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REFORM OF THE IMF AND WORLD BANK

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before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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CONTENTS

OPENING STATEMENTS OF MEMBERS

WITNESSES

SUBMISSIONS FOR THE RECORD

REFORM OF THE IMF AND WORLD BANK

Wednesday, April 12, 2000

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

The Committee met, pursuant to notice, at 9:30 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Vice Chairman of the Committee, presiding.

Present: Representatives Saxton, Sanford, Doolittle, Ryan, Stark, Maloney, Minge and Watt.

Staff Present: Christopher Frenze, Robert Keleher, Darryl Evans, Stephen Thompson, Colleen J. Healy, Howard Rosen, Daphne Clones, and Leah Liston.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. Good morning. It is a pleasure to welcome Dr. Meltzer and Dr. Lerrick, Dr. Calomiris, Mr. Levinson to the Committee this morning. As most everybody here knows, Dr. Meltzer serves as Chairman of the International Financial Institutions Advisory Commission (IFIAC), and the other members of the panel are also associated with the Commission. I would like to compliment you for taking the time and effort to grapple with some of the most complex and challenging issues in economic policy and producing such an excellent report.

Today we plan to focus on the substantive economic and financial issues related to the International Monetary Fund (IMF) and the World Bank and how they relate to proposals for reform. As one who has been involved in issues related to reform of the IMF for several years, I am encouraged by the emerging consensus that has developed on some basic principles relating to these important issues. The principles that now enjoy broad support include: first, the IMF should provide more transparency; second, the IMF should focus on short-term crisis lending; third, the IMF should scale back development lending; and fourth, the IMF should end interest rate subsidies.

There is significant agreement on a range of other issues as well. The main question remaining is how to consistently apply these concepts to IMF reform. Tactical differences in the applications of these principles should not be permitted to distract attention from how much consensus has been achieved on basic principles for IMF reform. For example, recently Secretary Summers has called on the IMF to focus on crisis lending while deemphasizing development lending and raise at least some IMF interest rates. This is very encouraging to those of us in Congress who have supported these objectives for quite some time and thus welcomed Summers' support of IMF reform. As news reports noted at the time, Mr. Summers seemed to borrow heavily from congressional critics of the IMF and from the expected recommendations of the Meltzer Commission.

Our perspective here at the Joint Economic Committee (JEC) has focused on transparency and the finances of the IMF. These two issues are closely related and have important implications for Congress. As a former IMF research director recently said, "the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and indeed, few inside the Fund, understand how the organization works."

However, the IMF is a publicly financed institution in which the U.S. has a prominent financial and policy-making role. Congress has an important responsibility to monitor how effectively taxpayer funds are being used and ensure that adequate safeguards are in place. Obviously, this lack of IMF transparency undermines Congress's ability to carry out this oversight responsibility. We have finally managed to decipher and decode the IMF's accounts, but IMF finances really are not understandable and do not comply with the transparency standards the IMF imposes on others.

Our Committee findings show that the base of the IMF financial support is much narrower, for example, than officially portrayed, with the U.S. contributing 26 percent of the IMF's usable resources and the G-10 countries contributing a full 77 percent of the IMF's usable resources. Over half the IMF membership contributes virtually no usable funds at all. Furthermore, in one recent period, 70 percent of the IMF credit was owed by just five borrowers. Russia and Indonesia together accounted for one-third of the outstanding credit. IMF interest rates are currently about 4.7 percent, far below the market rates available to IMF borrowers and below the rates available to the most creditworthy nations, such as the U.S.

Two years ago the Joint Economic Committee also found there were no effective safeguards or accounting controls in place to monitor IMF loan disbursements. Billions of dollars would be disbursed by the IMF with no effective accounting controls in place to enable the IMF to verify information and ensure that funds were properly used. Given the rather low public integrity standards in place among many IMF borrowers, this cavalier approach fails to take into account the fiduciary responsibility of the Fund to member countries and their taxpayers. After repeated public embarrassments, and my introduction of legislation mandating IMF accounting controls, it is good to see that the IMF is finally taking long overdue steps to address some of these issues.

Although most of our research at the Committee has focused on the IMF, reform of the World Bank is also needed. The overlap of IMF and World Bank development activities is acknowledged by each agency, but is apparently not viewed as a problem. Not only is the IMF involved in many development activities, but the World Bank has participated in bailouts during economic crises.

A clear distinction between the different missions of the IMF and World Bank is urgently needed, and this problem is also addressed by the Meltzer Commission.

The congressional agenda for reform of the IMF and the World Bank is an ambitious and compelling one. However, in the case of the IMF, the Congress has provided over one-quarter of the usable resources, more than the three next largest contributors all combined. Over time a continual assertion of congressional pressure can make a tremendous difference, and this is the intent of the *IMF Reform Act of 2000,* which I recently introduced. Congress is in debt to Chairman Meltzer and the Commission for providing an excellent blueprint for reform of the IMF and World Bank.

Before we go to the Commission, Dr. Meltzer and others, are there other Members who may have opening statements?

Mr. Minge.

[The prepared statement of Representative Saxton, together with the *IMF Reform Act of 2000* (H.R. 3750) appear in the Submissions for the Record on page 48.]

Representative Minge. Thank you. I would just like to make sure that we have submitted for the record an opening statement from Congressman Stark.

Representative Saxton. Without objection.

[The prepared statement of Representative Stark appears in the Submissions for the Record on page 58.]

Representative Minge. I would also like to just briefly note that I have been corresponding with the Chair of the Joint Economic Committee concerning the importance of holding a hearing on the balance of trade issue and the trade deficit that we have in the United States and the problems of a strong dollar, and I hope that this Committee will be able to move ahead to do that. I think these are two very important considerations for the American economy. In the short term, they may not appear to be as significant, but in the long term I think that if we don't address them, we are going to reap the consequences. So I hope we can do that, and with that I close my statement.

Representative Saxton. Thank you, Mr. Minge. Mr. Doolittle.

OPENING STATEMENT OF REPRESENTATIVE JOHN T. DOOLITTLE

Representative Doolittle. Thank you, Mr. Chairman. I look forward to hearing the proposals to reform the IMF and the World Bank, and I thank you, Mr. Chairman, for performing a valuable service by focusing attention on this issue. Restructuring and cutting back the powers of the International Monetary Fund, I think, is clearly necessary considering its role in the recent financial crises across the world.

The record of the IMF as banker to governments in financial distress has not inspired confidence. The IMF egregiously violates sound banking practices, calling into question its condemnation of the poor financial systems of loan recipients. Most recently the decision to lend to Russia, a country that has defaulted on its debt and shows little dedication to economic reform, demonstrates that the IMF is a poor role model for sound banking. Although the circumstances leading to financial crisis in Latin America, Asia, and Russia differ in many respects, a common thread was a lack of adequate banking supervision, transparency, and oversight.

Many countries use the banking system as an instrument of development strategy. The government chooses industries and ventures it believes will contribute to development. It then directs credit to these winners, often by encouraging commercial lenders to favor those industries. This policy undermines the growth of the sound banking system by preventing banks from assessing loan applications on the basis of such criteria as likelihood of repayment and available collateral. These highly regulated banking systems provide the perfect means for corrupt officials to funnel funds to politically-connected industries and individuals. Overall financial instability increases because loan assessments based on economic and business criteria including financial viability are suppressed in favor of loans made for political priorities. Such a system produces more bad loans and losses than a banking system based on sound credit practices.

In exchange for billions in credit to governments around the world, the IMF requires countries to implement specific policy changes to address the cause of the financial instability. Broad financial service reform, especially of commercial banking, has become a favorite IMF policy prescription. Typically this includes writing off bad loans, closing bankrupt institutions, and improving oversight of banking practices.

Would that the IMF followed its own advice. Instead of restricting or denying credit to countries with a record of resisting economic reform, the IMF eagerly enters into loan after loan. The most recent glaring example of this practice is Russia. Despite over $27 billion in IMF credit since 1992, the Russian Government has been unwilling or unable to reform the economy. It has defaulted on much of its debt. It has even admitted that as much as $50 billion in central bank reserves, including IMF loan proceeds, was siphoned off for questionable purposes with the cooperation of Russian officials.

Russia is the most recent example of decades of poor banking practices on the part of the IMF. Another is Peru, which entered into 17 different arrangements with the IMF between 1971 and 1977 despite repeated failure to meet many of the reform conditions that accompanied the loans. In effect, these IMF loans financed destructive economic policies that made Peru less able to repay its debt. A third example is a $3.4 billion IMF loan to Mexico, only one year after that country had initiated the 1982 Latin American debt crisis by defaulting on its debt.

Despite the IMF's vocal support for sound banking principles, its actions tell a different story. The IMF exports poor banking practice by example. It damages the international financial system when it continues to lend to countries like Russia, a financial black hole. In an October 1998 statement, the IMF noted that, quote, markets do not operate well when transparency and accountability are lacking and market participants do not operate under an internationally accepted set of principles or standards, end of quote. The world economy will continue to suffer so long as IMF actions fail to match IMF rhetoric.

[The prepared statement of Representative Doolittle appears in the Submissions for the Record on page 61.]

Representative Saxton. I thank the gentleman. We will proceed with our witnesses at this point. We appreciate your being here and want to express our gratitude for the great job you did, Dr. Meltzer, as Chairman and member of the Commission.

We want to give you plenty of time to express your thoughts on these important issues.

So, Dr. Meltzer, if you would like to begin, and thank you again for being here.

STATEMENT OF ALLAN H. MELTZER, CHAIRMAN, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Dr. Meltzer. Thank you, Mr. Chairman. Thank you for your opening statement. It is fair to say that the Commission followed the lead that you established for us, you and your staff, which was very helpful to us, as I say in my statement.

It is a great pleasure to appear here today to discuss the International Monetary Fund and the international financial institutions. The Joint Economic Committee's leadership and its staff have done valuable and important work to increase understanding of the IMF's working. At the very start of the Commission's work, we turned to the JEC staff for the help that they willingly gave. We are grateful to you, Mr. Vice Chairman, to the Chairman, the Members of the Committee and its staff.

Today I will focus mainly on the IMF and the bipartisan, Majority proposals for reform and change. Two of my colleagues, Dr. Calomiris, who was a member of the Commission, and Dr. Lerrick, who worked as a senior advisor to the Chairman, will talk about other aspects so that we will try to cover a full range of issues.

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

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

I can illustrate some broad agreements by referring to some of Treasury Secretary Summers' recent statements, namely his speech to the

Council on Foreign Relations, his testimony to the House Banking Committee, and his recent column in the *Financial Times*.

Secretary Summers' statements of core principles for reform calls for, one, clear delineation of responsibilities between the IMF and the multilateral development banks; two, a refocused IMF that concentrates on short-term liquidity lending; three, the establishment of preconditions to strengthen incentives that forestall crises; and, four, dissemination of information to markets. These statements are entirely in accordance with the Majority Report.

Secretary Summers would assign the development banks responsibility for, one, targeting financial resources to the poorest countries without access to private sector financing; and, two, increasing production of global public goods. He asks for reforms that will provide substantial improvement in the effectiveness of development aid and debt relief for the heavily indebted countries that implement effective economic development strategies. Again, he agrees with the Majority Report.

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

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

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

The preconditions the Majority chose are not arbitrary. One is an extension of the type of standards for bank capital that developed countries have now adopted based on the Basel agreement. Another is based on the WTO's (World Trade Organization) protocol 5 that permits foreign banks to complete in the country's markets. More than 50 countries have accepted this protocol. The remaining conditions require reasonable fiscal policy and the timely release of information on the maturity distribution of sovereign debt. These seem not only unobjectionable, but necessary for stability. Experience in Latin America has shown how much economic and financial stability improved locally and globally when banks had adequate capital and foreign banks were permitted to compete in Argentina and Brazil.

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

Some critics of the Majority Report, including the one of today's witnesses, claim that the Majority wanted to weaken or destroy the IMF, but instead settled for reducing its role. This is not only incorrect, it totally misses the point of the Majority Report.

The world has lived through a series of deep crises in the last 20 years. The Majority and many others believe there are three major reasons for the depth and frequency of these crises: first, the collapse of pegged exchange rates; second, the collapse of weak financial systems; and third, the long delay between the time a crisis erupts and the time the IMF or others are ready to help. The delay is caused by the long negotiation over the conditions that the crisis country must accept before help becomes available. Of course, it does not always meet those conditions. In fact, it rarely meets those conditions.

The Majority resolved the three problems by replacing *ex post* conditionality with preconditions that strengthen financial systems and avoid lengthy negotiation. The Majority also favored an end to pegged exchange rates, a view that Secretary Summers shares, as I said, a moment ago.

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

Criticisms of the Majority proposal for the development banks stress the number of poor people in middle-income countries. The number of poor people is an attractive criterion only at first glance. I am confident that on further reflection, reasonable people, including Secretary Summers, will agree with the Commission Majority that a better criterion is the number of people who lack adequate access to resources. China has many poor people. The Majority wants the development banks to continue to give technical assistance and support to China. But China holds more than $150 billion in foreign exchange reserves and receives private capital inflows that greatly exceed any amounts it receives or is ever likely to receive from the development banks. No less important, a reallocation of development bank lending from China to effective programs in the poorest countries would permit these agencies to increase aid to the poorest countries without – those countries without alternative resources. Dr. Lerrick will talk to that more fully in a few moments.

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

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

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

This administration, even more than previous administrations, has used the international financial institutions as sources of readily available funds to support its foreign policy. If it could not make heavily subsidized long-term loans through these institutions to Russia, China, Mexico, Brazil, and other countries whose policies the U.S. wishes to influence, the administration would have to change policy or ask Congress to appropriate the funds. Congress could perform better oversight, would question whether programs are successful and whether they benefit the American people.

This issue is sometimes described as a foreign policy issue. The Commission Majority is accused of interfering with the conduct of foreign policy. This accusation is usually made *sotto voce*. I do not agree with that characterization. The core issue is the constitutional responsibility of Congress to appropriate funds. Administrations for years circumvented the budget process to support Mobutu, Suharto, Marcos, and others. The Majority believes firmly that final decisions about spending should remain with the Congress, not the administration acting through the international financial institutions. This reform is most basic because it deals with legislative responsibilities and constitutional prerogatives that, once sacrificed, are difficult to recover. Thank you, Mr. Chairman.

[The prepared statement of Dr. Meltzer together with the IFIAC Report appear in the Submissions for the Record on page 64.]

Representative Saxton. Dr. Meltzer, thank you very much.

Dr. Lerrick.

STATEMENT OF ADAM LERRICK, SENIOR ADVISOR, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Dr. Lerrick. Good morning, Mr. Chairman. It is a privilege to address the Joint Economic Committee. I have worked with the staff for a number of years, particularly on IMF issues. I am pleased to note that the staff is going to address what is considered at the IMF the final frontier, which is the SDR (special drawing rights) department, which few inside the Fund understand, as well as outside the Fund. But the subject of my remarks this morning is going to be the financing of development grants.

One of the most controversial of the Meltzer Commission's proposals is the change in the format of development aid, the replacement of traditional subsidized loans by grants for infrastructure and social service projects. This is a core issue in the discussion of the effectiveness of aid. Although the concept of grants is familiar, the new model proposed by the Commission is a hybrid variety.

Grants are a gift, but a gift with strings attached. They make possible the funding of a program in full, but are paid only after audited proof of concrete results. They reinforce discipline by demanding a current copayment by the recipient, and they leverage every dollar of scarce aid resources by drawing upon the capacity and skills of the private sector. Even a decade ago, the capital markets did not imagine what they offer routinely today, sheer size, sophistication in instruments and the willingness to tolerate the risk which once deterred projects in the developing world.

Loud and determined voices have risen in protest of the grant concept, all with one recurring theme: Grants will mean less money for the world's poorest.

Secretary Summers wrote in the *Financial Times*, "This would dramatically reduce the total amount of resources that can be brought to bear in these developing economies and require an unworkable system for delivering such assistance." World Bank President Wolfensohn in a letter to Commission Chairman Meltzer deemed grants "unrealistic" and went on to write, "In a time of severely constrained foreign aid budgets, it is highly doubtful that donors would be able to provide and sustain the needed level of funding."

Clearly the analysts at the Treasury and the World Bank have misunderstood the economics of grant financing and have ignored the potential of the private sector. A $100 million World Bank loan does not require $100 million in grants to achieve the same result. Every dollar of annual grants replaces $17 of loans for the nations that need it most. The effective use of the $133 billion in equity resources already at the World Bank will generate an annual grant stream of $10.4 billion and support $185 billion in aid programs or 78 percent more than is currently provided to the poorest nations. Each new appropriation will yield 140 percent of its dollar value.

The first question that has been asked is how do grants replace loans. The economics of the Commission's grant financing proposal permits the development banks to leverage resources by drawing upon the vast capacity of the private sector. The only true aid component of development assistance and the only cash requirement of this new format in a world of sophisticated financial markets is the small grant or subsidy that fills the gap between what impoverished recipients can afford to pay and the real cost of supplying the service. Under the Commission's proposal, this ranges from 90 percent of cost to 10 percent, depending upon the nation's per capita income and capital market access.

An example will clarify the grant-loan equivalency. A $100 million, 20-year project can be financed through a traditional World Bank 20-year subsidized credit. This would require $100 million of aid resources. This is the traditional approach development banks have taken in the past. Alternatively, the project could guarantee annual payments of $13 million upon delivery of results. If the income level and capital market access of the recipient country qualify for 50 percent grant aid, the World Bank would enter into a direct contract to pay $6.5 million per annum to the provider upon delivery of service. The recipient government would enter into a similar contract with the provider to pay the remaining $6.5 million per year. The service provider would utilize the two contracts as security to obtain private sector funding. The financeable value of the direct World Bank revenue stream is $59 million. The financeable value of the recipient country revenue stream is $41 million. The reason for the difference is the different yields that the market would require on a direct contract with the World Bank compared to a contract with a recipient developing country. The private sector will provide the requisite $100 million in funding with only a $6.5 million per annum commitment of the World Bank.

This is how you achieve the leverage of $6.5 million in annual development assistance providing $100 million of development programs.

The key role here is the financing role of the private sector. Some may fear that the private sector will not provide the requisite resources because most truly poor countries are not creditworthy. This impediment is eliminated by the structure of the Commission's tools. The supplier is paid directly by the development bank upon independently verified delivery of service for its share of the cost. In the case of very poor countries with no capital market access, the direct payment obligation of the World Bank will equal 90 percent of total cost. A contract directly with the World Bank is eminently financeable in the private sector. The credit risk for the capital markets is therefore that of the service provider, which will be major international contractors or nongovernmental organizations, not the aid recipient. The favorable cost of this funding will be incorporated into the user fees on the project that is implemented.

As the income level or capital market access of the recipient nation increases, the share of the World Bank payment in total cost declines, but the ability to finance the recipient's obligations in the private sector rises.

The next question that has come up is where will the grant funding come from? The World Bank has $133 billion in paid-in equity resources today. Paid-in capital and retained earnings on the Bank's balance sheet amount to $29 billion, and IDA, its aid arm, holds $104 billion in resources. If this endowment is invested in market investments at a conservative 8 percent return, an income of $10.6 billion will be earned annually. After deducting $200 million in administrative expense to run the aid program, the existing resources in the Bank will generate a stream of $10.4 billion in annual grants in perpetuity.

The Commission has proposed two development bank tools: loans to promote institutional reform with subsidized interest rates based upon the Bank's own cost of financing, and grants covering a portion of user fees on infrastructure and social service projects. The extent of the interest and user fee subsidies varies between 10 and 90 percent based on the income level and capital market access of the recipient. The institutional reform loans would be funded through the issuance of debt secured by the Bank's investment portfolio.

The $10.4 billion annual grant flow would be utilized to pay the interest subsidy on institutional reform loans and the user fee subsidy on infrastructure and social service projects. Utilizing the Bank's guideline of 25 percent of programs devoted to institutional reform, the grant system under existing resources will support $185 billion in aid programs for the world's poorest countries. This is 78 percent more than the current $104 billion maximum under IDA's prevailing system of subsidized credits. The proposed structure has the additional benefit of reducing the Bank's capital at risk to the poorest countries by 55 percent because the endowment and grant revenue stream are unaffected by the financial condition of the recipients. This contrasts with the current system where the funds are totally lent out to the recipients, and if there are write-offs, such as proposed under HIPC legislation, or defaults, the resources are lost. The current level of IBRD non-aid lending can be maintained and supported by the callable capital of its industrialized members and a portion of the Bank's equity and investment portfolio.

The endowment would start at $50 billion representing the IBRD equity capital and undisbursed funds at IDA. As each $100 of existing IDA credits is repaid, instead of relending it, it would be added to the endowment. This would create investment income of $8 for each $100 repayment and provide grants that would leverage $140 in development programs. Similarly, each new appropriation would increase the endowment and raise total aid programs by 140 percent of the new funds provided.

Any modifications of the assumptions underlying the analysis, including changes in financing rates, investment returns or amortization schedules, will not alter the basic results significantly.

From a financial standpoint, the Commission's proposal is straightforward. The proposal is making effective use of scarce development funds and of sophisticated financial markets.

In the appendix to my written statement, I have provided an analysis of the sources of World Bank income currently. In contrast to the Bank's public statements, its income does not arise from lending activities. Interest rates on loans only cover the Bank's borrowing costs plus administrative expense. There is no link between loans to middle-income countries and transfers to the poorest members. The Bank's net income is derived from two sources unrelated to its development mandate, the investment of its equity capital and donor funds and the profit from the reinvestment of borrowed funds in the market instruments. Thank you very much.

[The prepared statement of Dr. Lerrick appears in the Submissions for the Record on page 251.]

Representative Saxton. Thank you, Dr. Lerrick.

Dr. Calomiris, you may proceed.

STATEMENT OF CHARLES CALOMIRIS, MEMBER, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Dr. Calomiris. Thank you, Mr. Chairman. Thank you for inviting me to appear here today. I want to begin by commending you and the Joint Economic Committee for having maintained over the last several years an open and lively forum for debate on reforming the IMF and the development banks.

It was a privilege for me to serve on the Meltzer Commission. We considered a remarkably broad range of issues, unearthed significant information pertaining to the financial institutions' actual policies, and made what I think are a set of careful and creative suggestions for reform.

Others may disagree with us on the details of our recommendations, but I hope they will agree that our deliberations were a good faith effort, as is apparent in the strong bipartisan majority that voted for the Commission Report.

In my previous testimony before the House and Senate Banking Committees, I outlined the Commission's recommendations, explained in my words the rationale behind them, and responded to Secretary Summers' preliminary reaction to our Report. Given the substantial common ground between Secretary Summers and the Commission, it is my hope and belief that most or all of the Secretary's doubts about our recommendations will be resolved by a fuller consideration of the logic that underlies those recommendations, and I note that Dr. Lerrick's excellent presentation here today is a good step in that direction vis-a-vis the grant funding proposals.

