, however, this approach may create the "moral hazard."

The answer to this legitimate concern is to make sure that all IMF program require the relevant private investors to contribute equitably to the costs of the support operation. Equity investors already do so; foreign holders of Asian securities have taken enormous losses and some have been wiped out. Foreign lenders to Thailand did so as well; they were required to convert their short-term claims at market interest rates into longer term claims at 2 percent. Korea's foreign creditors had to stretch out their maturities considerably and accept modest interest rates. Indonesia's foreign creditors will understandably receive the same (or worse) treatment. Major US banks have in fact recently reported substantial losses from their Asian lending.

Nevertheless, the IMF needs to build this element systematically into all its support programs. The model should be the Brady bonds that characterized the second, and final, stage of the Third World debt workout of the 1970s. Under that approach, existing creditors were required to take equiproportional losses, as determined by the IMF and the creditor countries, for each debtor nation. The lender had several choices for how to absorb the loss: par bonds at low interest rates, discounted bonds with market rates, new lending, etc. But each had to accept its fair share of the overall workout. Such a model, suitably modified to reflect the more complex array of lending entities that are now involved, needs to be included in all future IMF programs.

Conclusion

I thus conclude that the various criticisms of the IMF are either unfounded or can be answered through readily available changes in Fund policy and programs. The Congress should certainly urge the Administration to pursue such changes.

It would be a grave mistake, however, for the Congress to withhold its approval for the two new funding requests or to condition that approval on the implementation of changes in Fund policies. The Fund's need for additional resources, to position it to implement programs that are vitally in the interests of the United States, is far too great to permit any such delays.

The United States has an enormous interest in an effective and fully funded IMF. The Asian crisis reinforces and underlines that interest. I urge the Committee, and the Congress, to approve the Administration's proposals fully and promptly.

A final criticism relates to the transparency of IMF operations. The IMF insists that its borrowers increase the transparency and accountability of their policies and processes. Hence it is eminently logical to ask whether the IMF is sufficiently transparent itself.

The IMF is in fact more transparent than most observers realize. Almost every IMF program is available in full detail, including on the internet. But the process of disclosure is random and unstructured, and much more order could be brought to it. The United States has in fact been pushing for more IMF openness for at least twenty years.

The greatest need, in my view, is publication of the analyses of country outlooks by the IMF staff. The data portions of the Fund's country consultations are already published. But the markets need to know when country problems are foreseen, both to limit or avert the continued influx of unsound loans and to help induce the country to take preventative policy steps.

It must be recognized, however, that the Fund faces a genuine dilemma in this area as well. Full public disclosure of Fund materials would deter some countries from providing full data to the institution. Sovereign nations, including our own and certainly many industrial as well as developing countries, will always want to preserve a degree of confidentiality for some of their most sensitive financial and economic data. The Fund would thus probably lose access to some of its most important inputs if it mandated full disclosure. I would still support increased disclosure, as noted above, but a judicious balance must be struck in answering this question.

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