I will not reiterate my previous testimony here today, but I am happy to answer any questions that you or members of the Committee may have on these various topics. I do, however, want to emphasize one point here today that received less attention in earlier congressional hearings.

A basic premise of our Report is that the international financial institutions should be transformed into effective economic mechanisms. To be effective as economic mechanisms, that is, to avoid being employed merely as political slush funds for broad foreign policy objectives, they must have clearly defined goals and they must meet disclosure and governance standards that ensure that they stay true to those goals.

Some members of the Commission, notably Mr. Levinson, have disagreed with the Majority's view on this point. This, rather than the details of the economic reasoning of the Majority, I believe, lies at the heart of the disagreement between the Majority of the Commission and our critics. I think it is fair to say that Mr. Levinson in particular sees the multilateral agencies largely as vehicles of broadly defined American foreign policy.

Some observers might be forgiven for concluding from some of his remarks that he would use the IMF, WTO and development banks as tools to further protectionist interests of America's labor unions. I note, however, this is not what Mr. Levinson says motivates his statements, and I think it would be wrong to question his motives. Rather I want to question his central premise, that the IMF and World Bank should be used as tools to pressure countries to adopt particular policies in pursuit of American interests. I think instead that foreign aid should serve that function, and in so doing, aid should be subject to congressional oversight consistent with the essential balance of power envisioned in our Constitution.

The role of the multilateral institutions should be fundamentally different from that of foreign policy. The multilateral institutions should improve the world economy in three essential ways: First, by providing global public goods, for example, liquidity, the rule of law in international trade relations, and improvements in public health technology; second, by providing solutions to problems of negative externalities across countries, for example, pollution and economic instability that spills across national borders; and third, by offering an effective means for coordinating the global attack on poverty in the poorest countries.

These are sufficient challenges for the IMF, the development banks, the BIS (Bank for International Settlements) and the WTO. Adding a broad discretionary foreign policy role to that list of challenges is highly counterproductive. It crowds out scarce resources that are needed for bona fide economic objectives. It distracts the management of the institutions and forces them to depart from clear rules and objectives. It makes it hard to establish norms for the conduct of management and mechanisms to ensure their accountability and thus erodes the institutional integrity and credibility of the multilaterals.

The IMF's Russian fiasco of 1997-1998 illustrates that point nicely, as does the IMF's current program under negotiation with Ecuador. No knowledgeable observer of Ecuador with whom I have spoken believes that Ecuador will adhere to the fiscal or regulatory reform conditions that the IMF will attach to its proffered loan subsidies. Nor does anyone regard Ecuador's problem as one of illiquidity.

Ecuador has been suffering a deepening fiscal crisis for several years caused by the combination of an unresolved internal political struggle, weak banking system regulation and severe economic shocks. Under current circumstances, it is very hard to argue that channeling IMF loan subsidies to Ecuador makes sense either as a means of mitigating an illiquidity crisis (which doesn't exist) or of spurring institutional reform.

Some observers have argued that IMF aid is probably better understood as a means of sending political payola to the Ecuadoran Government at a time when the U.S. wishes to ensure continuing use of its military bases there for monitoring drug traffic. I am not sure if that perspective is correct, but if the United States wishes to provide foreign aid to Ecuador because of its value as a strategic military base for monitoring drug trafficking, let that policy be debated in Congress, and let our government decide whether to do so. Dragging the IMF into this affair only further weakens that institution's already damaged credibility.

I emphasize that I am not arguing against foreign aid, but rather for a separation between foreign aid broadly defined and the mandates of the international financial institutions. That principle also explains why I do not think that the development banks, the IMF or the WTO should require member states to adhere to specific rules governing their domestic economies unless, and I repeat unless, those rules are necessary for the successful implementation of the narrowly defined economic objectives of the economic institutions.

Let me clarify this point. Prudential regulatory standards for banks are a reasonable requirement for the IMF to impose on would-be borrowers since that requirement reduces the possibility of the abuse of IMF loans. That goal, reducing the abuse of IMF loans, not a general desire to impose bank regulatory standards, motivates the Commission's recommendations in this area. In this light it is clear why so-called core labor standards were not an element of our suggested prequalification requirements for the IMF. Similarly, because we saw the role of the other multilaterals as confined to providing global public goods, poverty alleviation, and solutions to externalities across countries and not to encroaching on national sovereignty for its own sake, we did not recommend that the World Bank or the WTO encourage either through carrots or sticks the adoption of core labor standards.

In this regard, I would like to clarify a statement that I made during the Commission hearings which Mr. Levinson has repeatedly quoted, one which pertains to U.S. trade policy as well as to the appropriate use of conditionality by the multilateral institutions. In my view, the effect of imposing core labor standards on other countries through threats of protectionist policies is both disadvantageous to Americans and immoral. It is disadvantageous to us because it raises the cost of U.S. consumer goods. It is immoral because the effect of those standards in developing economies would be to prevent poor people, especially underaged poor people, from earning essential income necessary to feed, clothe, and house themselves.

Nonetheless, I would not argue and did not argue during our hearings that the United States should always be willing to trade with any country or that countries should be allowed to participate in the multilateral institutions no matter what their domestic policies. For example, I specifically noted that countries like Nazi Germany were clear examples of evil, abusive regimes which so violated the basic human rights of their citizens that it would be unconscionable to trade with them much less support them. There may be examples in today's world that cross that line, but permitting starving 10-year-olds to work should not be sufficient to place a country on that black list.

Mr. Chairman, again, thank you and the Committee for inviting me and for your attention. I look forward to your questions.

[The prepared statement of Dr. Calomiris appears in the Submissions for the Record on page 261.]

Representative Saxton. Dr. Calomiris, thank you very much.

Mr. Levinson.

STATEMENT OF JEROME LEVINSON, MEMBER, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Mr. Levinson. Thank you, Mr. Chairman. I do appreciate this opportunity to be here today. Let me begin by saying that at page five of my statement – and I will not read my statement in its entirety – I assume it becomes part of the record, so I will just deal with some of the highlights of what has been said today. I refer to the fact that my separate dissenting statement should be available on the Commission website. I am informed that it is not and that the Chairman has not authorized it.

[The dissenting statement in question from the Commission's website appears in the Submissions for the Record on page 279; see also Dr. Meltzer's comments on page 35.]

Dr. Meltzer. That is not correct. It has been there for weeks.

Mr. Levinson. I am sorry. People have informed me, including staff members of this Committee, that they have not been able to access it and it has not been available. So if it is, then I am delighted, and I hope that in some way that that is a moot issue. Let's set that aside.

Now, Professor Calomiris has referred to my emphasis upon equity in the international economic system and the emphasis upon core worker rights and environmental conditions to be incorporated integrally into the World Trade Organization and to be a subject as well of the program conditionality of the World Bank and the IMF. There is no doubt that I do support that, and let me take this opportunity to set the record straight once and for all.

Professor Calomiris generously says that some people might conclude that my remarks – that I intend to use the IMF, WTO and development banks as tools to further the protectionist interests of American labor unions. However, he says that he notes that I disavow that intention. We all know that is a standard technique: You plant the seed as to what the intention is, and then you disavow believing that.

My father was a Teamster. He also had a chronic heart condition. He was in and out of hospitals. And to this day I can still hear him telling me that without the health plan that he got through the union, we would have been fiscally destitute. One day he did collapse at work, and he died of a heart attack; when the drivers who worked with him came to the house to pay their condolences to my mother, the shop steward for the union brought a $500 check for burial costs, and my mother got $10,000 from a life insurance policy which he could not otherwise have had except through the union.

I won a full tuition scholarship to Harvard. I got up at 5:30 in the morning to deliver the *Boston Globe* and the *Harvard Crimson* to the dorms, but I still could not have done it if I hadn't had some financial support from the family. That financial support was possible because of the fact that our medical costs were defrayed by the health plan that we obtained through the Teamsters Union. So my support of core worker rights, including above all freedom of expression and collective bargaining, is a matter of conviction and personal experience. I make no apologies for my support of that, nor do I make any apologies for my work with the AFL-CIO on these issues and my writings in this connection. So let's be clear. There is no doubt I support core worker rights. It is based upon personal conviction, personal experience. I work with the AFL-CIO people. I have no apologies to make for that association.

The heart of the difference between us is precisely this issue of equity in the international system conceived as a system. If we step back and look at the World Trade Organization, we see a mature dispute settlement system for resolution of trade conflict. If we look at the NAFTA (North Atlantic Free Trade Agreement), we see a chapter 11 on investor rights, which gives the investor in the case of U.S. the right to bring a suit against a state, namely Mexico or Canada.

If we look at the multilateral financial institutions, the World Bank and the IMF, we see that they are intervening in the labor market for what is called labor market flexibility, which is a euphemism for requiring countries to adopt measures which make it easier to fire workers, weaken the capacity of trade unions to negotiate on behalf of their members, and drive down wages to gain competitive advantage. However, they disavow intervention for the purpose of addressing labor market abuses such as the use of the coercive power of the state to deny workers the right of free association and collective bargaining. That, they say, is political.

It escapes me as to how intervention for the purpose of driving down wages and weakening trade unions is not political, but intervention for the purpose of protecting core worker rights is political. I think that position, frankly, is nonsense.

So the difference between us is that in my separate dissenting statement and in my statement today, I emphasize this question of the lack of equity in the system, the imbalance in the system. You would never know from reading the Majority Report that the Commission took any testimony on this issue. As I note in my prepared statement today, there was extensive testimony, but the issue isn't even addressed in the Majority opinion.

We heard this morning Professor Meltzer say that countries that don't meet the preconditions could still borrow at steep penalty rates of interest. If you look at page 43 of the Majority Report, they state, except in unusual circumstances, here I am quoting, where the crisis poses a threat to the global economy, loans would be only to countries in crisis that have preconditions that establish financial soundness.

Now, if you turn to page 44, you will see that – I am sorry, page 46. The new rules should be phased in over a period of three to five years. If a crisis occurs before the new rules are in place in most countries, countries should be permitted to borrow at an interest rate above the penalty rate. The superpenalty rate would give countries an additional incentive to adopt the new rules. So the ability to borrow at the superpenalty rate is for the transition period, but once you get to a steady state past the transition period, then we revert to the statement at page 43, which says that only countries that meet the preconditions are eligible for financing.

And this goes to one of the issues that Professor Calomiris addressed at the end of his statement, which is the egregious abuser of human rights. Under their criteria, as long as you meet the financial criteria, you automatically qualify. Professor Calomiris may have made that statement in the hearings about egregious abuses on human rights not being eligible, but that is not part of the Commission's Majority recommendation. Access to the resources of the IMF are automatic once you meet the financial criteria.

At page 44 they say the IMF would not be authorized to negotiate policy reforms. And they go on to say the policies necessary to improve economic performance and end a crisis are well known. Let's take the

East Asia crisis as an example. There are four possible explanations for the crisis in East Asia in 1997: First, that it was the result of the pressure from the United States authorities, in particular our administration, to open capital markets before the countries had institutions in place to regulate and discriminate among institutions that were borrowing abroad. That intervention is described in exquisite detail, quite frankly, in a remarkable article by David Sanger and Nicholas Kristoff of February 16, 1999, "How U.S. Wooed Asia to Let Cash Flow In." If you read this article, the overwhelming impression is that the origin of the Asian crisis was pressure to prematurely liberalize capital markets. They summarize the roster of culprits as follows: Responsibility can be assigned all around – here I am quoting – not only to Washington policymakers, but also to the officials and bankers in emerging market countries who created the mess, to Western bankers and investors who blindly handed them money, to Western officials who hailed free capital flows and neglected to make them safer, to Western scholars and journalists who wrote paeans to emerging markets in the Asian century, end quote. You notice who is absent from this roster? Workers. But they are the ones who paid the primary price.

Now let me just conclude by the three other explanations since I see the red light is on. The other primary explanation is that it was a purely financial crisis, a classic financial panic. That is set forth by Professor Sachs, another member of the Commission, in his article in the *American Prospect.* He says, by making it into a structural issue, short-hand known as crony capitalism, the IMF worsened the crisis by convincing investors that something was fundamentally wrong, when what you had was a classic financial panic.

The third explanation is the structural issue, and that is the one that underlies the Majority's recommendation for preconditions, that the problem was the crony capitalism, the close relationships among banks, government and corporate officials, and in that they joined with Mr. Fischer, Managing Director of the IMF, in the IMF analysis.

And the fourth explanation is moral hazard, that the bailout of Mexico led to the bailout and the imprudent lending by the banks in the east Asian countries, which I think is totally without support.

The more plausible explanation is that the banks in Japan and Western Europe, faced with recessionary conditions in both areas, looked for more profitable outlets, and as occurred in the decade of the 1970s, they placed them where they thought they could get the better rate of return, and, if you will recall, that was the decade of the Asian tigers, the great attraction of the east Asian countries.

So it is not at all clear, as the Majority says, that the analysis of the origin of the crisis is self-evident to everyone. In the east Asian crisis, there are at least four explanations, none of which are necessarily mutually exclusive, but if you take one as the primary explanation, that leads to a different conclusion as to what your remedy is. It is not at all clear, as the Majority says at page 44, that the policies are self-evident.

I would just leave the conclusion at this point that the major point of difference, then, is they take no account of the legitimacy of the issue of core worker rights and the environment as an integral part of the international system. They preclude the IMF from addressing through policy the underlying conditions that led to the crisis, and that is where the primary differences lay. I can go into detail as to why what Dr. Lerrick outlined is really patently absurd as a mechanism, et cetera, but I will leave that aside.

[The prepared statement of Mr. Levinson appears in the Submissions for the Record on page 267; the IFIAC's Report appears on page 69.]

Representative Saxton. Thank you very much.

My observations over the past several years have led me to believe that there are at least five issues that I would like to explore, which I believe are critical to this discussion. They are, first, the role of the United States in the IMF and the contribution that we make; second, the terms of the loans, that is, the length of the loans which we have described as primarily development loans; third, the subject of subsidized interest rates; fourth, the subject of interest rates that are actually charged to borrowers through the IMF; and fifth, the need for transparency.

So let me just ask a question about each of those and permit you to respond, and I will do this as quickly as possible, but I think these are five issues that really need to be discussed in some depth.

One of the issues that I raised in 1998 related to the IMF development lending, or the length of the loans, and the impact of the Fund's ability to act as a crisis lender. Both the Treasury and the Meltzer Commission are on record supporting a deemphasis of the IMF development lending. Although there are some differences about how much of this development lending activity should be deemphasized, this basic premise seems to be accepted, and I think that is good news.

Could you, Dr. Meltzer, begin by explaining to us from your perspective how development lending – what impact development lending has on IMF operations generally?

Dr. Meltzer. Development lending, in my judgment, and I believe in yours, should not be a part of IMF operations. This mixes roles. The IMF has an important role. That important role is to prevent liquidity crises that disrupt international financial markets and disturb the international economy; and second, to provide and disperse information.

Now, development lending – none of those functions require the IMF to be involved in development lending. In the interests of accountability and transparency, it is very good to have people be responsible; that is, the IMF be responsible for its sphere of activities. Development lending would be the responsibility of the World Bank and the other regional development banks. We certainly are in favor of development lending provided it is made – as the World Bank's research has shown, provided it is made for purposes that are going to be successful, not just to sprinkle money around the world, but to see that we actually have programs that lift countries out of poverty. And our criticism of the World Bank is that while their rhetoric on these issues is superb, their actual accomplishments are somewhat less than good.

Representative Saxton. Mr. Levinson made, I think, a great point when he said occasionally individuals and countries have an immediate urgent need for help, as in the passing of his father. When the IMF was established, it was established, from my understanding, for purposes of liquidity crisis lending, which is a short-term need that occurs and help is needed right away. Now, does long-term development lending in any way inhibit the IMF's ability to make these shorter-term loans?

Dr. Meltzer. In my judgment, no, it does not inhibit. In fact, the more they interfere and become involved in all sorts of other issues, the more that they sacrifice and become a multi-objective institution where they have to balance one objective against another. What they ought to be doing is doing their job and doing it better than they have been doing it.

Representative Saxton. Could the IMF's multi-year development programs reduce its available resources and ability to act in unexpected crises?

Dr. Meltzer. That is one of the ways that the conflict comes about. The IMF has a limited amount of resources. It could increase those resources, as you have suggested and your staff, by borrowing, but it has elected not to do that. So, yes, there is a limit on its resources, and the more it puts into development aid, the less likely it is going to have – the more likely it is going to have to come back to the Congress and the other Parliaments to ask for more money. But in a particular crisis it may find itself with insufficient funds. If we could get their balance sheets and income statements straightened out, we could make more clear statements about how much funding they have.

Mr. Levinson. Mr. Chairman, might I intervene at this point to comment on your comment and—

Representative Saxton. Sure.

Mr. Levinson. I think you have to put this issue of the IMF's – what appears to be development lending in some perspective. It really derived from the oil crisis of the 1970s, the Witteveen facility, the feeling that with the oil crisis the perception that the IMF had to make resources available on a longer-term basis to the countries than the conventional one to three years, because the oil crisis had created a qualitatively different situation. That was the origin of the Witteveen facility in 1977. That led to the expansion of the terms of IMF loans.

The problem of development lending, when it spills over from the short-term addressing of the problem that led to the liquidity crisis, leads you into this issue of what was the cause of the crisis. If you believe, as Chairman Meltzer, Professor Calomiris, and Stanley Fischer and the IMF staff, that the cause of the crisis in east Asia was primarily crony capitalism, shorthand for the improvident banking systems of those times, then the IMF says, well, of course, if that is the cause of the crisis there, we would be remiss if we didn't address that as part of our attempt to meet the short-term crisis. You would be criticizing us on that count if we didn't address that.

If your view is that it was a purely financial panic, as was Professor Sach's view, or that it primarily was the consequence of premature capital liberalization as the Kristoff and Sanger article implies, then you come out with a completely different situation. The IMF does not plunge into structural reform. You can't avoid deciding what is the basis of your analysis of what led to the crisis in the first place. That is the problem that their proposal leads to, because since it is only – since the IMF funding is only limited to countries which prequalify, you are precluded from addressing the underlying issues which may have led the country into the crisis.

Dr. Meltzer. May I interrupt just to say, sir, there is a role for the World Bank and the development banks. If there are long-term structural adjustments, we address those issues in great detail in our Report, come up with a mechanism for dealing with long-term structural adjustment problems and institutional reform. That has nothing to do with the question about – that just obfuscates what is an important issue, and that is how do we make the world safer, more secure, much less subject to risks than it is at present. That is one question. The second question is how do we help people out of poverty? There is no reason why those two questions have to be joined, and it simply obscures matters to join them.

Representative Saxton. Isn't it true – and I know Dr. Lerrick wants to say something – but isn't it true that, going along with what you just said, that when the IMF came to the United States in 1998 and requested and got $18 billion additional, it then came back with a proposal to sell gold in broad terms? Isn't it true that those activities and actions on the part of the Congress were necessary because the IMF had developed a need for additional funds, and they developed, at least in large part, a need for additional funds because of long-term development lending which didn't previously occur?

Dr. Meltzer. Yes. There are two separate issues there. One was to – to oversimplify, but not oversimplify greatly, the great drain on IMF resources was, of course, the assistance to Russia and the possibility that I think people recognized at the time that there might be a breakdown in the Chinese banking system that would create also a need for substantial additional funds. So rather than to meet those issues directly, like the question about aid to Russia, and come to the Congress and ask for an appropriation to assist Russia in its transition, the Administration presents you with the IMF as a source of that money and try to cover over the fact, or at least to obscure the question about why they need the money.

Now, the money was needed because they are in the development lending business, in the transitional lending business. In my judgment, and, I believe, in the judgment of many of the people at the IMF privately, they should never have been in that business. They didn't know anything about the business when they got into it. They avoided for a very long time doing the things that were necessary to make the transition succeed like suggesting to these countries that they impose the rule of law and such other things. They saw the problem. It is really a clear case of what Mr. Levinson is complaining about: They saw the problem initially as purely financial, and it wasn't – as a purely financial problem. That was the problem that the World Bank – if there was going to be an international lender – should have done or was a problem that the G-7 more likely should have done, but it was not a problem that the IMF should have handled. It wasn't well equipped to do it, and I believe it was a mistake to get them involved, and it is a mistake to keep them involved.

Representative Saxton. Dr. Lerrick?

Dr. Lerrick. Mr. Chairman, very briefly, Mr. Levinson's comments are confusing a relatively straightforward issue. What the Commission has proposed is the division of responsibility between the IMF and the development banks. Now, if you have a crisis, whatever its origin – it may be structural or financial, it may be purely from an external shock – the Fund's job is to provide temporary liquidity during a short period of up to 240 days up to one year, let's say, as an arbitrary benchmark. If it is truly a financial crisis, the Fund's role is to address it by providing liquidity to the system. At the end of three weeks, a month, two months, you will know whether it is purely a financial crisis because then the country will stabilize and not require additional resources. If it is a structural crisis, then the problems will persist.

What the Fund's job is, is to provide liquidity for a period of time so the country can come up with a structural reform program and obtain long-term financing to enact that program either from the private capital markets, such as Colombia did in 1985 without any Fund assistance, or from the development banks through a loan program to enact those structural reforms and finance them. So the source of the crisis does not affect how the Fund should provide assistance.

Representative Saxton. We are going to have to move along here. That was the first of five questions that I thought I was going to ask in five minutes. Those of you who have not dealt with this on a steady basis as some of us here are getting an idea of how complex some of these issues are.

In the sense of fairness, I would like to go to Mr. Stark. I have four more questions. One is relative to the role of the U.S., one is relative to the subsidized interest rates, one is relative to the interest rate charged to borrowers, and, finally, the need for transparency.

Mr. Stark, it is your turn, sir.

Representative Stark. Thank you, Mr. Chairman. I will be brief. I would rather be out protesting, I think, with my friends out on Pennsylvania Avenue than listening to this kind of rarified elitist group. But the first statement is that while we have been waiting for the completion of the testimony, our staff went out – and I admit, Dr. Meltzer, to being technically challenged, but I am dammed if we can find the Minority Reports on your webpage. So I challenge you, if you could find them, print them out—

Dr. Meltzer. I would be glad to do that. I should point out to you, Mr. Stark, that it is no longer my webpage. It is the property of the U.S. Treasury. They assured me that those were put there.

Representative Stark. Well, they have hidden it so the people with thick fingers like myself can't find it. Any assistance you can give us on finding it would add immeasurably to your credibility.

[A printed copy of the dissenting view from the IFIAC's website appears in the Submissions for the Record on page 279; see also Dr. Meltzer's comments on page 35.]

Dr. Meltzer. May I respond to that just very briefly?

Representative Stark. It is either there or not there, Doctor.

Dr. Meltzer. May I just say that one reason it was delayed in getting there was because none of the members of the Minority chose to send the copies of the report to me. They chose to send them elsewhere, but not to me. When it was called to my attention—

Representative Stark. I am not here to arbitrate squabblings.

Dr. Meltzer. I just want to let you know that I absolve myself from responsibility for that.

Representative Stark. I haven't been troubled with academic squabbles for a great number of years, Doctor, and I would rather not start again.

I am concerned that the IMF seems to be more concerned with problems of bankers – which I was once – and not very much with the problems of the poor in the world, as seems to be well-documented in testimony before us this morning. And if indeed it is determined by the Majority that you ought not to be criticized and ought not to make decisions about financing various countries based on political decisions, then I guess it goes down to us. If at some point we can get the votes to do as you would do to some countries – that is cut off their money – that sounds like a good alternative to me. I am dammed if I can figure out with all that I hear this morning what you all have done in the world except help those that don't need any help. That is not at least why I labor in this vineyard.

It seems to me the Commission's recommendations, at least in the Majority, deal only with banking requirements. And you suggest that – for instance, in environmental protection – that you should concentrate on the production of global goods. Dr. Meltzer, you say it should include the rational protection of environmental resources. I would challenge you – not now, because I have limited time – to give me a memo on irrational environmental protection. I presume that would be emotional and other kinds, but I would like some examples there.

[Chairman Meltzer's written response to Representative Stark appears in the Submissions for the Record on page 278.]

As to labor standards I never was in a union, but I have a father-in-law who was a Teamster, and if I ever voted against the unions, he would break my leg. And I seem to recognize that as enough influence. But putting Frank with a high school education up against Dr. Calomiris would be tough. Now, my father-in-law was on strike with the Teamsters in Oakland back many years ago, and my wife tells me that they went six or nine months with Hamburger Helper and splitting a little can of tuna four ways. This was when she was in kindergarten, and she would never cross a picket line, remembering that. But, of course, Dr. Calomiris would have put her to work in kindergarten delivering papers or doing something like Mr. Levinson did.

I am just troubled – do you have children, Dr. Calomiris?

Dr. Calomiris. Congressman, I have two daughters. I suggest you leave them out of the discussion.

Representative Stark. Good. In your academic background – you have a doctorate; I presume it is not an M.D. Do you know who Jonathan Swift was? Did you ever read *A Modest Proposal*? Seriously, did you ever read it? Do you know what it is?

Dr. Calomiris. Many years ago I think I did read it, Congressman.

Representative Stark. It sounds just like you. Go back and read it, and it will bring joy to your hard hearts. Jonathan Swift and you had the same idea permitting starving 10-year-olds to work. I think it takes you back, you and the Heritage Foundation, back to the 1800s where your ideas may have had some credence. But to bring that baloney to us in a free world with people starving, and our fight now is whether to bring all of this wonderful help to China who enslaves children and not give it to Cuba who somehow people have decided is worse than China, eludes me.

My question is why we put up with this nonsense from the IMF and the World Bank and why we as a democratic country continue to support it. That is my question, Mr. Chairman.

Dr. Meltzer. Are these questions addressed to us or—

Representative Stark. To Mr. Levinson to start. He makes more sense than any of you, and then you can go down the table.

Representative Saxton. If the Chair may, I would just like to let Dr. Calomiris respond first.

Dr. Calomiris. Thank you very much.

Mr. Stark, I have no interest in seeing children, particularly poor children, work. That is not something that I would like to see. I would certainly embrace proposals that you might want to propose or others might want to propose for us as a country to undertake more economic responsibility to make that unnecessary. However, let me—

Representative Stark. How about making it illegal?

Dr. Calomiris. Let me make it very clear, that if you make it illegal for them to work, but do not simultaneously do other things that enable them to continue to survive, you are behaving immorally, sir.

Representative Stark. Bingo. What have you done in this la-di-da group that you belong to to help any of the poor children in China, for example?

Dr. Calomiris. We have proposed, sir, substantial increases in poverty alleviation programs by the development banks, for example.

Representative Saxton. Mr. Levinson.

Representative Stark. That is laughable on its face.

Mr. Levinson. It is difficult to know where to begin, but to begin with, Mr. Stark, I would not put my name to this Majority Report under any circumstances because it is so partial, it is so incomplete and one-sided and so biased that under no circumstances would I sign it. I was sorely tempted to vote with three members of the Commission who wanted to abolish the institutions altogether, because it is so difficult to get them to move off of it. The culture of the institution is so wedded to this neoclassical economic vision which sees any government intervention as undesirable, including labor standards.

What are we talking about with respect to labor standards? We are talking about the most basic rights, freedom of association and collective bargaining so that workers can engage in free trade unions and then negotiate what is appropriate in their own circumstances in terms of wages, benefits. It is the labor unions in places like Brazil that have been in the forefront of agrarian reform and addressing the child labor issues. I know of nobody that has been addressing the child labor abuses who doesn't couple measures to address those issues with complementary measures to provide financing for education and for the families so that the children can be withdrawn from the labor force without economic detriment.

It is a false dichotomy to say you are for one or the other. The Majority simply refuse to address and object to the incorporation of these core worker rights as they were defined by the AFL-CIO people in testimony. Freedom of association and collective bargaining, the Majority want no part of that as part of the international economic system.

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

Dr. Meltzer. I would like to take up the issue with Mr. Stark. I first would like to ask you a question, sir. Have you read the Report?

Representative Stark. No, I haven't read the Report, Dr. Meltzer

Dr. Meltzer. You can't possibly make some of your statements if you had read the Report—

Representative Stark. Oh, yes, I could. But all you have to do is listen to the palaver you have brought here this morning, and that is basis enough. I have never heard such arrogant, insufferable nonsense.

Dr. Meltzer. May I respond to your statement? That issue came up at the very beginning. I had a meeting with Mr. Levinson. As a result of that meeting, or as partly as a result of that meeting and other discussions I had, I met with a member of the Democratic Minority. He told me at the time, as Mr. Levinson had told me, that members of the Democratic Minority, or certainly large parts of the Democratic Minority, would not read the Report, accept the Report, have anything to do with the Report if it didn't have core labor standards. I pointed out to them—

Representative Stark. How about environmental protection?

Representative Saxton. Let him finish, please.

Dr. Meltzer. Let me just say at that time I told them what I will now say to you. It is not an arrogant statement, it is a statement of fact. I told them as far as this Commission was concerned, first, it didn't seem to be within our jurisdiction, but even if we extended our jurisdiction, it was not true that even if I favored core labor standards, it would not be true of either the Majority or the Democratic Minority appointed to the Commission that we would approve core labor standards. There was no chance in that Commission at all.

I explained that at the time to a member of the Minority Party – I would be happy to tell you his name, but I don't want to quote him without his being here – that that really is the sum and substance of the issue. If it had been brought to the Commission, it would have been voted down. The Majority was not in favor of it, neither the Majority appointed by the Republicans nor the Minority appointed by the Democrats.

So to say that we didn't consider it, we did discuss it. Mr. Levinson himself talks about the issue. We didn't put it in the Report because it did not seem to me useful to say that we were against it. It was not within our jurisdiction, and so we simply avoided the issue. That is the sum and substance of the issue. You may not like that result, but as I explained earlier when I discussed this issue with other members of your party, that you are not going to take our Report and enact it into law verbatim. You are going to look at it.

If the Congress wants to discuss core labor standards, certainly that is within their prerogatives. That has very little to do with the financial reforms. There are pressing financial reforms that need to be done. We need to improve the poverty programs of the world. The World Bank has wonderful rhetoric, but very poor performance.

Representative Stark. No performance and lots of rhetoric.

Representative Saxton. The gentleman's time has expired.

We are going to move on to Mr. Sanford.

Representative Sanford. I would just say that this is getting a little spicy for my taste. It feels more like a Judiciary Committee rather than something as analytical as a Joint Economic Committee.

I would want to disassociate myself from the line of questioning or reasoning of my colleague from California because I think that legitimately we can have strong policy disagreements on all kinds of different things, but to pull in a witness's kids and how many kids he has, to me, is very irrelevant.

First question, Dr. Meltzer, rate of return for World Bank. Are there any estimates as to the overall rate of return for the World Bank?

Dr. Meltzer. On its loans? On its loans, it charges – it receives a rate equal to the rate at which it borrows, plus usually a half of percent premium that it charges for administrative fees. So its rate of return – if it borrows at 6 percent, its rate of return on the loan is 6-1/2 percent and so on.

Representative Sanford. But that could include the default rate; in other words, probably a negative rate of return if you include default or restructuring, et cetera?

Dr. Meltzer. I don't know the answer to that question. I would guess that the answer is not a negative rate of return overall.

Dr. Lerrick. Mr. Sanford, when the World Bank lends money, it just takes its pure borrowing costs. In Dr. Meltzer's example, it issues a bond at 6 percent, and it then adds on a small margin of between .25 and .5 percent to cover its administrative expenses, which are just out-of-pocket expenses. That is the lending rate.

Now, it does provision for loan losses, but that does not come from its lending activities. It comes from its net income, and its net income is unrelated to its lending activities. For instance, the World Bank has $29 billion of equity capital on which it pays no interest or dividends. Just the investment of these funds at 6 or 7 percent generates close to $2 billion a year in net income. That is how they provision for loan losses. They do have reserves on their balance sheet of a number of billions of dollars.

Representative Sanford. So, the blended rate – in other words, if you include the cost of capital from the taxpayer to the World Bank in the initial setup, the blended, in essence, rate would be negative?

Dr. Lerrick. Well, if you include the taxpayers' cost of funds, then it would be negative, yes.

Representative Sanford. So I guess what I am getting at is oftentimes I hear with these types of organizations that, quote, we cost the taxpayer nothing. I hear that as almost a consistent refrain. That is probably not really true if you look at cost of capital in a total sense.

Dr. Lerrick. Mr. Sanford, that is absolutely not true. If you look at the Commission Report, there is an estimate of the cost of the development banks to the membership each year. It is approximately $22 billion per year.

Dr. Meltzer. About $5 billion to the United States.

Representative Sanford. But it is generally thrown out?

Dr. Lerrick. All of the IFIs (International Financial Institutions) claim that their costs to the donor country taxpayers are zero. For instance, in the Commission's Report there is an analysis of what the cost of the multilateral development banks is, and the total cost to members is approximately $22 billion per annum. The share of the cost of the United States is approximately $5 billion per annum.

Mr. Levinson. That is like comparing apples and oranges, frankly, Mr. Sanford.

Representative Sanford. Why do you say that?

Mr. Levinson. Of course, you can get a high rate of return if you alternatively use some money by looking for commercial—

Representative Sanford. Let's come back to that. I want to go down a particular line of thought with that.

The second is tied to subsidized rates, which is if you consider the risk profile of whether an IMF or World Bank – if you consider the risk premium that a normal commercial enterprise would charge in that environment we do have a subsidized rate; is that not correct?

Dr. Meltzer. That is correct, yes.

Dr. Lerrick. Of approximately 7 percent per annum.

Representative Sanford. Where I am going to with this is—

Dr. Lerrick. On interest-bearing loans. On the loans that are going through IDA which have zero interest in essence the subsidy is 15 to 20 percent per annum.

Representative Sanford. So we have something that costs the American taxpayer about $5 billion. We have something where a taxpayer in America is subsidizing, in essence, development in other parts of the world to the exclusion of development maybe in their own county or their own home State; is that not correct? In other words, if you subsidize – in other words, you would encourage one to build a plant in Turkey, for instance, as opposed to building the same plant in Memphis, Tennessee, given the fact that the rate may different via a World Bank loan; is that correct?

Dr. Meltzer. That is correct, they are subsidizing.

Representative Sanford. Then my question is why couldn't a lot of this activity simply be handled through commercial banks as opposed to World Bank and as opposed to the IMF?

Dr. Meltzer. That is the Majority recommendation, that the IMF – that is one that has drawn many of the sparks – that the World Bank and other lending be taken out of China and other countries where they can borrow in the capital markets and that this aid and assistance be given principally – in fact, exclusively to countries which are poor and cannot borrow on the capital markets. So we do take up that issue. In fact, we have been severely criticized, I think incorrectly, because it is the number of poor people in the world without resources that we want to help.

Dr. Lerrick. Mr. Sanford, the development banks portray themselves as lending to countries that don't have access to private sector capital and to projects that are of no interest to the private sector, in essence saying that the private sector lends 80 percent of what it provides to 12 countries, whereas the development banks lend to the world. The fact is that 11 countries account for 70 percent of World Bank lending, and those countries include – China, Argentina, Mexico, Indonesia, Korea, Brazil, the Philippines, Turkey; the list of usual suspects and the same countries you are talking about in private sector lending.

Representative Sanford. Mr. Levinson, I cut you off. I wanted to go down—

Representative Saxton. Your time has actually expired. Could you wrap up in the next minute or so, please.

Representative Sanford. I will let you do so, the last minute, yes, sir.

Mr. Levinson. I think that the testimony, if you will pardon me, is misleading. They continually refer to World Bank. First they propose that the World Bank divest itself of any operations in Asia and Africa, so what you have done then is turn the World Bank into a super development agency for Africa, then only until the African development bank can take over, in which case it then becomes something that deals with what they call public goods, solving the problem of malaria and HIV in Africa – I don't know why anyone could believe that the World Bank is going to do any better than the World Health Organization – or that it becomes the coordinating agency for other NGOs, so you really don't have the World Bank as an alternative.

Representative Sanford. Your counterpoint to that would be what, sir?

Dr. Lerrick. That is a different issue. There are two distinct issues. One is what should each institution have as its responsibility, and the second issue is where should these institutions as a group be lending their money. They are totally separate questions. The Commission has assigned global public goods and transnational projects to the World Bank. That has nothing to do with whether you want the development banks, as a group, to be sending resources to China and Argentina or not.

Dr. Meltzer. Mr. Chairman, may I interrupt just one moment to say that the staff has just handed me a copy. I would like to respond to Mr. Stark's question of my integrity.

Representative Sanford. Let's do that on somebody else's time. I have 30 seconds, and coming back to you—

Dr. Calomiris. I just wanted to clarify, because Mr. Levinson asked why the World Bank should be involved in this rather than the WHO (World Health Organization). In our deliberations we identified financial aspects of promoting the public goods of global health where the World Bank would play a role. So we do believe that it does have a role to play here.

Representative Saxton. We are going to proceed to go to Mrs. Maloney now.

Before we do that, Dr. Meltzer, would you like to take 30 seconds?

Dr. Meltzer. Yes. I have here – Mr. Frenze just gave me a copy of the Report by Mr. Levinson which was downloaded from the website. I believe that the location on the Web site is as part of the Commission Report; that is, that it is there as part of the whole Commission Report. We have been sent – I must say we sent out something like 3,000 copies of this Report. So we have not been negligent about trying to produce it. I am really sorry that you question my integrity about this because—

Representative Stark. I merely questioned my ability to find it, Doctor, and I am —

Representative Saxton. It must be your computer skills.

Dr. Meltzer. If you download the Report and read the Majority Report, you will find the Minority Report.

[A printed copy of the dissenting view from the IFIAC's website appears in the Submissions for the Record on page 279.]

Representative Saxton. Mrs. Maloney, proceed, please.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. Thank you, Mr. Chairman, for focusing on the important issue of international financial institution reform. I would like to begin by saying that I do believe there should be some reforms to the IMF. I agree with my colleagues who said earlier that we can have honest policy debates and disagreements, but really the bottom line is when there is a financial crisis, it is people that suffer, particularly in the world's poorest countries.

As a member of the Banking Committee, earlier in a bipartisan way Chairman Leach and Ranking Member LaFalce voted to provide a debt relief for the world's poorest countries at the end of last year. Chairman Leach gave a strong statement, and I quote, "Relieving the debt burdens of the world's poorest countries is one of the foremost economic, humanitarian, and moral challenges of our time," end quote.

I look forward to the debate as it goes forward on the reform of the IMF, but one thing that I urge all of my colleagues in a bipartisan spirit is not to use HIPC (Heavily Indebted Poor Countries) relief legislation as a vehicle for IMF reform. I believe that, as one of the principles of the Meltzer Commission Report, that additional debt relief for desperately poor countries must not be delayed, tied up, or hindered in any way by efforts to move forward reforms of the IMF and World Bank. As the world's wealthiest and most influential Nation, our actions will set the standard for additional HIPC reform and relief in the country.

Secondly, under the debate for international financial institutions, in some areas there is broad agreement. And all sides, I believe, agree that private capital is the preferred way to address international financial problems, and when situations require the relief or assistance of IFIs, their operation should be transparent and accountable. And the arrival of the IFI Commission Report, I want to note, does not mark the beginning of efforts to really reform these entities. The administration is already leading the world in its efforts to modernize IFIs. Treasury is already working to refocus the IMF to lend on shorter maturities, and Secretary Summers has already stated before the Banking Committee and publicly that the World Bank should focus on lending to projects that would otherwise go unfunded by the private sector. So I welcome this Commission Report and its debate.

I would like to begin by asking Mr. Levinson and then anyone who would like to comment, can you discuss the dangers that the spreading of the Asian financial crisis, the so-called Asian contagion, presented to the United States, especially to small investors and mutual fund investors? I like to ask – and I remember it did not turn into a great problem, but there was tremendous fear in our financial markets during the Asian crisis. I would like to ask if the recommendations of the IFI Commission had been enacted in 1998, would the countries that received IMF aid have been eligible? And what would the impact have been on the ability of the IFIs and leaders like Larry Summers and others to react to and find the contagion?

Mr. Levinson. I think the impact would have been major, that most of the countries who were helped as part of the East Asian rescue would not have been eligible for IMF financing if the Commission recommendations had been in place. And with respect to contagion, I think Mr. Fischer testified to that and said that the reason that he felt that the IMF intervention was necessary was that otherwise there would have been significant ripple effects which would have meant an even deeper decline in the economic development activities of these countries; it would then have impacted on our own economy and have continued for a longer period of time.

That, of course, gets to the heart of the issue. South Korea was organized on a completely different set of principles. They followed the Japanese model of directed credit. If Korea had not made the complete transformation to the kind of criteria that they outline as the necessary preconditions, they wouldn't have been eligible for IMF financing. Remember, on page 44 of their Report they say the IMF is prohibited from negotiating a program with a country in difficulty. If you don't prequalify – Brazil, for example, now has imposed some limits on foreign banking because they are concerned, about foreign domination of their banking sector. They have a strong domestic banking system. Under the Majority criteria, Brazil would not be eligible. But Brazil has sufficient weight in the economy that it may have major ripple effects throughout Latin America. Th criteria are too rigid.

The other thing Fischer noted – an admittedly extreme example – he said that Nazi Germany would not be eligible for financing on political grounds. Under their criteria, if you qualify under the purely financial criteria, you are eligible. No other considerations can be taken into account.

So it is much too rigid. It is risky in terms of the effects upon our own domestic economy because it is such a straightjacket, and I frankly think it would be disastrous.

Dr. Meltzer. May I respond to that briefly?

Representative Saxton. The gentlelady's time has expired, but Dr. Calomiris has been coming out of his seat trying to respond to something that Mr. Levinson said.

Representative Maloney. Also, could Dr. Meltzer respond, too, if he wishes?

Representative Saxton. The problem is we have 20 minutes to go before we have to vacate the room, and so I am trying to move through as much subject matter here as quickly as possible.

Dr. Calomiris. I will really try to be fast. Let me try to respond to your question. The answer has three parts. First of all, keep in mind that we envision a phase-in of five years. The right way to ask your question, if I may, is if these recommendations had been passed in 1992, then how would that have affected the Asian countries in 1997? May I answer that question that way? Because the point is that if these recommendations are to be phased in, then if we had passed these recommendations even in 1997, they wouldn't have been phased in for five years, so things would have just proceeded more or less as they did.

Now, if the policies had been put in place in 1992 and phased in by 1997, suppose that Korea had qualified. And they might have because of the powerful incentives that Dr. Meltzer talked about for trying to qualify. Well, then, I think that the liquidity available would have been allowed, and the problems in the banking system would have been much less. Suppose they didn't qualify? We still then would allow at the discretion of the IMF, then waiving of the prequalification requirement, but lending at a superpenalty rate, which they could have done.

Now, here is something that Mr. Levinson missed. If you actually look at the flows of funds that went to the Asian countries by the IMF, not the flows that were promised, but the flows that actually went, they were quite small relative to what was promised. There was very little actual liquidity assistance provided by the IMF to those countries, but there were rigid fiscal requirements which Mr. Stiglitz and others have criticized which did affect those economies.

Under our standards, which would not have required the fiscal melt-down in those countries that the IMF imposed, and which would have made funds available on a much larger basis immediately as liquidity protection, that those countries would have fared much better, even if they hadn't prequalified, than they did under the IMF's programs.

Finally, just to note we never said that every country in the world should be an IMF member. We were attaching prequalifications requirements and lending rules to IMF members. I think Mr. Levinson raises an interesting question of who should be allowed to join the IMF. We never dealt with that question. He never made a recommendation that we deal with that question that I can remember, and if he did, I think it is a reasonable question, and I support his view that the IMF shouldn't be available to Nazi Germany.

Dr. Meltzer. I will be very brief. I want to thank you, Mrs. Maloney, for your interest in these issues. They are very important issues from the standpoint of the United States.

Three major reasons why crises have been deep and severe: One is pegged exchange rates collapse; the second is financial systems collapse; and the third one is it takes a long time to negotiate the 40, 50, 60 terms that the IMF imposes on these countries. Our Report says get rid of pegged exchange rates, strengthen the financial systems, make the rate of lending automatic so that it would come quickly. Then the crisis would not have occurred if these things had been in place. Dr. Calomiris has spoken to that, so I won't repeat it.

Let me say also, bear in mind that countries that did not get IMF assistance, that rejected IMF assistance – Malaysia – they recovered as fast and as well as many of the countries that received that assistance. So the assistance came, the big assistance came, because the U.S. became the sink for exports from those countries. That was the proper policy for the United States to follow at the time, but it isn't a good long-run strategy for the U.S. to follow. If we don't deal with the crisis, we are going to be in a position of absorbing those exports all the time to bail them out. Our Report tries to say, let's get rid of the problem, and then we won't be the sink for exports that no one else is willing to take.

Representative Saxton. Thank you very much.

Let me get back to my line of questioning. I indicated that I thought, first of all, I, as the Chairman and now the Vice Chairman of this Joint Committee, have worked with our staff hard and, I might say, tirelessly trying to bring about certain reforms to the IMF which I think are necessary, and I am delighted that it appears there are four our five measures that we have been working for that both the Treasury and your Commission and I tend to agree on.

We talked about the length of terms of loans during the first round of questioning. During this series of questions I would like to talk about the issue that Mr. Sanford brought up, subsidized loans, and then the need for transparency, and then the role, and the important role, the United States plays in bringing about these decisions at the IMF.

First of all, what is the average rate that the IMF charges on its loans? Dr. Meltzer, what is the current—

Dr. Meltzer. I will let him answer that.

Dr. Lerrick. Very simply, Mr. Chairman, for the vast majority of IMF loans, leaving aside the special emergency facility which is relatively new, the IMF takes as its base what they call the SDR interest rate, which is an arithmetic average weighted according to size in the world economy, of the 3-month Treasury bill rates in the United States, France and the U.K. and 3-month interbank and CD rates in Germany and Japan.

Representative Saxton. Doesn't it turn out to be about 4.7 percent currently?

Dr. Meltzer. That is correct. And now they are charging somewhat of a penalty.

Representative Saxton. So if my old clients when I used to be in the real estate business went down to the bank today to borrow money for 30 years to buy a house, how much would they pay here in the United States?

Dr. Meltzer. Now, over 7 percent.

Representative Saxton. So 4.7 percent is a good rate of interest, isn't it?

Dr. Meltzer. Yes, it is.

Representative Saxton. There are two subsidies that I can identify here. Mr. Sanford talked about a subsidized rate. Is there a subsidy which the United States taxpayer pays in order to enable these 4.7 percent loans to be paid? And is there a subsidy which we absorb in a different way because the market rate of interest on loans to other countries would be significantly higher than 4.7 percent? So if our Treasury rate is, say, 6 percent, and we are loaning at 4.7 percent, is that not a subsidy? And is it also not a subsidy if the market would charge, say, 15 percent in some risky venture at someplace in the world, and we are loaning at 4.7 percent, are those not two subsidies which are inherent and current IMF practices?

Dr. Meltzer. Yes and yes. We treat the loan as a short-term loan, whereas many of these loans roll over and over again. So we give them the short-term rate, but the loan goes on for many years. Second – and we have some documentation in our Report about how many years, but I won't trouble you with that.

Second, of course, there is the risk premium. That is the second subsidy. We absorb the risk premium.

Dr. Lerrick. Mr. Chairman, also two other sources of costs, subsidies that you are providing. One is the significant portion of the reserve position of the United States on which there is no interest paid at all. On most of it you receive the SDR rate after adjustments, but there is a portion, which is approximately $2.5 billion, on which no interest is paid at all. In addition, there is a subsidy because the IMF reduces the rate that it pays on the funds that the U.S. provides by an amount to generate provisions for loan losses.

Unlike a private sector institution or most other financial institutions, the IMF shares the cost of providing provisions for loan losses between the borrowers and the lenders. So they are effectively reducing your rate below the 4.7 percent base. The SDR rate may be 4.7, but the IMF is not going to pay you 4.7 percent. It is going to reduce it to less than 4.7 percent in order to build the provisions for loan losses.

Representative Saxton. Thank you.

Let me talk about the American taxpayers' right – or at least their Representatives' rights to understand how the IMF operates and what happens to American taxpayers' dollars. I remember hearing a 5-minute Saturday address by President Clinton, and he started by saying, "I would like to talk about the IMF. It is not a bowling machine," an exact quote. He was saying that because the American people not only don't have access to information about the IMF, but unfortunately because of the arcane way or secret way in which the IMF operates, the American people, the taxpayers and their Representatives, I might add, have a terrible time figuring out what the IMF is doing.

This speaks to the issue of transparency. You have made recommendations in your Report about transparency. I believe that Secretary Summers has also made statements about transparency. Would you comment briefly on this subject?

Dr. Meltzer. Yes. You and your Committee deserve a great deal of credit for bringing this issue to the attention of the American public and staying with it long enough to figure out what some of those balance sheets and income statements really look like. Dr. Lerrick has also worked on that for the Bretton Woods Commission and in cooperation with your Committee. I think that it is absolutely inexcusable that we can't pick up the balance sheet and income statement of the IMF and say, this is how much money they have, this is how much money the United States provides for them, this is our share; that they hide behind numbers like 18 percent when you know we are actually paying 26 percent. And all of those things should be transparent, observable, and open to the American public and to the Congress so that people can make reasonable judgments about what is going on.

Mr. Levinson. Mr. Chairman, just to introduce some minimum balance, it is true that there has been a great deal of criticism of the IMF with respect to transparency, but also let's recognize they are putting much more out with respect to article 4 consultations, summaries. But it is also an international institution, so they have to in many instances get the consents of the governments who are providing confidential information with respect to the economy and finances of the country. But certainly anyone, I think, who knows anything about this would say there is a great deal more information now available.

Secondly, it isn't as if we don't have a representative in these institutions. We have an executive director, a treasury. The Congress can call that representative up and does call her up to testify on the subject matter. The IMF, it seems to me, is not a mystery. It is a credit union. The difference between a normal credit union and the IMF is that instead of taking the members' money and loaning it to the other members, they have what they call an exchange of assets. They purchase the currencies. That creates the element of confusion and difficulty, and it is very difficult to explain, I agree.

Representative Saxton. Thank you. I am going to move on to my next question. We are going to run out of time here shortly.

I would just like to comment that we had the U.S. representative to the IMF before us, and there were several important questions that she could not answer. You may have read her testimony. Beyond that it has taken us three years to get to some answers.

We believe, in our society – whether it is in local government where in New Jersey we have sunshine laws to open the doors, or whether it is in public hearings like this one where we talk about the American taxpayers' money, or whether it is American taxpayers' money being used and decisions being made by an international organization known as the IMF, that the doors ought to be open. That is a pretty simple concept that we have in this country, and one that we are and I am going to continue to work for.

Let me just talk about now the role of the United States Government at the IMF. This is a very interesting topic. When Karin Lissakers was before us, we asked her how decisions were made at the IMF. There had been some large number, 2,000 decisions made at the IMF. We asked her how many votes had been held, and she said 12 to 14. We were curious and went one step forward and asked, how do you make decisions? She said, well, by consensus. I don't know what that means. I guess they get everybody in the room, and they all just kind of nod their heads, and off they go with the decision.

Now, it is interesting to note that the IMF says that the United States has 17 percent, contributed 17 percent of the money to the IMF. But if you define usable money, the United States – that is, money that is actually usable at the IMF, the United States contributes 26 percent. As a full partner contributing 26 percent, it seems to me that the United States ought to have significant say, more than a consensus, about what decisions are made at the IMF.

Would you like to comment on that, Dr. Meltzer?

Dr. Meltzer. I think in many ways it has a very large say about the decisions that are being made, not through the process that you just described, but through a different process through which the Secretary of the Treasury or his aides talk to the Managing Director of the IMF and tell them what it is that the United States wants the IMF to do, and then most of the people in the room nod their head and agree with that. That is why there is not much voting process that goes on.

The U.S. has a lot of influence in the IMF, but it uses it to carry out what I believe is a very poor and unacceptable policy as far as the American people are concerned. That is, they allocate money to programs that the American people don't get a chance to vote on. It uses this as a way of going through the back door and not asking Congress to appropriate money for projects that it wants to have, whether in Russia or Mexico or some other country. That, I think, is the heart of the question and a big part of the differences between those people who like our Report and those who don't.

Representative Saxton. So if the United States Government contributes all of this money and decided that we wanted – either through legislation or through administrative policy – that we wanted to have shorter-term loans issued to the IMF, that we wanted to restructure the subsidization of interest rates, that we wanted the IMF to open their doors, and that we wanted to exert the U.S. influence in a more dramatic way, we could do that, couldn't we?

Dr. Meltzer. We would go a long way toward getting those reforms, yes, sir. That is my opinion.

Dr. Lerrick. Mr. Chairman, I would like to make one comment. It is important to understand that there is not a single decision in any of the international financial institutions that is not made without the agreement and accord of the U.S. Treasury because the U.S. Treasury can stop any other decision from being made. The U.S. Treasury has veto power over all major decisions. What the U.S. Treasury does, if there is an issue that is important to the U.S. Treasury where it is not in agreement with the rest of the membership, is stop all other programs from going forward in the institution.

So your statement that the U.S. should have significant influence? The U.S. Treasury has more than significant influence in all of the international financial institutions far beyond its percentage ownership, whether it be 26 percent or 17 percent or 13 percent.

Representative Saxton. That is exercised, is it not, through the Department of Treasury, that influence?

Dr. Lerrick. Yes.

Dr. Meltzer. Yes.

Representative Saxton. Now, Secretary Summers has indicated that he thinks it would be a good idea to have shorter-term loans, and less subsidization of rates, and he thought it was a good idea to bring about policy in the IMF that brings about more transparency. So do you expect that those things will happen?

Dr. Meltzer. I light a candle.

Mr. Levinson. I think Dr. Lerrick's statement is really excellent with respect to the fact that the United States has influence. I just want to add one thing. Any director in any one of these institutions has the right to demand an up or down record vote in the board. So if there are decisions by consensus, it is because no director, including our own, has demanded an up or down record vote in which everyone is recorded. But that right exists, and any director can exercise it.

Representative Saxton. The point that I was trying to make is the United States can make – and the point that Dr. Meltzer and Dr. Lerrick were trying to make, and I guess Dr. Calomiris would as well, is that the United States has more than significant influence on decisions that are made, and therefore, if it becomes the policy of this country to make changes at the IMF, it is eminently doable.

Mr. Levinson. They still have to convince the other members. They certainly have influence, but the Europeans and the Japanese also have a significant voice in these institutions. The developing countries are also more assertive. So 26 percent is not 51 percent. There are qualified majorities for recommending new articles or quorums and that kind of thing, that is true, and the United States can use that to block, as Dr. Lerrick has pointed out.

Representative Saxton. Dr. Calomiris.

Dr. Calomiris. I just wanted to emphasize, too, that the ability to veto or stop something is not necessarily the same as the ability to completely transform the institution. So I agree with Mr. Levinson.

Mr. Chairman, if I can have 10 seconds for the record to make a couple of brief clarifications, I want to point out that contrary to what I think the impression was that Mr. Levinson gave early on, the Majority did not support and does not support the idea of allowing the IMF to impose labor market flexibility on other countries. I just want to emphasize that, that we were not – as I think he suggested – arguing that point.

If you look on page 39 of the Report, we actually say this. I just want to be clear that it is not a one-sided discussion in that respect.

Mr. Levinson. I never implied – the Commission Majority.

Dr. Calomiris. I just want to be clear that we were not in favor of the continuing practice of the IMF telling countries how to run their labor markets.

I also want to agree with him largely on the discussion of the Asian crisis, but I want to disagree a little bit. Here I will use my status as an economist and his as a lawyer to tell him that he doesn't, I think, completely understand the subtleties of the substantial agreement that exists among the people he mentioned, Joe Stiglitz, Jeff Sachs, and myself, for example.

I haven't been able to detect in the analysis of the causes of the Asian crisis much disagreement. All of us agree that there are a combination of factors that led to the Asian crisis. All of us have written about it extensively. The bottom line and the most important point is that the Majority's recommendations take care of all of the elements, that is, strengthening domestic financial systems so that the domestic banks don't have perverse incentives, which Mr. Stiglitz has emphasized, Mr. Sachs has emphasized and I would emphasize. That is part of our proposal; providing greater liquidity through the IMF to prevent unnecessary melt-downs, all three people would be in favor of.

So our proposals do not stand or fall depending on what weights you attach to the different explanations of the Asian crisis. I just want to make that clear.

Representative Saxton. Thank you.

So far my questions have all centered around points of agreement between the administration, your Commission, and even the Majority of this Committee. Let me ask a question that I am not sure there has been agreement on.

I went to Russia in November, and one of the primary reasons I went was to try to get the members' of the Russian Duma perspective on what happened to IMF funds that were loaned to Russia. It became very clear to me before, during and after that trip that the IMF does not have effective procedures or safeguards in place to verify information and monitor funds after they are disbursed. And I repeatedly talked about this, back in 1998 and 1999 and, of course, again this year because of the Russian experience that we had.

It seems to me to be quite incredible that an institution entrusted with public funds for over half a century would not have effective accounting controls and safeguards in place to monitor funds that flow through it to other countries. Would you comment on your perspective on that?

Dr. Meltzer. Yes. It is a deplorable fact that when the money goes to the Central Bank of Russia, that the IMF has no knowledge or ability to constrain where that money goes. That is one of the reasons why, in thinking through our World Bank proposals, we tried to come up with a scheme which the money would not go through the central banks, but would be paid to the vendors. I think no one who knows about that system can say that it is anything but a deplorable system, that we have no real mechanisms in place to control corruption.

Mr. Levinson. I think that there is a basic conceptual issue here, Mr. Chairman. The IMF makes the money available to the central bank. It has a negative list, usually, for which the central bank certifies the money will not be used. The central bank can use the money to put it into its reserves. It can pay for imports. It can make the money available for capital investment or borrowing by domestic banks. There is not an indelible ink that is put on IMF dollars that you can then trace through. That is impossible to do. You are dependent upon the—

Representative Saxton. Are you defending the status quo?

Mr. Levinson. No. What I am saying is you have a situation where unless you are going to specify that the money can only be used for imports of a certain nature or some such thing like that, there is no way that you can provide liquidity or balance of payments financing for a country and then follow the money through to its ultimate uses. That defeats the whole purpose of making the money available to meet immediate needs of the country in crisis.

Dr. Meltzer. If we limit the IMF to short-term loans and do the development aid through the system of grants that we propose, then a great part of that problem goes away, Mr. Chairman.

Mr. Levinson. Even the short-term money can't be followed. The money that goes into the central bank can go into the reserves. It never leaves.

Dr. Meltzer. If we give a country that is *in extremis* – and that really is the Commission's proposal; that is, it can only borrow from the IMF when no one else is willing to lend, when the markets are closed – then under those circumstances we can be pretty sure that the money is going to be used – short-term money is going to be used for the designated purpose.

It is true what Mr. Levinson says. We can't tag the dollars to know that they went there, but if they have a balance of payments crisis, they are unable to pay their debt, under those circumstances we give them liquidity aid because no other bank in the world is willing to lend to them, then we can be pretty sure that they are going to use that – that that makes a marginal difference to them in their ability to pay their debt. That really is the purpose of making them a lender of last resort.

Mr. Levinson. You still are not going to be following the individual dollars as to whether it was used for debt repayment or for imports or stayed in the reserves.

Representative Saxton. What Dr. Meltzer is saying is that there will be less propensity to misuse funds if loans are made over a short term, unlike last summer when the IMF disclosed that it had been lied to by the Russian Central Bank in previous loans and at the same time announced approval of a new series of loans for Russia, which I then went to follow, and it was kind of interesting. Members of the Duma decided it was all American bankers' greed that provided for the outflow or missing funds. So it was very interesting.

Well, we are essentially out of time. Dr. Meltzer, I wanted to ask you one final question about legislation that I have introduced relative to IMF reform. I won't go into all of the aspects of it, but it is very similar to the subjects that we have been discussing here, the role of the United States, the length of terms, subsidization of rates, and the need for transparency. Do you generally agree – have you looked at the bill, and do you think it is generally moving in the right direction?

[The bill H.R. 3750, the *IMF Reform Act of 2000*, appears in the Submissions for the Record on page 51.]

Dr. Meltzer. I have read the bill and the press release on the bill, and I think it generally moves in the right direction, sir. I think the idea that you have come up with of using our ability to withdraw our funds, that is, to withdraw our tranches from the Fund, as a way of disciplining the Fund and encouraging them to do things is a step that we would want to take hesitantly, but we should not be unwilling to take.

Representative Saxton. Thank you very much. I want to thank all four panelists for being with us today. Mr. Levinson, Dr. Calomiris, Dr. Lerrick, Chairman Meltzer. You folks have toiled together with some difference of opinion for a long and arduous task that you undertook. We appreciate all of your points of view, and we appreciate very much that you have come out with a work product that we think – that I think personally moves this process forward very smartly. Thank you very much.

Dr. Meltzer. Thank you, Mr. Chairman.

Representative Saxton. The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

It is a pleasure to welcome Dr. Meltzer and our other witnesses before the Committee this morning. Dr. Meltzer served as Chairman of the International Financial Institution Advisory Commission, and the other members of the panel were also associated with this Commission. I would like to compliment you for taking the time and effort to grapple with some of the most complex and challenging issues in economic policy, and producing such an excellent report. Today we plan to focus on the substantive economic and financial issues related to the International Monetary Fund (IMF) and World Bank, and how they relate to proposals for reform.

As one who has been involved in issues related to reform of the IMF for several years, I am encouraged by the emerging consensus that has developed on basic principles. The principles stating that the IMF should provide more transparency, focus on short-term crisis lending, scale-back IMF development lending, and end deep IMF interest subsidies, now enjoy broad support. There is significant agreement on a range of other issues as well.

The main question remaining is how to consistently apply these concepts of IMF reform. Tactical differences in the application of these principles should not be permitted to distract attention from how much consensus has been achieved on basic principles of IMF reform.

For example, recently Secretary Summers has called on the IMF to focus on crisis lending, de-emphasize development lending, and raise at least some IMF interest rates. This is very encouraging to those of us in Congress who have supported these objectives for quite some time, and thus welcomed Summers' embrace of IMF reform. As news reports noted at the time, Summers seemed to borrow heavily from Congressional critics of the IMF and from the expected recommendations of the Meltzer Commission.

Our perspective here at the JEC has focused on transparency and the finances of the IMF. These two issues are closely related, and have important implications for Congress. As a former IMF research director recently said, "the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and indeed, few inside, the Fund understand how the organization works..."

However, the IMF is a publicly financed institution in which the U.S. has a prominent financial and policy making role. Congress has an important responsibility to monitor how effectively taxpayer funds are being used and ensure that adequate safeguards are in place. Obviously, this lack of IMF transparency undermines Congress' ability to carry out this oversight responsibility. We have finally managed to decipher and decode the IMF's accounts, but IMF finances really are not understandable and do not comply with the transparency standards the IMF imposes on others.

Our Committee findings show that the base of IMF financial support is much narrower than officially portrayed, with the U.S. contributing 26 percent of usable resources, and the G-10 contributing 77 percent. Over half the IMF membership contributes virtually no usable funds. Furthermore, in one recent period, 70 percent of IMF credit was owed by just five borrowers. Russia and Indonesia together accounted for one-third of outstanding credit. IMF interest rates are currently about 4.7 percent, far below the market rates available to IMF borrowers, and below the rates available to the most creditworthy nations such as the U.S.

Two years ago the JEC also found that there were no effective safeguards or accounting controls in place to monitor IMF loan disbursements. Billions of dollars would be disbursed by the IMF with no effective accounting controls in place to enable the IMF to verify information and ensure that funds were properly used. Given the rather low public integrity standards in place among many IMF borrowers, this cavalier approach fails to take into account the fiduciary responsibility of the Fund to member countries and their taxpayers. After repeated public embarrassments, and my introduction of legislation mandating IMF accounting controls, it is good to see the IMF finally taking long overdue steps to address some of these issues.

Although most of our research at the Committee has focused on the IMF, reform of the World Bank is also needed. The overlap of IMF and World Bank development activities is acknowledged by each agency, but is apparently not viewed as a problem. Not only is the IMF involved in many development activities, but the World Bank has participated in bailouts during economic crises.

A clear distinction between the different missions of the IMF and World Bank is urgently needed, and this problem also is addressed in the Meltzer Commission Report. The World Bank should focus its efforts on helping the poorest in nations that have no alternative sources of funds, and should do so mostly through grants, not loans, as the Commission recommends. We should reduce the burden of debt on the poorest nations, not perpetuate this problem with more lending from the IMF and World Bank.

The Congressional agenda for reform of the IMF and the World Bank is as ambitious as it is compelling. However, in the case of the IMF, the Congress has provided over one-quarter of the usable resources, more than the three next largest contributors combined. Over time, a continual assertion of Congressional pressure can make a tremendous difference, and this is the intent of the *IMF Reform Act of 2000*, which I have recently introduced. Congress is in debt to Chairman Meltzer and the Commission for providing an excellent blueprint for reform of the IMF and World Bank.

106TH CONGRESS
2D SESSION

H. R. 3750

To reform the International Monetary Fund.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 29, 2000

Mr. SAXTON introduced the following bill; which was referred to the Committee on Banking and Financial Services

A BILL

To reform the International Monetary Fund.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "IMF Reform Act of 2000".

SEC. 2. REFORMS OF THE INTERNATIONAL MONETARY FUND.

(a) IN GENERAL.—The Bretton Woods Agreements Act (22 U.S.C. 286–286nn) is amended by adding at the end the following:

"SEC. 63. REFORMS OF THE INTERNATIONAL MONETARY FUND.

"(a) ANNUAL REPORTS.—

"(1) CONTENTS.—The Secretary of the Treasury shall submit annually to the Committee on Banking and Financial Services of the House of Representatives and the Committee on Foreign Relations of the Senate a written report on whether the Fund has complied with the requirements of subsection (b) throughout the 12-month period covered by the report. If, during such period, the Fund has instituted a quota increase, the report shall document the reasons why it is not feasible for the Fund to obtain sufficient funds from the private sector.

"(2) EFFECTS OF FAILURE TO SUBMIT REPORT OR FAILURE TO CERTIFY IMF COMPLIANCE WITH REQUIREMENTS.—If the Secretary of the Treasury fails to submit the report for a 12-month period before the beginning of the first fiscal year that begins after the end of the 12-month period, or if the report submitted pursuant to this section fails to comply with the preceding sentence or fails to certify that the Fund has complied with each requirement of subsection (b) throughout the 12-month period, then subsection (c) shall apply for such fiscal year.

"(b) REQUIREMENTS.—The requirements of this subsection are the following:

"(1) MARKET INTEREST RATES.—The Fund is prohibited from charging, and does not charge, interest on any loan unless the interest rate is—

"(A) except as provided in subparagraph (B), comparable to the rates of interest in the financial markets, adjusted for risk; and

"(B) is not less than 400 basis points greater than the London InterBank Offered Rate.

"(2) 1-YEAR LOAN MATURITY.—The Fund is prohibited from making, and has not made, a loan with a maturity of more than 1 year after the date on which made.

"(3) LOANS ONLY TO ADDRESS CURRENCY CRISES.—The Fund is prohibited from making, and does not make, a loan except for the purpose of addressing a currency crisis.

"(4) TERMINATION OF ESAF.—The Fund has abolished the Enhanced Structural Adjustment Facility of the Fund.

"(5) RELEASE AND REORGANIZATION OF OPERATIONAL BUDGETS.—The Fund is required to, and does, publish each operational budget of the Fund, with any information that could disrupt financial markets or affect adversely the national security of any country redacted, and is required to, and does, reorganize and restate the publicly available financial statements of the Fund in a manner consistent with the Fund's code of good practices, and with the principles of transparency and accountability.

"(6) NO LOANS FOR COUNTRIES FALSIFYING LOAN DOCUMENTS.—The Fund is prohibited from making, and has not made, a loan to or for the benefit of the government of any country which the Secretary of the Treasury or the Fund has found during the preceding 5 years to have falsified any item of information on any loan documentation submitted to the Fund. In addition, the Fund is required to institute, and has implemented, accounting controls and safeguards to curb potential misuse of loans by borrowers, and in any case in which the controls and safeguards are considered insufficient to prevent such a misuse, the Fund is prohibited from making, and has not made, a loan.

"(7) EXHAUSTION OF OPPORTUNITIES FOR PRIVATE BORROWING BEFORE INSTITUTING QUOTA INCREASE.—The Fund is required to exhaust, and has exhausted, all feasible opportunities to borrow from the private sector before instituting a quota increase for the member countries of the Fund.

"(c) WITHDRAWAL OF AUTHORITY TO MAKE LOANS TO THE FUND; REDUCTION OF RESERVE TRANCHE POSITION OF THE UNITED STATES.—If this subsection applies for a fiscal year—

"(1) the Secretary of the Treasury may not make a loan under section 17 during the fiscal year; and

"(2) the Secretary of the Treasury shall cause the reserve tranche position of the United States at the Fund to be maintained at a level that is not more than $5,000,000,000 less than the lesser of—

"(A) in the case of the first fiscal year for which this subsection applies, the level of the reserve tranche position immediately before this subsection applies; or

"(B) in the case of any other fiscal year, the level at which this subsection required the reserve tranche position to be maintained during the most recent prior fiscal year for which this subsection applied.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect 3 years after the date of the enactment of this section.

SEC. 3. END OF UNITED STATES PARTICIPATION IN AND SUPPORT FOR THE ENHANCED STRUCTURAL ADJUSTMENT FACILITY OF THE INTERNATIONAL MONETARY FUND.

(a) PROHIBITION ON FUTURE FUNDING.—No officer, employee, or agent of the United States may, directly or indirectly, provide any thing of value to the International Monetary Fund for the purpose of providing resources to, or supporting the activities of the Enhanced Structural Adjustment Facility or other concessional lending facility of the International Monetary Fund.

(b) VETO OF USE OF AVAILABLE FUNDS.—Section 5 of the Bretton Woods Agreements Act (22 U.S.C. 286c) is further amended by adding at the end the following: "The director appointed to represent the United States at the Fund shall use every effort to terminate the Enhanced Structural Adjustment Facility of the Fund within one year after the date of the enactment of this sentence. No director appointed to represent the United States at the Fund shall vote for any proposal to use resources of the Enhanced Structural Adjustment Facility of the Fund for any purpose, except for a proposal to abolish the Facility and return any remaining resources to the member countries of the Fund in proportion to the quotas of such countries during calendar year 1975, or to General Resources of the Fund.".

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RANKING MEMBER

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HOWARD ROSEN
STAFF DIRECTOR

OPENING STATEMENT

CONGRESSMAN PETE STARK, RANKING MEMBER
REFORM OF THE IMF AND THE WORLD BANK

April 12, 2000

Last week, the United Nations reported that 1.2 billion people, or about a quarter of the world's population, currently live in poverty. That is 4½ times the number of every man, woman and child in the United States. These 1.2 billion people barely survive on $1 a day.

Half the world's population live on just $2 a day.

These statistics are rather startling, especially given the euphoria over the current prosperity we are experiencing in the United States.

Over much of the last 50 years, the number of people living in poverty has fallen, but since 1996, the number of people living in poverty has actually increased.

If these facts are not enough to get your attention, allow me to provide you with one more. By the time this hearing concludes this morning, more than 1,100 children and 400 adults in places like India, Sudan, and Mozambique, will die due to starvation and hunger-related illnesses. That number will increase to 24,000 by the end of the day.

It should be obvious from these few facts that we are not doing enough to end poverty and improve the lives of all people around the world. It makes me wonder if these so-called "development organizations" that we are discussing this morning are part of the solution or part of the problem.

The amount of global wealth created over the last 50 years is unparalleled in modern history. Given all the achievements, it is difficult to understand why we haven't been able to do more to eradicate global poverty and improve the well-being of all workers and their families. Wealth creation has not translated into poverty reduction. If there is one lesson to be learned from the last 50 years, it is that wealth creation alone is not enough to improve standards of living.

Apparently, the World Bank and the International Monetary Fund have not learned this simple, yet important lesson.

Although these economic institutions established after World War II have contributed to the creation of wealth around the world, they have not succeeded in enabling everyone to share in that wealth. In fact, some might say these same organizations which were established to reduce poverty and economic hardship, have, in some cases, actually made things worse, not better.

In this week's New Republic, Professor Joseph Stiglitz, former World Bank Chief Economist and former member of President Clinton's Council of Economic Advisors, writes that "all the IMF did was make East Asia's recessions deeper, longer and harder."

Recent criticism of the International Monetary Fund and the World Bank is justified. The Fund's effectiveness has been hampered by its almost single-minded focus on economic growth and financial stability and almost total disregard for the well-being of individuals. Both the IMF and the World Bank are captivated by the neo-classical view that fiscal deficits, regardless of their cause, are always bad, and that the only tools available to economic policymakers are interest rates. The Fund and the Bank take advantage of countries when they are most in need, coercing them to adopt policies which will benefit the rich at the expense of the poor. This seems to reflect a gross misapplication of the true objectives of "economic development."

We can no longer afford to turn a blind eye to this arrogance.

The consequences of this arrogance are felt primarily by the country in trouble, but also by other countries around the world. For example, as a result of the Asian financial crisis, US manufacturing employment fell by ½ million jobs. This is equal to the entire population of Washington, DC. Imagine if within a span of 6 months to a year, everyone in DC lost their job, health care, and pension. We are not immune from financial crises which break out in countries on the other side of the globe.

We desperately need to reform these institutions; not destroy them. In fact, we need to do more, not less, to help reduce poverty and economic hardship around the world.

When John Sweeney, President of the AFL-CIO, testified before the International Financial Institution Advisory Commission, he stated that "these institutions are necessary for stable, pro-growth international order." He went on to say, "However, the policies of the International Financial Institutions need to be drastically altered before they can fulfill this important mandate. Their current policies too often hurt workers by imposing draconian conditions designed to promote 'labor market flexibility,' but which actually undermine workers' fundamental human rights to form unions and bargain collectively."

These institutions have ignored labor rights and environmental protection in their single-minded pursuit of growth. Protecting workers and the environment are not barriers to economic development. Just the opposite – the only economic development that can be sustainable over the long run is one which is based on ensuring that all workers enjoy the highest possible conditions and that the environment is protected.

The flip side of the race for profits is the "race to the bottom" in terms of workers' conditions and their living standards. As firms attempt to cut costs, they cut into the livelihood of individual workers and their families. In fact the vast majority of workers around the world do not even enjoy the most basic labor market protections. Instead, labor rights, as well as environmental protection, have become bargaining chips in the current model of globalization.

We need a new model of globalization, one that is founded on the rights of workers, not corporations; one that is more sensitive to the environment, and not indoctrinated by the religion of the free market.

Some claim that labor standards and environmental protection are outside the realm of the IMF and the World Bank. The Bank seems more interested in getting projects approved than making sure that these projects do not harm workers and the environment. The IMF is willing to insist that a country's banking system meet certain reporting requirements, but it is not willing to insist that all workers in a country be afforded certain internationally-agreed upon basic rights. The fact that the Fund and the Bank do not yet have the expertise to advise countries on labor standards and environmental protections, does not mean that these two institutions should ignore these important considerations. Ignorance is no excuse for irresponsibility.

Dr. Meltzer and his colleague suggest little to correct this injustice. They devote pages of their report to which exchange rate a country might have, while giving only scant reference to the need for basic labor standards and environmental protection. Does it really matter if a country has a crawling peg or a pegged currency when 10 year old boys and girls are being forced to work under unsafe and unsanitary conditions? Where are our priorities?

In his dissent of the Commission's report, Mr. Jerome Levinson, whom I welcome to the Committee this morning, calls on the International Financial Institutions to pay more attention to labor standards and environmental protections. Unfortunately, Dr. Meltzer has decided not to allow the public to consider this view. By refusing to include the dissenting reports on the Commission's web site, Dr. Meltzer is guilty of the same lack of transparency for which he criticizes the IMF and the World Bank. The International Financial Institutions Advisory Commission was established by the US Congress, not the IMF. All those interested in reforming the International Financial Institutions should have access to all points of view, not just those of Dr. Meltzer and his colleagues.

In their attempt to make the IMF and World Bank more free-market-friendly, Dr. Meltzer and his colleagues ignore the real challenge to the International Financial Institutions – how to do more to reduce poverty, improve working conditions, protect the environment and avoid financial and economic crises.

Maybe the IMF and the World Bank should issue one less glossy publication extolling the supposed virtues of free-market structural reforms and instead inform the world of labor and environmental abuses so that we might be able to gather the courage to stop them.

I hope that as we debate the intricacies of IMF financing and its gold holdings this morning, we don't lose sight of our primary objective – reducing poverty and economic hardship and protecting the environment while ensuring economic and financial stability.

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Rep. John T. Doolittle Statement for JEC Hearing on Reform of the IMF and the World Bank

I look forward to hearing your proposals to reform the IMF and the World Bank. You have performed a valuable service.

Restructuring and cutting back the powers of the International Monetary Fund is clearly necessary considering its role in recent financial crises across the world.

The record of the IMF as banker to governments in financial distress has not inspired confidence. The IMF egregiously violates sound banking practices, calling into question its condemnation of the poor financial systems of loan recipients. Most recently, the decision to lend to Russia, a country that has defaulted on its debt and shows little dedication to economic reform, demonstrates that the IMF is a poor role model for sound banking.

Although the circumstances leading to financial crisis in Latin America, Asia, and Russia differed in many respects, a common thread was a lack of adequate banking supervision, transparency, and oversight.

Many countries use the banking system as an instrument of development strategy. The government chooses industries and ventures it believes will contribute to development. It then directs credit to these "winners," often by encouraging commercial lenders to favor those industries. This policy undermines the growth of a sound banking system by preventing banks from assessing loan applications on the basis of such criteria as likelihood of repayment and available collateral.

These highly regulated banking systems provide the perfect means for corrupt officials to funnel funds to politically connected industries and individuals. Overall financial instability increases because loan assessments based on economic and business criteria, including financial viability, are suppressed in favor of loans made for political priorities. Such a system produces more bad loans and losses than a banking system based on sound credit practices.

In exchange for billions in credit to governments around the world, the IMF requires countries to implement specific policy changes to address the cause of the financial instability. Broad financial service reform, especially of commercial banking, has become a favorite IMF policy prescription. Typically, this includes writing off bad loans, closing bankrupt institutions, and improving oversight of banking practices.

Would that the IMF followed its own advice. Instead of restricting or denying credit to countries with a record of resisting economic reform, the IMF eagerly enters into loan after loan. The most recent and glaring example of this practice is Russia. Despite over $27 billion in IMF credits since 1992, the

Russian government has been unwilling or unable to reform the economy. It has defaulted on much of its debt. It has even admitted that as much as $50 billion in Central Bank reserves, including IMF loan proceeds, was siphoned off for questionable purposes with the cooperation of Russian officials.

Russia is only the most recent example of decades of poor banking practice on the part of the IMF. Another is Peru, which entered into 17 different arrangements with the IMF between 1971 and 1977 despite repeated failure to meet many of the reform conditions that accompanied the loans. In effect, these IMF loans financed the destructive economic policies that made Peru less able to repay its debt. A third example is the $3.4 billion IMF loan to Mexico only one year after that country had initiated the 1982 Latin American debt crisis by defaulting on its debt.

Despite the IMF's vocal support for sound banking principles, its actions tell a different story. The IMF exports poor banking practice by example. It damages the international financial system when it continues to lend to countries like Russia, a financial black hole.

In an October 1998 statement, the IMF noted that "Markets do not operate well when ... transparency and accountability are lacking, and market participants do not operate under an internationally accepted set of principles or standards." The world economy will continue to suffer so long as IMF actions fail to match IMF rhetoric.

Reform of the IMF and World Bank

by Allan H. Meltzer

Carnegie Mellon University,

American Enterprise Institute,

And former Chairman of the International Financial Institution Advisory Commission

Joint Economic Committee

April 12, 2000

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

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

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

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

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

These statements are entirely in accordance with the majority report.

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

Again, he agrees with the majority report.

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

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

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

The pre-conditions the majority chose are not arbitrary. One is an extension of the type of standards for bank capital that developed countries have now adopted, based on the Basel agreement. Another is based on the WTO's protocol 5 that permits foreign banks to compete in the country's markets. More than fifty countries have accepted this protocol. The remaining conditions require reasonable fiscal policy and the timely release of information on the maturity distribution of sovereign debt. These seem not only unobjectionable but necessary for stability. Experience in Latin America has shown how much economic and financial stability improved, locally and globally, when banks had adequate capital and foreign banks were permitted to compete in Argentina and Brazil.

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

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

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

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

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

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

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

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

Conclusion

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

This administration, even more than previous administrations, has used the international financial institutions as sources of readily available funds to support its foreign policy. If it could not make heavily subsidized long-term loans through these institutions to Russia, China, Mexico, Brazil and other countries whose policies the U.S. wishes to influence, the administration would have to change policy or ask Congress to appropriate the funds. Congress could better perform oversight, would question whether programs are successful and whether they benefit the American people.

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

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

Report of the

INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Allan H. Meltzer, Chairman

Table of Contents

Preface

In the last two decades, large crises in Latin America, Mexico, Asia, and Russia heightened interest in the structure and functioning of international financial institutions. Calls for additional capital for the International Monetary Fund to respond to these crises raise questions about how the Fund uses resources, whether its advice increases or reduces the severity of crises and its effect on living standards.

Growth in private lending and capital investment, and the expanding objectives of the international development banks, raise questions about the adequacy and effectiveness of these institutions. Repeated commitments to reduce poverty in the poorest nations have not succeeded. A large gap remains between promise and achievement.

Disputes about the functioning of the World Trade Organization have increased as its role in service industries expanded. Concerns for the environment and the welfare state clash with concerns elsewhere to maintain open trading arrangements, avoid protection, and spur development.

Frequent, large banking crises focus attention on financial fragility, inadequate banking regulation, and the role of the Bank for International Settlements and its affiliated institutions. Are financial standards inadequate? How should they be improved? What should be done to reduce the role of short-term capital in international finance?

In November 1998, as part of the legislation authorizing approximately $18 billion of additional funding by the United States for the International Monetary Fund, Congress established the International Financial Institution Advisory Commission to consider the future roles of seven international financial institutions:

the International Monetary Fund,
the World Bank Group,
the Inter-American Development Bank,
the Asian Development Bank,
the African Development Bank,
the World Trade Organization, and
the Bank for International Settlements.

The Commission was given a six-months life. It held meetings on twelve days and public hearings on three additional days. All Commission meetings and hearings were open to the public. And, to make its work accessible to a broad public, the Commission established an interactive web site. All papers prepared for the Commission and unedited transcripts of all meetings and public hearings are available on the Commission's web site; http://phantom-x.gsia.cmu.edu/IFIAC. All documents will be published as a permanent record of the Commission's work.

The Commission did not join the council of despair calling for the elimination of one or more of these institutions. Nor did it decide to merge institutions into a larger multi-purpose agency. A large majority agreed that the institutions should continue if properly reformed to eliminate overlap and conflict, increase transparency and accountability, return to or assume specific functions, and become more effective. These changes are most important for the International Monetary Fund and the multilateral development banks, so the report directs most attention to those institutions.

Since it had a short life, the Commission relied heavily on people with expertise gained through years of research or experience working with or for the seven institutions we were asked to consider. We are grateful to all who assisted us by writing papers, on very tight deadlines, to inform us and help us understand the functioning, roles, and responsibilities of these institutions, and the effects and effectiveness of their programs. We are grateful, also, for their suggestions for changes. Many of the authors of commissioned papers contributed further by testifying before the Commission and by answering questions. Other witnesses at Commission meetings and public hearings brought a broad spectrum of opinions that illuminated areas of public concern or supplemented the information in the commissioned papers. A list of the witnesses and authors is included at the end of the report.

The members of the Commission benefited also from the opportunity to meet informally with the Managing Director of the International Monetary Fund, the Presidents of the World Bank and the Inter-American Development Bank, the U.S. Executive Directors of the Fund and the Bank, the Secretary of the Treasury, and their staffs. We are especially grateful to Dr. Stanley Fischer, Acting Managing Director of the International Monetary Fund, and President James Wolfensohn of the World Bank who presented their views and responded to questions at one of our hearings.

The Commission operated under Treasury Department rules. We had the pleasure of working with Mr. Timothy Geithner, Ms. Caroline Atkinson, Mr. William McFadden, Ms. Lauren Vaughan, and many other Treasury personnel.

The Commission's report recommends many far-reaching changes to improve the effectiveness, accountability, and transparency of the financial institutions and to eliminate overlapping responsibilities. These proposals should not be taken as criticism of the individuals who work in and guide these institutions. We have been impressed repeatedly not only by the dedication and commitment of many of the people we met but also by their willingness to assist us, inform us, and supply the information that helped us complete our task.

The Commission depended on the work of a dedicated staff that arranged meetings, organized material, and prepared research reports and drafts of the final report. Their names are listed in the report. Mr. Donald R. Sherk, though not a member of the staff, helped us in numerous ways, improved our understanding of the development banks and allowed us to benefit from his long experience and deep knowledge of their problems and prospects.

I am personally grateful to the members of the Commission who worked together in a spirit of comity and harmony, who gave willingly of their time and counsel, and never complained about the heavy demands placed on them. It has been my great pleasure to work with them. Each of them recognized the important contributions that the international financial institutions have made and can make in the future. They joined enthusiastically in this bipartisan effort to suggest reforms and restructuring that the majority believes will improve the functioning of financial markets, the stability of the world economy, and the incomes of people in rich and poor countries.

Allan H. Meltzer
Chair
March 2000

Votes of the Commission

The Commission approved the following report by a vote of 8 to 3. Voting affirmative were: Messrs. Calomiris, Campbell, Feulner, Hoskins, Huber, Johnson, Meltzer and Sachs. Opposed were: Messrs. Bergsten, Levinson and Torres.

The Commission voted unanimously that (1) **the International Monetary Fund, the World Bank and the regional development banks should write-off in their entirety all claims against heavily indebted poor countries (HIPCS) that implement an effective economic and social development strategy in conjunction with the World Bank and the regional development institutions, and (2) the International Monetary Fund should restrict its lending to the provision of short-term liquidity. The current practice of extending long-term loans for poverty reduction and other purposes should end.**

Executive Summary:
General Principles and Recommendations for Reform

In November 1998 as part of the legislation authorizing $18 billion of additional U.S. funding for the International Monetary Fund, Congress established the International Financial Institution Advisory Commission to recommend future U.S. policy toward seven international institutions: the International Monetary Fund (IMF), the World Bank Group (Bank), the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), the African Development Bank (AfDB), the Bank for International Settlements (BIS), and the World Trade Organization (WTO).

The economic environment in which the founders expected the IMF and the Bank to function no longer exists. The pegged exchange rate system, which gave purpose to the IMF, ended between 1971 and 1973, after President Nixon halted US gold sales. Instead of providing short-term resources to finance balance of payment deficits under pegged exchange rates, the IMF now functions in a vastly expanded role: as a manager of financial crises in emerging markets, a long-term lender to many developing countries and former Communist countries, an advisor and counsel to many nations, and a collector and disseminator of economic data on its 182 member countries.

Building on their experience in the 1930s, the founders of the Bank believed that the private sector would not furnish an adequate supply of capital to developing countries. The Bank, joined by the regional development banks, intended to make up for the shortfall in resource flows. With the development and expansion of global financial markets, capital provided by the private sector now dwarfs the volume of lending the development banks have done or are likely to do in the future. And, contrary to the initial presumption, most crises in the past quarter century involved not too little but too much lending, particularly short-term lending that proved to be highly volatile.

The frequency and severity of recent crises raise doubts about the system of crisis management now in place and the incentives for private actions that it encourages and sustains. The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.

High cost and low effectiveness characterize many development bank operations as well. The World Bank's evaluation of its own performance in Africa found a 73% failure rate.[1] Only one of four programs, on average, achieved satisfactory, sustainable results. In reducing poverty and promoting the creation and development of markets and institutional structures that facilitate development, the record of the World Bank and the regional development banks leaves much room for improvement.

The Commission's Aims

In 1945, the United States espoused an unprecedented definition of a nation's interest. It defined its position in terms of the peace and prosperity of the rest of the world. It differentiated the concepts of interest and control. This was the spirit which created the International Financial Institutions and which has guided the Commission's work. Global economic growth, political stability and the alleviation of poverty in the developing world are in the national interest of the United States.

The Commission believes that performance of the IMF, the Bank, and the regional banks would improve considerably if each institution was more accountable and had a clearer focus on an important, but limited, set of objectives. Further, the IMF, the Bank, and the regional banks should change their operations to reduce the opportunity for corruption in recipient countries to a minimum.

Accountability, accomplishment, effectiveness, and reduction in corruption will not be achieved by hope, exhortation, and rhetoric. Programs must be restructured to change incentives for both recipients and donor institutions. Each institution should have separate functions that do not duplicate the responsibilities and activities of other institutions. The IMF should continue as crisis manager under new rules that give member countries incentives to increase the safety and soundness of their financial systems. For the Bank and the regional banks, emphasis should be on poverty reduction and development not, as in the past, on the volume of lending.

[1] Based on World Bank data from the Bank's web site.

IMF

The IMF should serve as quasi lender of last resort to emerging economies. However, its lending operations should be limited to the provision of liquidity (that is, short-term funds) to solvent member governments when financial markets close. Liquidity loans would have short maturity, be made at a penalty rate (above the borrower's recent market rate) and be secured by a clear priority claim on the borrower's assets. Borrowers would not willingly pay the penalty rate if financial markets would lend on the same security, so resort to the IMF would be reduced. It would serve as a stand-by lender to prevent panics or crises. Except in unusual circumstances, where the crisis poses a threat to the global economy, loans would be made only to countries in crisis that have met pre-conditions that establish financial soundness. To the extent that IMF lending is limited to short-term liquidity loans, backed by pre-conditions that support financial soundness, there would be no need for detailed conditionality (often including dozens of conditions) that has burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual.

Four of the proposed pre-conditions for liquidity assistance that we recommend are: First, to limit corruption and reduce risk by increasing portfolio diversification, **eligible member countries must permit, in a phased manner over a period of years, freedom of entry and operation for foreign financial institutions.** Extensive recent history has demonstrated that emerging market economies would gain from increased stability, a safer financial structure, and improved management and market skills brought by the greater presence of foreign financial institutions in their countries. A competitive banking system would limit use of local banks to finance "pet projects," or lend to favored groups on favorable terms, thereby reducing the frequency of future financial crises.

Second, to encourage prudent behavior, safety and soundness **every country that borrows from the IMF must publish, regularly and in a timely manner, the maturity structure of its outstanding sovereign and guaranteed debt and off-balance sheet liabilities.** Lenders need accurate information on the size of short-term liabilities to assess properly the risks that they undertake.

Third, **commercial banks must be adequately capitalized either by a significant equity position, in accord with international standards, or by subordinated debt held by non-governmental and unaffiliated entities.** Further, the IMF in cooperation with the BIS should promulgate new standards to ensure adequate management of liquidity by commercial banks and other financial institutions so as to reduce the frequency of crises due to the sudden withdrawal of short-term credit.

Fourth, **the IMF should establish a proper fiscal requirement to assure that IMF resources would not be used to sustain irresponsible budget policies.**

To give countries time to adjust to these incentives for financial reform, **the new rules should be phased in over a period of five years. If a crisis occurred in the interim, countries should be allowed to borrow from the IMF at an interest rate above the penalty rate.**

Maintenance of stabilizing budget and credit policies is far more important than the choice of exchange rate regime. **The Commission recommends that countries avoid pegged or adjustable rate systems.** The IMF should use its policy consultations to recommend either firmly fixed rates (currency board, dollarization) or fluctuating rates. Neither fixed nor fluctuating rates are appropriate for all countries or all times. Experience shows, however, that mixed systems such as pegged rates or fixed but adjustable rates increase the risk and severity of crises.

Long-term structural assistance to support institutional reform and sound economic policies would be the responsibility of the Bank and the regional banks. **The IMF should cease lending to countries for long-term development assistance (as in sub-Saharan Africa) and for long-term structural transformation (as in the post-Communist transition economies).** The Enhanced Structural Adjustment Facility and its successor, the Poverty Reduction and Growth Facility, should be eliminated.

The IMF should write-off in entirety its claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy in conjunction with the World Bank and the regional development institutions.

In keeping with the greatly reduced lending role of the IMF, the Commission recommends against further quota increases for the foreseeable future. The IMF's current resources should be sufficient for it to manage its quasi lender of last resort responsibilities, especially as current outstanding credits are repaid to the IMF.

The Development Banks

At the entrance to the World Bank's headquarters in Washington, a large sign reads: "Our dream is a world without poverty." The Commission shares that objective as a long-term goal. Unfortunately, neither the World Bank nor the regional development banks are pursuing the set of activities that could best help the world move rapidly toward that objective or even the lesser, but more fully achievable, goal of raising living standards and the quality of life, particularly for people in the poorest nations of the world.

Collectively, the World Bank Group and its three regional counterparts employ 17,000 people in 170 offices around the world, have obtained $500 billion in capital from national treasuries, hold a loan portfolio of $300 billion and each year extend a total of $50 billion in loans to developing members.

There is a wide gap between the Banks' rhetoric and promises and their performance and achievements. The World Bank is illustrative. In keeping with a mission to alleviate poverty in the developing world, the Bank claims to focus its lending on the countries most in need of official assistance because of poverty and lack of access to private sector resources. Not so. Seventy per cent of World Bank non-aid resources flow to 11 countries that enjoy substantial access to private resource flows.

The regional institutions overlap with the World Bank in several ways. They compete for donor funds, clients and projects. Their local offices are often in the same cities. The regionals repeat the World Bank's organizational structure, which focuses on subsidized loans and guarantees to governments, zero-interest credits to the poorest members, and loans, guarantees and equity capital for private sector operations. Recently, the World Bank expanded its field offices, increasing duplication and potential conflict in the regions. The Commission received no reasonable explanation of why this costly expansion was chosen instead of closer cooperation with the regional banks and reliance on the regional banks' personnel.

All the Banks operate at the country level, defining their objectives within the nation-states instead of the region or the globe. Their patterns of lending over the past 3 years are very similar: to the same countries and for the same purposes. Four to six of the most credit-worthy borrowers, all with easy capital market access, receive most non-aid resource flows: 90% in Asia; 80-90% in Africa; 75-85% in Latin America.

Performance is one of the Commission's principal concerns. Ending or reducing poverty is not easy. The development banks cannot succeed in their mission unless the countries choose institutions and government policies that support growth. Developing country governments must be willing to make institutional changes that promote improved social conditions, reward domestic innovation and saving, and attract foreign capital. To foster an environment conducive to economic growth, the development banks must change their internal incentives and the incentives they offer developing countries.

The project evaluation process at the World Bank gets low marks for credibility: wrong criteria combined with poor timing. Projects are rated on three measures: outcome, institutional development impact and sustainability. The latter, central to progress in the emerging world, receives a minimal average 5% weight in the overall evaluation. Results are measured at the moment of final disbursement of funds. Evaluation should be a repetitive process spread over many years, including well after the final disbursement of funds when an operational history is available.

The Banks seldom return to inspect project success or assess sustainability of results. After auditing 25% of its projects, the World Bank reviews only 5% of its programs 3 to 10 years after final disbursement for broad policy impact. Though the development banks devote significant resources to monitoring procurement of inputs, they do little to measure the effectiveness of outputs over time.

Recommendations for the Development Banks

To function more effectively, the development banks must be transformed from capital-intensive lenders to sources of technical assistance, providers of regional and global public goods, and facilitators of an increased flow of private sector resources to the emerging countries. Their common goal should be to reduce poverty; their individual responsibilities should be distinct. Their common effort should be to encourage countries to attract productive investment; their individual responsibility should be to remain accountable for their performance. Their common aim should be to increase incentives that assure effectiveness. The focus of their individual financial efforts should be on the 80 to 90 poorest countries of the world that lack capital market access.

All resource transfers to countries that enjoy capital market access (as denoted by an investment grade international bond rating) or with a per capita income in excess of $4000, would be phased out over the next 5 years. Starting at $2500 (per capita income), official assistance would be limited. (Dollar values should be indexed.) Emergency lending would be the responsibility of the IMF in its capacity as quasi lender of last resort. This recommendation assures that development aid adds to available resources (additionality).

Performance-Based Grants

For the world's truly poor, the provision of improved levels of health care, primary education and physical infrastructure, once the original focus for development funding, should again become the starting points for raising living standards. Yet, poverty is often most entrenched and widespread in countries where corrupt and inefficient governments undermine the ability to benefit from aid or repay debt. Loans to these governments are, too often, wasted, squandered, or stolen.

In poor countries without capital market access, poverty alleviation grants to subsidize user fees should be paid directly to the supplier upon independently verified delivery of service. Grants should replace the traditional Bank tools of loans and guarantees for physical infrastructure and social service projects. Grant funding should be increased if grants are used effectively.

From vaccinations to roads, from literacy to water supply, services would be performed by outside private sector providers (including NGOs and charitable organizations) as well as by public agencies. Service contracts would be awarded on competitive bid. Failure to perform on earlier projects would weigh heavily against participation in future bids. Quantity and quality of performance would be verified by independent auditors. Payments would be made directly to suppliers. Costs would be divided between recipient countries and the development agency. The subsidy would vary between 10% and 90%, depending upon capital market access and per capita income.

Institutional Reform Loans

Institutional reforms lay the groundwork for productive investment and economic growth. They provide the true long-term path to end poverty. Reforms are more likely to succeed if they arise from decisions made by the developing country.

Lending frameworks, with incentives for implementation, should be redesigned to fit the needs of the poorest countries that do not have capital market access. The government of each developing economy would present its own reform program. If the development agency concurs in the merit of the proposal, the country would receive a loan with a subsidized interest rate. The extent of the interest rate subsidy would range from 10% to 90%, as in grant financing of user fees. **Lending for institutional reform in poor countries without capital market access should be conditional upon implementation of specific institutional and policy changes and supported by financial incentives to promote continuing implementation.** Auditors, independent of both the borrowing government and the official lender, would be appointed to review implementation of the reform program annually.

Division of Responsibility

To underscore the shift in emphasis from lending to development, the name of the World Bank would be changed to World Development Agency. Similar changes should be made at the regional development banks.

Development Agencies should be precluded from financial crisis lending.

All country and regional programs in Latin America and Asia should be the primary responsibility of the area's regional bank.

The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East.

Regional solutions that recognize the mutual concerns of interdependent nations should be emphasized.

The World Development Agency should concentrate on the production of global public goods and serve as a center for technical assistance to the regional development agencies. Global public goods include treatment of tropical diseases and AIDS, rational

protection of environmental resources, tropical climate agricultural programs, development of management and regulatory practices, and inter-country infrastructure.

In its reduced role, the World Development Agency would have less need for its current callable capital. Some of the callable capital should be reallocated to regional development agencies, and some should be reduced in line with a declining loan portfolio. The income from paid-in capital and retained earnings should be reallocated to finance the increased provision of global public goods. Independent evaluations of the agencies' effectiveness should be published annually.

Debt Reduction and Grant Aid to the Poorest Countries

The World Bank and the regional development banks should write off in entirety their claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy under the Banks' combined supervision. Moreover, bilateral creditors, such as the U. S. government, should similarly extend full debt write-offs to those HIPC countries that pursue effective economic development strategies.

More generally, the **United States should be prepared to increase significantly its budgetary support for the poorest countries if they pursue effective programs of economic development.** This support should come in several forms: debt reduction, grants channeled through the multilateral development agencies, and bilateral grant aid. The current level of U. S. budgetary support for the poorest countries is about $6 per U.S. citizen ($1.5 billion total), so there is scope for a significant increase in funding if justified by appropriate policies and results within the developing countries.

The Bank for International Settlements

During its 70-year history the BIS has adapted well to large changes in the financial industry and central banking practices. Its ability to adapt was due largely to its limited and homogeneous membership. An example of such adaptation is the way the BIS quickly rose to the challenge of meeting regulatory deficiencies at the international level. The BIS has also demonstrated its ability to convince the most financially important countries to adopt its standards.

The Commission recommends that the BIS remain a financial standard setter. Implementation of standards, and decisions to adopt them, should be left to domestic regulators or legislatures. The Basel Committee on Bank Supervision should align its risk measures more closely with credit and market risk. Current practice encourages misallocation of lending.

The World Trade Organization

The WTO has two main functions. First, it administers the process by which trade rules change. Trade ministers (or their equivalent) negotiate agreements that national legislative bodies can approve or reject. Second, the WTO serves as a quasi-judicial body to settle disputes. Part of this process involves the use of sanctions against countries that violate trade rules.

Quasi-judicial determination, when coupled with the imposition of sanctions, can overwhelm a country's legislative process. As WTO decisions move to the broader range of issues now within its mandate, there is considerable risk that WTO rulings will override national legislation in areas of health, safety, environment, and other regulatory policies. The Commission believes that quasi-judicial decisions of international organizations should not supplant national legislative enactments. The system of checks and balances between legislative, executive and judicial branches must be maintained.

Rulings or decisions by the WTO, or any other multilateral entity, that extend the scope of explicit commitments under treaties or international agreements must remain subject to explicit legislative enactment by the U.S. Congress and, elsewhere, by the national legislative authority.

Chapter 1
Introduction

The postwar financial institutions established at Bretton Woods in 1944 are unique in many ways. The mission of the Bretton Woods institutions was to promote monetary and financial stability, to reconstruct countries devastated by war, and to expand the reach of the market system by offering open trade and market access to all countries. Never before have the victors in war established a framework to promote growth, development, and global prosperity.

These institutions, and the U.S. commitment to maintain peace and stability, have had remarkable results. In more than fifty postwar years, more people in more countries have experienced greater improvements in living standards than at any previous time. With the help of our allies, we have avoided global war. Our former adversaries are now part of the expanding global market system. They seek to achieve the benefits of freer trade and exchange in a system based on growth of personal liberty and increased ownership of private property.

The postwar economic order permitted countries to adopt a strategy of export-led growth. This policy required imports of technology, services, and raw materials that spread prosperity to other countries. The international framework provided a sufficient degree of financial stability to absorb costly oil shocks, regional wars, and occasional financial disturbances.

Expansion of trade, capital flows, and economic activity permitted improvements in health care, longevity, education, and other social indicators. Growth provided resources to solve old environmental problems and address new ones. Peace, economic and social progress, and stability contributed to the spread of democratic government and the rule of law to many countries.

The Congress, successive administrations, and the American public can be proud of these achievements. The United States has been the leader in maintaining peace and stability, promoting democracy and the rule of law, reducing trade barriers, and establishing a transnational financial system. Americans and their allies have willingly provided the manpower and money to make many of these achievements possible. The benefits have been widely shared by the citizens of developed and developing countries.

The dynamic American economy benefited along with the rest of the world. Growth of trade spread benefits widely. Per capita consumption in the United States tripled. As in other countries, higher educational attainment, improved health services, increased longevity, effective environmental programs, and other social benefits accompanied or followed economic gains.

Serious challenges remain. The beneficiaries of globalization must include the poorest members of the world economy. Instability of the world economy must be mitigated.

The Institutions

The principal Bretton Woods Institutions are the International Monetary Fund (IMF) and the World Bank Group (Bank). The initial role of the IMF was to smooth balance-of-payments adjustment in a system of fixed but adjustable exchange rates. The Bank's original charge was to foster postwar reconstruction in war-devastated regions and to encourage economic development by lending to developing countries. Initially, neither institution had the resources or the experience to make major contributions. The Marshall Plan and other assistance from the United States, and the prodigious efforts of people in the war-devastated countries, achieved postwar reconstruction.

Beginning in the 1960s, countries created regional development banks to supplement the Bank's work. The Inter-American Development Bank (IDB, 1959), the African Development Bank (AfDB, 1964) and the Asian Development Bank (ADB, 1966) provide loans and grants for development in their respective regions.

The General Agreement on Tariffs and Trade (GATT) joined the IMF and the Bank in 1948. Through successive rounds of multilateral negotiation, GATT reduced most tariff barriers to negligible values. Nontariff barriers remained. In 1995, GATT ended, replaced by the World Trade Organization (WTO) with broader powers and expanded responsibilities to settle trade disputes. The U.S. economy continued to benefit greatly from the expansion of world trade and participation in the WTO.

New Conditions, New Challenges

The economic environment in which the founders expected the IMF and the Bank to function no longer exists. The pegged exchange-rate system, which gave purpose to the IMF, ended between 1971 and 1973, after President Nixon halted U.S. gold sales. Instead of providing short-term resources to finance balance-of-payment deficits under pegged exchange rates, the IMF now functions in an expanded role as a manager of financial crises in emerging markets, as a long-term lender to developing economies and former Communist countries, as a source of advice and counsel to many nations, and collector of economic data on its 182 member countries.

Building on their experience in the 1930s, the founders of the Bank believed that the private sector would not furnish an adequate supply of capital to developing countries. The Bank, joined by the regional development banks, intended to make up for the shortfall in resource flows. With the development and expansion of global financial markets, capital provided by the private sector now dwarfs any volume of lending the development banks have done or are likely to do in the future. And, contrary to the initial presumption, most crises in the past quarter-century involved not too little but too much lending, particularly short-term lending that proved to be highly volatile.

Beginning with the Latin American debt problems of the 1980s, followed by Mexico's crisis in 1994-95, and the Asian financial and economic problems of 1997-98, parts of the world economy have experienced the largest financial traumas and recessions of the postwar years. Liabilities of bank failures in crisis countries often reached 20% of annual income, a far greater financial collapse than occurred in any developed country, including the United States, during the depression of the 1930s or the banking and U.S. savings-and-loan failures in the 1980s.

The crises in developing countries destroyed large parts of the wealth of their citizens. In an interrelated global economy, financial flows and trade declined, particularly U.S. and European exports and inter-regional exports and imports. The effects spread to other developing and developed countries. The frequency and violence of these crises, and the weakness of many emerging countries' financial systems show the need for a new framework and new policies to restore and strengthen economic stability, growth and development.

The Commission recognizes that financial crises have occurred throughout history and cannot be eliminated entirely. However, the frequency and severity of recent crises raise doubts about the system of crisis management now in place and the incentives for private actions that it encourages and sustains. The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.

High cost and low effectiveness characterize many development bank operations also. The World Bank's evaluation of its own performance in Africa found a 73% failure rate.[1] Only one of four programs, on average, achieved satisfactory, sustainable results.

In reducing poverty and promoting the creation and development of markets and institutional structures that facilitate growth, the record of the World Bank and the regional development banks leaves much room for improvement. Six principal reasons for the development banks' poor record in poverty reduction and institutional reform are:

(1) by far the largest share of the Banks' resources flows to a few countries with access to private capital;

(2) the amount of funds provided by development banks to their largest borrowers is small compared to the private-sector resources received;

(3) the host government guarantee, required by all Bank lending, eliminates any link between project failure and the Bank's risk of loss;

(4) money is fungible so that any linkage between development bank resources and specific projects or policy changes is difficult to trace and often nonexistent;

(5) countries do not implement reforms unless they choose to do so, and they rarely sustain reforms imposed by outsiders; and

(6) development projects typically succeed only if the recipient country has a significant interest in the project and directs its efforts to achieve success.

IMF and Bank Assistance

In the past, the Fund has worked to achieve growth and economic stability by making loans conditional on changes in monetary, fiscal, exchange rate, trade or labor-market policies. The World Bank has added other conditions. Countries often face a long list of conditions that, if followed, would restrict the role of national political institutions and the development of responsible, democratic institutions.

While it is always difficult to know what would have happened in the absence of the IMF's or Bank's conditions, their research, as well as considerable research by outsiders, finds no

[1] Underlying data are from the World Bank's web site.

evidence of systematic, predictable effects from most of the conditions.[2] A recent summary of conditional lending concludes:

"[I]t is now well-accepted that Fund-supported programs improve the current account balance and the overall balance of payments. The results for inflation are less clear...In the case of growth, the consensus seems to be that output will be depressed in the short-run as the demand reducing elements of the policy package dominate."[3]

A main reason for the IMF's modest success is that countries come to the IMF mainly when they have serious problems, often when they are in crisis. The IMF's relatively standard advice includes reducing domestic spending and permitting the country's currency to depreciate. Reducing spending lowers incomes. Reduced spending and a depreciated currency typically improve the current account and may reduce inflation.

If the IMF did not exist, the market would force a country in crisis to follow similar policies. Perhaps the IMF's assistance cushions the decline in income and living standards. Neither the IMF, nor others, has produced much evidence that its policies and actions have this beneficial effect. One reason may be that IMF loans permit some private lenders to be repaid on more favorable terms, so the benefits have gone mainly to those lenders. Or, the IMF's loans may permit governments to maintain spending that remains politically attractive despite its low social value.

The last possibility receives support in recent work at the World Bank. Assessing Aid summarizes the results of experience and research:

"Foreign aid has at times been a spectacular success...

"On the flip-side, foreign aid has also been, at times, an unmitigated failure...

"Financial aid works in a good policy environment....

"Improvements in economic institutions and policies in the developing world are the key to a quantum leap in poverty reduction....

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[2] See Assessing Aid, Oxford University Press for the World Bank, 1998 and, at the IMF, the many papers by Mohsin Khan and his associates, most recently N. Ul Haque and M.S. Khan, "Do IMF-Supported Programs Work? A Survey of Cross-Country Empirical Evidence." IMF Working Paper, November 15, 1999 (unpublished).

[3] Ul Haque and Khan, *op. cit.*, pp. 16-17. Comments made by Graham Bird, when the paper was presented, suggest that the conclusion is supported in several previous studies.

"Aid can nurture reform even in the most distorted environment--but it requires patience and a focus on ideas, not money."[4]

The Commission believes that the effectiveness of foreign aid and progress against poverty would increase and financial crises would be reduced in number, frequency and severity, if current programs of the IMF and the development banks change to focus attention on institutional reform, incentives for improved domestic arrangements and policies, greater transparency and accountability, reduced opportunities for corruption in developing and restructuring countries, and the provision of global public goods. These improvements will yield maximum benefit only if governments continue to foster open markets and further reduce barriers to trade in goods, services, and long-term capital.

The Role of the Commission

The international financial institutions have made signal contributions to prosperity and the spread of democratic government. These institutions have not adapted appropriately to the changes in the economic environment of the past quarter century. A majority of the Commission agrees that the main problems of the international financial institutions are:

- overlapping missions and mission creep;
- lack of transparency and accountability;
- failure to prevent the increasing depth and severity of international financial and economic crises;
- ineffectiveness, corruption in developing countries, and waste of resources;
- commandeering of international resources to meet objectives of the U.S. government or its Treasury Department;
- failure to develop successful regional and global programs to confront transnational problems in agriculture, transportation, forestry, environmental, and health care;
- overuse of conditional lending and the imposition of multiple conditions;
- inability to enforce commitments on borrowers unwilling to meet them, and
- reluctance to reduce lending to countries that do not honor their obligations.

[4] Assessing Aid, *op. cit.*, pp. 1-4. Much additional work at the Bank by David Dollar and his collaborators provides evidence for these conclusions.

Recognizing that international financial institutions have often achieved results at extremely high cost to the citizens of the crisis countries, or failed to achieve their missions, and that the rhetoric of their leadership is often distinctly different from the institutions' accomplishments, Congress established the International Financial Institution Advisory Commission. Its mandate was to examine:

— the effects of globalization, increased trade, capital flows, and other relevant factors on these institutions;

— the adequacy, efficacy, and desirability of current policies and programs at such institutions as well as their suitability for the beneficiaries of such institutions;

— cooperation or duplication of functions and responsibilities of such institutions; and

— other matters the Commission deems necessary to make recommendations pursuant to the preparation of its report.

Congress asked the Commission to report on:

- changes in policy goals set forth in the Bretton Woods Agreements Act and the International Financial Institutions Act;
- changes in the charters, organizational structures, policies and programs of the international financial institutions;
- additional monitoring tools, global standards, or regulations for, among other things, global capital flows, bankruptcy standards, accounting standards, payment systems, and safety and soundness principles for financial institutions;
- possible mergers or abolition of the international financial institutions, including changes in the manner in which such institutions coordinate their policy and program implementation and their roles and responsibilities; and
- any additional changes necessary to stabilize currencies, promote continued trade liberalization and to avoid future financial crises.

At its start, the Commission agreed unanimously to consider the roles and tasks that should be assigned to these institutions if they were created anew in the year 2000. The members recognized that the new or changed roles and assignments might require changes in the institutions' charters, their size and the scope and directions of their activities. It agreed that the economic environment had changed greatly in the more than fifty years since the principal institutions began operations and that the institutions had grown and changed in response to crises and changes in the world economy. Many of these changes were unplanned or opportunistic. Some of the institutions, particularly the World Bank, have become so large and have taken on so many different tasks that effectiveness has been sacrificed. Frequent reorganization and changes of mission have reduced efficiency and wasted resources. Programs that overlap with IMF or regional bank activities have led to conflict and failure to achieve agreed-upon goals.

The Commission believes that to encourage development, countries should open markets to trade, and encourage private ownership, the rule of law, political democracy and individual freedom. Market economies work best when they operate in an environment where national governments and international institutions follow predictable policies that maintain economic stability, protect political freedom and private property, and sustain incentives for efficient, purposeful behavior leading to wealth creation that benefits all members of the society.

The principal role of public-sector institutions is to provide global public goods, create and maintain the framework and rules that permit the private sector to function productively, generating wealth to reduce poverty and pay for social improvements. Effective international financial institutions can contribute importantly to this process.

In drafting its recommendations, the Commission sought to encourage these desirable outcomes by:

(1) assigning specific responsibilities to particular institutions, avoiding overlap wherever possible;

(2) increasing transparency of aims, decisions, and financial statements, and accountability for achievements and effectiveness;

(3) relying more on incentives and local decision-making and much less on programs and conditions imposed by multilateral agencies;

(4) sustaining and expanding opportunities for trade and sustainable, long-term capital movements; and

(5) increasing incentives for institutional reform, expansion of markets, and prompt provision of reliable information about economic, financial, and political changes.

The United States has a large role in the world economy. It is a leading exporter and importer of goods and services. U.S. citizens own, directly or through corporations and institutional investors, $2 to $3 trillion of foreign assets.

The U.S. interest is not entirely commercial, financial or mercantile. With the help of other democratic, market economies we have been the leader in spreading democracy, the rule of law, and economic stability. U.S. efforts to restructure international financial institutions should continue this tradition of leadership by fostering arrangements appropriate to the new environment these efforts will create. Reforms are necessary to enable the international financial institutions to play an important role in promoting growth, stability, and responsible, democratic government for the next 50 years and beyond.

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Chapter 2

The International Monetary Fund

Near the end of World War II, forty-four nations, led by the United States, met at Bretton Woods, New Hampshire to establish postwar economic and financial arrangements designed to prevent a return to the economic instability of the interwar years. The common diagnosis of interwar problems found the causes in competitive devaluations of principal currencies, exchange controls on current account transactions, protective tariffs and other restrictions on trade and payments. To prevent a reoccurrence of monetary and financial instability, the Conference established the International Monetary Fund (IMF).

The Articles of Agreement state that the IMF seeks to promote international monetary cooperation, facilitate the expansion of international trade, promote exchange-rate stability and avoid competitive depreciation. The agreement established a multilateral system for international payments for goods and services that assisted member states to correct balance-of-payments problems, while avoiding measures destructive of national and international prosperity.

The IMF's early goals reflected three main assumptions that the founding countries believed would, and should, characterize future financial relations:

(1) The world economy would remain on a system of fixed, but adjustable, exchange rates tied to gold or the dollar with the gold price fixed at $35 per ounce.

(2) After an initial postwar economic adjustment, payments for goods and services would be free of exchange controls.

(3) Capital account transactions such as lending, borrowing, investing, and repaying could be subject to exchange controls at the discretion of the home country government.

The founders expected the IMF to make short-term loans to assist countries with payments deficits and to advise countries that failed to remove controls on current account. Over the years, the IMF has increased the frequency and scope of consultations and advice. It now engages all members annually about their economic conditions and policies. These consultations, requiring huge documentation, consume more person-hours than any of the IMF's other activities.

Two of the founders' key assumptions are no longer valid. The fixed but adjustable exchange-rate system ended in August 1971 when President Nixon closed the gold window, ending the U.S. commitment to keep the dollar price of gold at $35 per ounce. In March 1973, major countries agreed that the fixed exchange-rate system would not be restored. Thereafter, currency values would be determined in various ways ranging from freely floating exchange rates at one end to firmly fixed exchange rates at the other.

By 1973, many countries had removed exchange controls on both trade and capital movements. The international economy faced a new challenge--to reconcile growth, low inflation and high employment with open trading arrangements and international capital mobility. The oil shocks of the 1970s and the mistaken economic policies in many countries that produced large deficits and inflation increased the difficulty of achieving these goals and objectives. Nothing in the founding mission or the accumulated experience of the IMF prepared it to deal with these evolving challenges.

Seeking New Roles

The end of the gold/dollar standard meant that the IMF's central mission---supporting a fixed global exchange-rate system based on the dollar---had disappeared. The IMF interpreted its original purposes broadly as it searched for new roles. It took responsibility for dealing with financial and economic problems affecting developing countries or the international economy. It provided advice to developing countries on monetary, fiscal and foreign-exchange policies that it believed to be conducive to stability in the balance of payments, and it offered loans to countries that agreed to follow its advice. The IMF's influence grew significantly during the 1980s, especially as the result of its role in the Latin American debt crises.

In August 1982 the Mexican government announced that it could not service its external debts. The IMF organized and supervised the administration of a plan to reschedule the private commercial debts that the Mexican government had incurred over the previous decade. IMF lending did not channel net new funding to Mexico. Rather it lent the money to enable Mexico to service the debt. Mexico's debt increased, but it avoided default.

The IMF made its loans conditional on the implementation of a package of long-term economic reforms. Many of the conditions required sacrifices by the local population, loss of jobs and deep reductions in living standards.

Other developing countries, particularly in Latin America, found that net private capital inflows declined or became negative. Unable to service their debts, these countries, too, agreed to the IMF's conditions. They borrowed to service their external debts and avoid default. Establishing the conditions was straightforward; enforcing them proved difficult.

It soon became apparent that the growing debt burdens of Latin America's debtor countries were not sustainable, regardless of whether countries followed or ignored IMF advice. IMF assistance postponed debt reduction. The postponement of the inevitable debt write-down and restructuring was costly. It delayed renegotiation of the debt and the resumption of capital inflows, investment and economic growth. As a result the decline in living standards was deeper and more prolonged. During the 1980s, as the unpaid principal and accumulated interest rose, Latin America remained stagnant. Many critics of the IMF policy of lending to countries that could not service their debts viewed this policy as contributing to the delay of the necessary restructuring process and subsequent recovery.

Write-downs of Latin American debts were finally agreed upon at the end of the 1980s, under the Brady plan. On average, creditors wrote off about one-third of the face value of outstanding claims.

By the early 1990s, developing economies had experienced renewed growth of international trade and widespread privatization of state-owned enterprises. Many liberalized financial sectors and reformed fiscal and monetary policies. These changes ushered in a new era of large capital flows, especially to Latin America, Asia, and the transition economies of eastern and central Europe. Capital flows of the early 1990s were larger relative to income than at any time since the end of the 19th century. Unlike the earlier postwar years, the source of the funds was mainly from private lenders and investors. Much of the capital went to private firms and banks in developing countries.

The collapse of the Soviet Union and mass privatizations in eastern and central Europe, and the establishment of new fiscal and monetary institutions throughout the region, offered another opportunity for the IMF to expand its purview. Pressed by the United States and other industrial countries, the IMF undertook to advise and support the transformation of the former Soviet Union and its allies from socialist command and control to market economies with private ownership of the means of production and distribution. The IMF was ill-equipped for this task; it had no previous experience to guide it. Moreover, reliance on IMF funding bypassed the appropriations process in the U.S. Congress and foreign parliaments, a process that is the centerpiece of democratic government.

The new tasks undertaken by the IMF in the 1980s and 1990s transformed the institution from a short-term lender to support balance-of-payments adjustment to a source of long-term, conditional lending and macroeconomic advice to developing and transforming countries. With the assumption of this new role, the number, size, type and duration of long-term loans increased markedly. With the new tasks came new requests for increases in members' quotas or subscriptions.

The IMF is currently involved in structural adjustment programs in some seventy countries. Many have received IMF credit for more than twenty years. Four countries have remained almost continuously in debt. Table 2-1 shows, for the period 1949-99, the number of years during which countries have been in debt to the IMF.

Table 2-1
Years of Indebtedness by Countries
1949-99

Number of	Less than 10	10-19	20-29	30-39	40-49
Countries	29	25	46	20	4

Note: The table excludes countries that joined in the 1990s and first borrowed in 1995 or later.
Source: IMF.

Whatever the wisdom of these programs, their longevity is a clear sign that the IMF has departed from the principle of providing member states exclusively short-term balance-of-payments assistance as envisaged by its founders.

Transformation of the IMF into a source of long-term conditional loans has made poorer nations increasingly dependent on the IMF and has given the IMF a degree of influence over member countries' policymaking that is unprecedented for a multilateral institution. Some agreements between the IMF and its members specify scores of required policies as conditions for continued funding. These programs have not ensured economic progress. They have undermined national sovereignty and often hindered the development of responsible, democratic institutions that correct their own mistakes and respond to changes in external conditions.

Crisis Management

IMF assistance to developing countries increased in both scale and scope in the 1990s. These changes reflect the IMF's enlarged role in managing financial crises and the size and depth of recent crises.

1994-95: The Mexican Crisis

The 1994-1995 Mexican crisis is seen by many as a watershed in the history of the "new" international monetary system and the "new" IMF. It raised important questions about the effectiveness of IMF assistance in preventing such crises. Mexico had been the largest single recipient of IMF credit during the six years leading up to the crash of the Mexican peso in December 1994. With its loans it received frequent advice, conditions, and visits by IMF officials and staff. After the crisis, the IMF approved an eighteen-month standby credit worth $17.8 billion, the largest financial package ever granted a member state and one clearly beyond the borrowing limits that the IMF had always maintained. The U.S. Treasury offered to provide up to $20 billion in additional funds through its Exchange Stabilization Fund and the Federal Reserve's swap network. According to the General Accounting Office (GAO), Mexico eventually used some $13 billion of IMF money and $13.5 billion of U.S. official funds.

The Mexican program established several bad precedents. Congress had shown that it opposed a large expenditure to aid Mexico. The Treasury used the Exchange Stabilization Fund to circumvent the Congressional budget process. And the IMF circumvented established procedures for approving loans and limiting their size in relation to the borrower's IMF quota.

The IMF and the U.S. Treasury view the Mexican bailout as a success. It certainly enabled the Mexican government to redeem some of its debts (tesobonos) as they matured. These were short-term, dollar-linked bonds that the government had issued in an unsuccessful attempt to avoid devaluation. Thus foreign private investors avoided large losses. The IMF-Treasury bridge loan allowed the Mexican government to maintain its debt payments, support insolvent Mexican banks, and protect many insolvent bank borrowers from being forced to repay their debts.

After the IMF, the U.S. Treasury, and the foreign creditors had been repaid, however, the Mexican taxpayer was left with the bill. The cost of the banking system bailout is currently estimated at roughly 20 percent of Mexico's annual GDP. Real income per capita in 1997, despite ups and downs, was no higher in 1997 than twenty years earlier. Real wages of the lowest paid workers, those receiving the minimum wage, have fallen 50% since 1985. Chart 2-1 shows these data.

As Chart 2-2 shows, Mexico's total (public and private) external debt, expressed in 1996 U.S. dollars, has grown fivefold over the period since 1973, or fourfold when expressed on a per capita basis. Real wages are lower and the burden of financing the debt is much higher for each Mexican worker.

The IMF is not entirely responsible for these failures. Policies of Mexico's government and changes in international oil prices have a role. But Mexico is one of the IMF's largest clients. Either IMF policy prescriptions have not worked, or the IMF has continued to lend despite Mexico's past failures to follow IMF policy conditions and advice.

1997-98: The East Asian Crisis

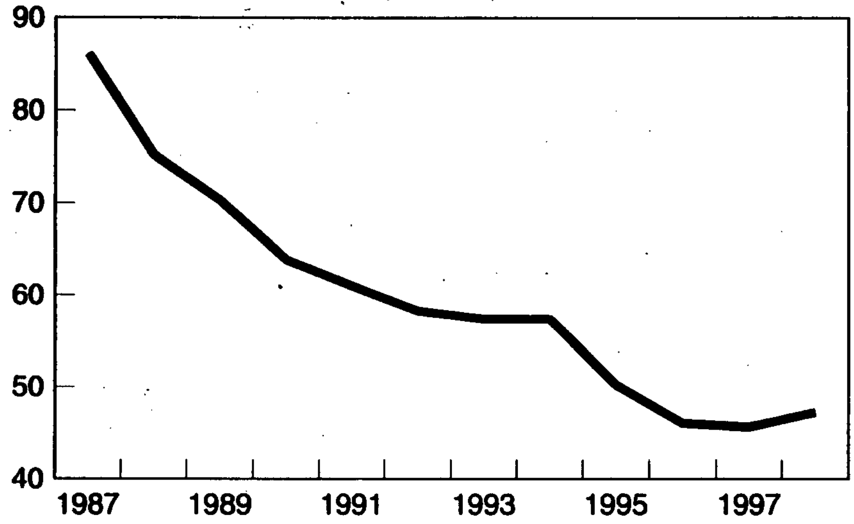
The East Asian crisis erupted in the summer of 1997 and went on to reverberate around the world. This crisis occurred for different reasons than the Mexican crisis and involved far larger capital movements. Its impact on the rest of the world was correspondingly greater and, not surprisingly, the IMF increased its promised assistance to more than $100 billion, much more than in the Mexican program.

The IMF's actions in Asia have been criticized on several counts. First, it provided no public warning of the impending catastrophe despite evidence that the IMF was aware of the problems developing in Thailand. Second, critics of the IMF's intervention in East Asia complained that liquidity assistance was too slow and inadequate, partly as a consequence of the many conditions attached to disbursement. Third, critics claimed that the policy conditions set by the IMF were inappropriate, designed for countries with large budget deficits and high

Chart 2-1

Real Minimum Wages in Mexico

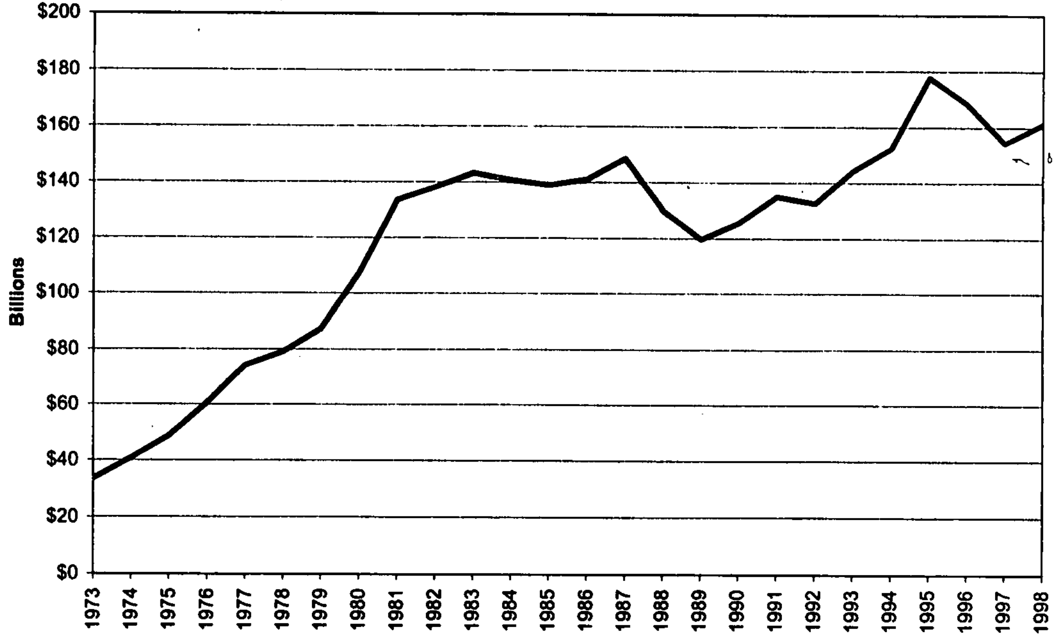
Minimum Wage/Consumer Price Index
(1985=100)



Source: Bank of Mexico

Chart 2-2

Mexico, Real Total External Debt (1998 Dollars)



* Nominal dollar value of external debt is deflated by the U.S. GDP deflator indexed to a 1998 base.
Source: Bank of Mexico

inflation. The causes of the Asian crisis were very different. Cutting government expenditure, raising taxes, raising interest rates and closing banks aggravated the crises. These criticisms were not universally accepted, but the IMF subsequently modified some of its mandates, implicitly accepting some of the criticism.

Critics also claimed that, by preventing or reducing the losses borne by international lenders, the IMF's 1995 Mexican program sent the wrong message to international lenders and borrowers. By preventing or reducing losses by international lenders, the IMF had implicitly signaled that, if local banks and other firm institutions incurred large foreign liabilities and governments guaranteed private debts, the IMF would provide the foreign exchange needed to honor the guarantees. Economists give the name "moral hazard" to the incentive inherent in such guarantees.

The IMF has repeatedly denied this charge. What can be said with certainty is that: (1) to forestall outflows, Thailand, Korea, and others followed Mexico by guaranteeing private debts denominated in foreign currencies, (2) foreign lenders made the subsequent crises much worse by offering large short-term loans before the crisis under the guarantees and (3) as the size of the short-term debt increased, dependence on IMF or foreign government loans became increasingly likely; otherwise the guarantees could not be honored.

The importance of the moral hazard problem cannot be overstated. The powerful root of moral hazard lies in the IMF's encouragement, or lenders' perception of its encouragement, of short-term, foreign currency loans to developing countries, particularly where the domestic banking and financial infrastructure is weak. To address the core problem, the IMF should discourage excessive reliance on short-term borrowing and encourage financial institutions in the borrowing countries to adopt higher standards of safety and soundness. The IMF has belatedly accepted the importance of these problems.

Whether or not the IMF contributed to moral hazard in Asia, it did little to end the use of the banking and financial systems to finance government-favored projects, eliminate so-called "crony capitalism" and corruption, or promote safer and sounder banking and financial systems. Mexico, Asia and, subsequently, Russia and Latin America show the risk to international financial stability created by large short-term, foreign-denominated lending to countries with weak financial and banking systems.

1998-99: The Russian Crisis

Russia relied heavily on IMF lending in the mid-1990s. IMF assistance was supported enthusiastically by the G-7 governments, who sought to support Boris Yeltsin and the reform process in Russia. By using the IMF, the major donor members could supply aid without asking their legislatures to appropriate the money. Increasingly, concern about Russia's political stability---especially given its nuclear capabilities---underlay decisions to provide assistance. Aid continued even when the prospects for reform were bleak and there was little or no economic rationale for assistance. By mid-1998, a number of factors, including a fall in oil prices, a weak financial system, lack of political and economic reform, and the East Asian financial crisis, encouraged private investors in Russia to withdraw their capital. This precipitated a financial crisis for the Russian government and the ruble.

The IMF announcement in July 1998 of more than $20 billion in emergency assistance failed to prevent the collapse of the Russian stock market and a default on Russian sovereign debt. The IMF suspended the program in late 1998 under pressure from the U.S. Congress and other critics, who viewed assistance to Russia's corrupt government as wasteful and counterproductive. In 1999 the IMF resumed assistance.

The role of the IMF in fostering large capital inflows, and the moral-hazard problem of anticipated assistance, is clearest in the case of Russia. The IMF agrees that foreign lenders made loans and bought securities fully expecting that the IMF would facilitate the orderly repayment of hard-currency-denominated debt to foreigners in the event of a crisis. In the view of many lenders, Russia was too important, politically, to fail.

In the event, foreign investors were not protected by IMF assistance. Some observers view the losses suffered by foreign investors in Russia as an antidote to future moral-hazard plays by investors in emerging markets; others see Russia as a special case because of the extreme difficulty the IMF had in making loans to the unstable and kleptocratic Russian government at the time of its crisis. It is not clear that investor losses in Russia will prevent future moral-hazard problems elsewhere.

No less important, the economic results of the program are poor. Although private markets have developed in Russia, there is an immense poverty problem. Russia has not privatized land, reformed its tax system, established a credible rule of law, established a sound financial system with transparent accounting, or raised living standards. Chart 2-3 shows that real income (GDP) has fallen almost every year since the IMF's programs started.

On the positive side, Russia has established a political democracy for the first time in its history. There are many private enterprises, no shortages of goods, and after the 1998 devaluation and the 1999 rise in oil prices, the prospect that output will start to rise.

Summary on the Mexican, Asian and Russian Crises

The crises in Mexico, Asia and Russia were large by any standard. Financial failures wiped out a vast amount of wealth. Gains in income achieved over a decade were, in some cases, destroyed in a few weeks. Poverty increased as living standards fell. This is the most serious cost of these crises.

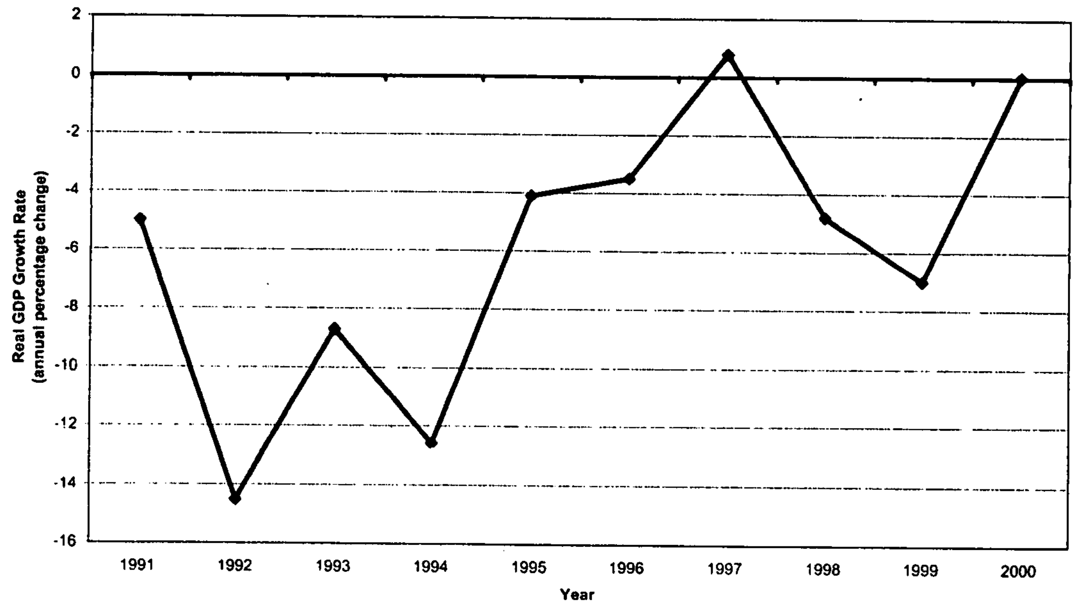
For the United States, there were benefits as well as costs. Import prices fell, thereby permitting consumers to benefit from the decline in prices abroad and the devaluation of foreign currencies. The United States absorbed imports from the countries struggling out of crisis. This has been beneficial to consumers and purchasers of inputs for domestic production but costly to the workers and firms that compete with imports.

The role of the IMF has evolved along with the changing nature, causes and size of the crises faced. While the IMF can point to some successes, it has presided over, and fostered, a crisis-prone system. Moreover, IMF efforts have not been particularly effective, relative to resources utilized, in maintaining financial and economic stability.

There is little evidence that IMF efforts have prevented the periodic financial crises that can set back income growth for many years. IMF programs and prescriptions frequently delay necessary adjustments to emerging problems, resulting in a protracted period of growth suppression. Reform of this system is essential not only for growth and improved living standards in developing countries, but also to avoid the periodic crises that can threaten worldwide financial stability.

Chart 2-3

Russia
Real GDP Growth Rate
(1991 - 1999)



Source: World Economic Outlook. International Monetary Fund. August 1999.

Broadening the IMF's Mission

While some see the crises of the 1990s as reason to limit the IMF's influence and narrow its focus, the IMF and its member governments reacted to recent problems and criticisms by seeking to enlarge the scope of the IMF's role in developing countries. Three recent expansions of IMF authority reflect this conclusion. First, in 1998, the Interim Committee of the IMF endorsed a proposal to amend the IMF charter to add yet another function to the IMF's mission: the promotion of capital account liberalization.

Second, the IMF proposed in September 1999 to transform its Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility. The principal reason for this initiative is the poor economic record of developing countries that receive IMF assistance. In many cases, these economies have contracted over the past twenty years. The IMF has been criticized for not taking the problem of poverty into account when it advises countries.

The ESAF is the mechanism by which the Fund provides concessional lending to poor countries in exchange for macroeconomic adjustment and structural reforms. The new plan requires governments seeking assistance to submit a poverty-reduction plan for IMF approval. With this expansion of IMF programs, the Fund has added the job of making long-term development loans to emerging countries to its long-standing practice of supervising and setting conditions for cyclical macroeconomic policies.

When the Poverty Reduction and Growth Facility is added to its traditional tasks, the IMF will be responsible for monitoring and setting conditions for virtually all aspects of developing countries' economic and social policies. Moreover, the new facility duplicates the responsibilities of the development banks, a source of potential conflict and waste.

Third, the IMF has established a Contingent Credit Line (CCL) facility to offer pre-qualified members immediate access to financing during a liquidity crisis. This was in response to a U.S. Treasury initiative to enhance the IMF's ability to provide rapid liquidity assistance to member countries during an emergency. The CCL is so poorly designed that, to date, no country has applied.

The CCL has four serious flaws. First, availability of CCL credit is not automatic but depends on the IMF's judgment that the country has not contributed to its problems. This is a subjective judgment and a possible reason for delay and negotiation. Second, the IMF does not mandate a penalty rate for CCL loans. Once again, the IMF is fostering counterproductive borrowing incentives by offering subsidies. Third, countries must apply in advance for admission to the CCL program. To date, they have been unwilling to do so, perhaps concerned that the application would be interpreted as a sign of impending or potential crisis and, therefore, detrimental to their perceived creditworthiness. Fourth, part of the reason countries have little interest in applying for the CCL is that other channels of IMF assistance remain available. This undermines the incentive for countries to undertake reforms in order to gain access to the CCL.

Old and New Criticisms

The IMF contributed to the remarkable success of the postwar economic order, the IMF has also been criticized from many different perspectives. Here we consider twelve of the principal criticisms. Members of the Commission do not necessarily endorse or subscribe to all of these criticisms. They are listed to summarize the context in which reform must occur and some of the problems that reform proposals must address.

(1) The IMF creates disincentives for debt resolution when it lends to insolvent sovereign borrowers. This is contrary to an early hope that IMF lending to insolvent countries would facilitate debt renegotiation. The opposite often seems to transpire; the provision of an apparently unlimited external supply of funds forestalls creditors and debtors from offering concessions. One commentator wrote:

> "Rather than the policy providing the IMF with a lever to encourage burden sharing by the banks, the banks realized that they could use it as a club in their battle with governments."[5]

Indeed, it is often argued that IMF lending to insolvent sovereign debtors strengthens the long-run bargaining position of creditors by avoiding the short-run crisis precipitated by default on debt service and by involving an agent of creditor country governments in the bargaining process. Countries become more resistant to writing down their debts. There are large potential gains to be achieved by hastening workouts of unsustainable levels of debt. Delay is socially

[5] B. Eichengreen, Toward a New International Financial Architecture: A Practical Post-Asia Agenda. Washington: Institute for International Economics, 1999, p. 71.

costly. Lenders wait for resolution of outstanding claims, so the country cannot borrow for investment and growth. Unemployment rises and living standards fall.

(2) The IMF wields too much power over developing countries' economic policies. The use of IMF resources and conditionality to control the economies of developing nations often undermines the sovereignty and democratic processes of member governments receiving assistance. IMF staff often admit (with pride) that the executive branch of borrowing nations likes to use IMF conditions to exact concessions from their legislatures. While this mechanism may sometimes work to achieve desirable reforms, it often does so by shifting the balance of power within countries in ways that distort the constitutionally established system of checks and balances. A related complaint, often voiced by union advocates, is that the IMF's policies interfere with the rights of workers in developing countries by promoting "labor-market flexibility" as a condition for assistance. The critics regard these policies as inimical to the growth of trade unions in developing nations.

(3) Despite its influence on developing countries, the IMF often fails to enforce its conditions. Enforcement of conditions is not uniform or predictable, and differences in enforcement may reflect the political power of recipients to avoid compliance.

(4) There are shortcomings in the ways the IMF funds itself and in the way it accounts for its funding and reports its financial position. Jacques Polak, a highly influential staff member and later an Executive Director of the Fund, described the problems:

> "The cumulative weight of the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for which the balance sheet...<u>contains no information whatever on the magnitudes of its outstanding credits or its liquid liabilities</u>. More seriously, the Fund's outdated financial structure has been a handicap in its financial operations."[6]

One consequence of this lack of transparency is that member governments do not know whether the Fund has sufficient resources to carry out its missions. Also because many countries pay

[6] J.J. Polak, <u>Streamlining the Financial Structure of the International Monetary Fund</u>. Princeton: Essays in International Finance 216. September 1999, p. 2. Emphasis added.

most of their quota in inconvertible currency, member countries' true shares of funding costs cannot be computed readily. The U.S. share of funding costs has been larger than its quota share and has varied over time depending on the demand for dollars as the form of borrowing from the IMF.

(5) The G-7 governments, particularly the United States, use the IMF as a vehicle to achieve their political ends. This practice subverts democratic processes of creditor countries by avoiding parliamentary authority over foreign aid or foreign policy and by relaxing budget discipline.

(6) IMF interventions---both long-term structural assistance and short-term crisis management---have not been associated, on average, with any clear economic gains to recipient countries. Numerous studies of the effects of IMF lending have failed to find any significant link between IMF involvement and increases in wealth or income.[7] IMF-assisted bailouts of creditors in recent crises have had especially harmful and harsh effects on developing countries. People who have worked hard to struggle out of poverty have seen their achievements destroyed, their wealth and savings lost, and their small businesses bankrupted. Workers lost their jobs, often without any safety net to cushion the loss. Domestic and foreign owners of real assets suffered large losses, while foreign creditor banks were protected. These banks received compensation for bearing risk, in the form of high interest rates, but did not have to bear the full (and at times any of the) losses associated with high-risk lending. The assistance that helped foreign bankers also protected politically influential domestic debtors, encouraged large borrowing and extraordinary ratios of debt to equity. Further, this system encouraged unsafe banking practices including insufficient diversification, excessive political influences on the allocation of bank credit, and excessive reliance on short-term capital to finance long-term investment.

(7) The IMF's governance structure limits its independence to pursue bona fide economic objectives and insulates it from proper accountability. The IMF's management and oversight board are not distinct, its deliberations are not public, and formal votes are rare. If the G-7 finance ministers can agree on a policy that they wish to pursue, for whatever reason, they can use the IMF as the instrument of that policy. The assistance to Russia is a clear illustration.

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[7]This is the conclusion of many studies including S. Edwards, "The International Monetary Fund and the Developing Countries: A Critical Evaluation," *Carnegie-Rochester Conference Series on Public Policy*, 31, 1989, pp. 7-68. N. Ul Haque and M.S. Khan, "Do IMF Supported Programs Work? A Survey of Cross Country Empirical

(8) The IMF has at times encouraged countries to adopt pegged exchange-rate systems. These systems proved to be unsustainable. The reliance on pegged exchange rates increased developing countries' vulnerability to crises.

(9) Economists criticize the IMF staff's economic doctrines, which are the basis for IMF policy guidance. Edwards (1989) provided an early criticism of the IMF approach to economic modeling.[8] Other critics allege that forecasts are biased and inaccurate and that the IMF places excessive emphasis on short-term forecasting. A recent evaluation of the research department found insufficient attention to weak financial sectors in developing countries as a cause of macroeconomic instability.

(10) The IMF's mission has expanded until it overlaps and conflicts with other international financial institutions. Its recent decision to establish a poverty facility puts the IMF into the province of the development banks, weakening accountability and increasing cost. The IMF lacks expertise in poverty alleviation, so the broadening of its mandate diverts funding from the poorer countries to pay for redundant administrative costs.

(11) The IMF is deficient as a mechanism for providing liquidity during crises. The IMF could act as a quasi-lender of last resort during bona fide liquidity crises in emerging market countries. But conditional lending under existing programs---often requiring protracted negotiations for the disbursement of staged releases of funds over a long period of time---is not an effective means of responding to a sudden liquidity crisis.

(12) The IMF relies too much on mandates and conditional lending dictated from abroad and too little on credible, long-term incentives that encourage local decision-makers to act responsibly and reform domestic regulations, laws, institutions, and practices.

This long list of criticisms reflects the enormous responsibilities the IMF has undertaken in the last two decades, the latitude it has been granted to act, the absence of provisions limiting its authority and ensuring its accountability to the public in developed and developing countries, its frequent lack of success in maintaining stability and the high cost of its crisis interventions. By reporting these criticisms, the Commission does not intend to voice unqualified support for each of them. Nor do we mean to suggest that the IMF always fails in its mission. As noted in the introduction, international financial institutions have played useful roles in the extraordinary

Evidence," IMF Working Paper, November 15, 1999, (unpublished). Brealey, R.A. and Kaplanis, E., The Impact of IMF Assistance on Asset Values. Working paper, Bank of England, September, (1999).

[8] See fn. 3 this chapter.

postwar expansion. Many of these contributions occurred, however, under conditions that no longer exist. The Commission also recognizes many examples of the IMF's success in encouraging beneficial policies. At the same time, the Commission takes these criticisms seriously, and its recommendations to improve the IMF's effectiveness and the stability of the international economy respond to their valid aspects.

Recommendations

Six core principles guide our recommendations. These are:

- (1) "sovereignty" -- the desire to ensure that democratic processes and sovereign authority are respected in both borrowing and lending countries;
- (2) "separation" -- the desire to define a set of tasks for the IMF that are distinct from the tasks of other multilateral agencies, to avoid counterproductive overlap;
- (3) "focus" -- establishing clear priorities and placing credible bounds on authority to ensure that the IMF does not continue to experience mission creep;
- (4) "effectiveness" -- designing mechanisms that are likely to achieve desired objectives at reasonable cost while avoiding corruption and other undesirable side effects;
- (5) "burden-sharing" -- ensuring that the burden of financing IMF operations is shared equitably among nations;
- (6) "accountability and transparency" -- ensuring that the governance and accounting structure of the IMF provide accurate information about IMF actions, that IMF officials are accountable for their actions, and that reports are available and understandable.

The Mission of the New IMF

The Commission recommends that the IMF be restructured as a smaller institution with three unique responsibilities which, if properly performed, would increase global stability, improve the functioning of markets, and help countries improve domestic monetary and fiscal policies.

(1) to act as a quasi-lender of last resort to solvent emerging economies by providing short-term liquidity assistance to countries in need under a mechanism designed to avoid the abuse of liquidity assistance to sponsor bail outs and under a system that would not retard the development of those institutions within the recipient country that would attract capital from commercial sources;

(2) **to collect and publish financial and economic data from member countries, and disseminate those data in a timely and uniform manner** that permits market participants to draw useful information about member countries' economic performance across time and across countries; and

(3) **to provide advice (but not impose conditions) relating to economic policy** as part of regular "Article IV" consultations with member countries.

Except in unusual circumstances, where the crises poses a threat to the global economy, loans would be only to countries in crises that have pre-conditions that establish financial soundness.

The IMF should be precluded from making other types of loans to member countries. The current practice of extending long-term loans in exchange for member countries' agreeing to abide by conditions set by the IMF should end. Doing so would avoid duplication with other agencies and ensure that the IMF focuses on a clearly defined set of economic objectives.

The Commission recommends that **long-term institutional assistance to foster development and encourage sound economic policies should be the responsibility of the reconstructed World Bank or regional development banks** under a new mechanism---one designed to increase the probability of achieving bona fide objectives, without exerting excessive control over member countries' policies (see Chapter 3). **The IMF's Poverty and Growth Facility should be closed.**

Participation in IMF Programs

All IMF members should be expected to provide accurate economic and financial information in a timely manner. Increased reliance on private capital flows makes it imperative to improve the quantity, quality, and timeliness of information. Accurate information increases the number of market participants and improves market stability and efficiency.

Developed countries report on their economies and policies to the OECD. Central bankers discuss these topics at the BIS. Finance ministers of the G-7 countries exchange information and report on their problems and prospects at G-7 meetings. OECD members should be allowed to opt out of IMF Article IV consultations. All other countries should be required to participate.

IMF consultations are valuable. They force countries to review systematically and explain their policies and contribute to the development of data sources. **To enhance the value of Article IV consultations, all reports should be published promptly.** The IMF has shown leadership in recent years by encouraging publication and dissemination of its reports. We recommend that publication become mandatory.

The Commission recommends two types of restriction on the IMF's role as quasi-lender of last resort. First, the central banks of large, industrial countries should continue to function as lenders of last resort for their own currencies and financial systems. The IMF does not have, and cannot be expected to have, the resources to protect the payments systems of advanced industrial countries against an internal drain. And these countries have fluctuating exchange rates, so they do not have to respond to an external drain.

Second, **to be eligible to borrow in a liquidity crisis, a member should meet minimum prudential standards. Countries that meet the standards would receive immediate assistance without further deliberation or negotiation.** The IMF would not be authorized to negotiate policy reforms. The policies necessary to improve economic performance and end a crisis are well-known. The IMF's role would be to provide liquidity, promptly, in a financial crisis under strict rules. These rules reflect experience in many financial crises where fragile financial systems could not bear the strain caused by repatriation of foreign capital or reductions in foreign lending. Further, IMF assistance should be limited to illiquid not insolvent borrowers. **IMF (or Development Bank) lending should not be used to salvage insolvent financial institutions, directly or indirectly, or to protect foreign lenders from losses.**

Rules for IMF Lending

First, to limit corruption and reduce risk by increasing portfolio diversification, **eligible member countries must permit freedom of entry and operation for foreign financial institutions in a phased manner over a period of years.** Foreign institutions hold a highly diverse portfolio of loans to borrowers in many countries and different industries. They would be expected to act in much the same way as global industrial companies with assets in many countries; they would stabilize and develop the local financial system. They would benefit by diversifying their risks on the international financial marketplace. Countries would gain from increased stability, a safer financial structure, and from the management and market skills that global banks would impart. A competitive banking system would limit use of local banks to finance "pet projects," or lend to favored groups on favorable terms.

Second, consistent with the Basel Commmittee's recent reform proposal, the Commission believes that bank regulation should incorporate market discipline as a means of measuring and enforcing prudential capital standards. **To establish market discipline in the domestic financial sector and protect the soundness of financial institutions, commercial banks must be adequately capitalized. This can be achieved in different ways including a significant equity base and the issuance of uninsured subordinated debt to non-governmental and unaffiliated entities.** The function of the subordinated debt is to encourage prudent behavior by banks and monitoring by the subordinated investors.

Third, to encourage prudent behavior, safety and soundness **every country that borrows from the IMF must publish regularly the maturity structure of its outstanding sovereign and guaranteed debt and off-balance-sheet liabilities in a timely manner.** Lenders need accurate information on the size of short-term liabilities to assess properly the risks that they undertake.

Fourth, **the IMF should establish a proper fiscal requirement to assure that IMF resources would not be used to sustain irresponsible budget policies.**

Under any system of minimum standards for access to assistance, including the standards used by the central banks of the industrialized countries, the entire financial structure may be put at risk by the inability of one large participant to meet the minimum standards for assistance. This "too big to fail" argument has been used to rescue many insolvent institutions. The responsibility of the lender of last resort should be to the market, not to the individual participant. In recent decades, the collapse of the Penn Central, Drexel Burnham, and Russia have been met by loans to the market and solvent borrowers. Direct assistance was not given to the insolvent entity.

Terms for Lending

The Commission envisions a liquidity assistance mechanism that would be used to alleviate crises when private sector financing is temporarily unavailable. Historical experience suggests that liquidity crises typically last for a matter of weeks or, in extreme cases, for several months. To ensure that liquidity assistance is only used as a last resort, **IMF loans (1) should have a short maturity (e.g., a maximum of 120 days, with only one allowable rollover), (2) should pay a penalty rate** (that is, a premium over the sovereign yield paid by the member country one week prior to applying for an IMF loan), **and (3) should specify that the IMF be given priority in payment over all other creditors, secured and unsecured.**

The penalty rate premium could increase with the length of time the loan remains outstanding. This would provide an incentive for early repayment.

Phase in

The new rules should be phased in over a period of three to five years. If a crisis occurs before the new rules are in place in most countries, countries should be permitted to borrow at an interest rate above the penalty rate. The "super penalty rate" would give countries an additional incentive to adopt the new rules.

Some countries may choose not to adopt the proposed rules. The names of the countries should be disclosed along with their ineligibility for IMF lender-of-last-resort services. Defaults should not always be prevented in these countries or elsewhere.

Ensuring Priority of IMF Claims on Sovereigns

One way to ensure priority of IMF claims is to require security or collateral. There are some practical difficulties in this approach for many countries. For example, commodity exports can serve as collateral, but this is a cumbersome process. Also, it may unintentionally encourage countries not to privatize important export-producing sectors (so that the government can retain control over exports to serve as collateral).

Second, "negative pledge clauses" may prevent some governments from effectively subordinating existing creditors by pledging collateral on new loans. Many existing sovereign debt contracts specifically exempt from negative pledge clauses short-term debt, debt to foreign monetary authorities and multilateral institutions, and debt which is not publicly offered. There are various possible approaches to resolving the legal and practical problems of ensuring IMF priority when negative pledge clauses apply. For example, IMF advances can be treated as "exchanges of assets," rather than as loans, to avoid the application of negative pledge clauses. Another approach, in a crisis, would take advantage of the grace period allowed before the enforcement of negative pledge clause violations (typically 90-120 days). This would permit collateralized (secured) IMF loans of sufficiently short maturity.

Perhaps the most promising and simple approach to ensuring IMF seniority, while waiting for markets and governments to resolve the practical and legal problems of providing collateral, would be to require IMF members to agree to three debt management rules as part of the prequalification requirement for access to IMF liquidity assistance: (1) **Member countries must specifically exempt the IMF from the application of negative pledge clauses in all new sovereign debts issued by the member country.** Most sovereign debt outstanding by developing economies is of relatively short maturity. Within a period not much longer than the phase in, contracts could be amended to give priority to the IMF. Issuers interested in hastening the conversion process could also repurchase outstanding debt, or ask creditors to accept an exchange of new debt (containing the exemption) for old debt. (2) **Borrowers would give the IMF explicit legal priority with respect to all other creditors, secured and unsecured.** (3) **Member countries that default on their IMF debts would not be eligible for loans or grants from other multilateral agencies or other member countries.**

Credit Limits

Credit limits are necessary to restrict the amount of assistance that a country can receive from the IMF. The limit should reflect the capacity of the sovereign to repay its debt to the IMF. A borrowing limit equal to one year's tax revenues might be a reasonable credit limit.

Other Recommendations

Extraordinary Events. The Commission recognizes that countries may need to borrow for reasons other than a liquidity crisis. In such cases, vehicles other than the IMF are available. For example, countries should apply to a multilateral development bank or a United Nations' agency, if emergency assistance to alleviate starvation or disease is called for. Or, if a country undertakes institutional reform or poverty alleviation programs, it should apply for assistance to the development banks.

If extraordinary political events lead some group of countries to determine that they wish to act jointly to provide foreign aid or loans to another nation (as, for example, appears to have been the determination of the G-7 finance ministers in the case of Russia in the late 1990s), the lending countries---acting through appropriate constitutional and parliamentary procedures---should provide the aid directly.

Following a financial crisis, a country will often find that it wishes to undertake institutional reforms. It may want to spread the burden of adjustment to the crisis differently than the market solution. For example, it may wish to shield the weakest or poorest parts of the society from bearing the full burden determined by market processes. Expenditures for these purposes can be financed either domestically, or by borrowing abroad if the country has established credit, or from multilateral development institutions, if the access to capital markets is restricted.

The IMF should not be used as a "slush fund" to satisfy decisions of the G-7 finance ministers or other groups of powerful members. Such practices undermine the IMF's role as a supplier of liquidity, distort the incentives of lenders and borrowers in international capital markets, bypass the budget process in the lending countries and, by imposing conditions, undermine the development of responsible, democratic decision-making in the borrowing countries.

Exchange Rates. A pegged exchange rate is neither permanently fixed nor flexible. A country commits to maintain its exchange rate only as long as it chooses to do so. Pegged exchange-rate systems have proved to be costly and usually unsustainable in a crisis.

Countries have spent billions of dollars and raised domestic interest rates to unsustainable levels in fruitless attempts to prevent devaluation. Stanley Fischer, First Deputy Managing Director of the IMF, summarizes the experience in the 1997-98 Asian crises.

> "It is a fact that all countries that had major international crises...relied on a pegged or fixed exchange-rate system before the crisis; and it is also true that some countries that appeared vulnerable but that had flexible exchange rates avoided such crises. Countries with very hard [firm, non-adjustable] pegs have been able to sustain them. Accordingly, we are likely to see emerging market countries moving toward the

two extremes of either a flexible rate or a very hard peg--and in the long-run, the trend is almost certainly to be towards fewer currencies."[9]

A majority of the Commission agrees with this conclusion. **Countries should choose either firmly-fixed rates or fluctuating rates.** Neither system is ideal for all countries, at all times, and under all conditions. Mixed systems typically work poorly, as they did in Asia.

Rigidly-fixed systems require large reserves or lines of credit. They acquire needed credibility gradually, often only after the country surmounts a crisis. To increase credibility, some countries, adopting a fixed exchange rate, have chosen to establish a currency board or, in a few cases, have taken a strong foreign currency---such as the dollar or the Euro---as their domestic money. The eleven countries that joined the European Central Bank have taken a different route, a common currency internally and a fluctuating exchange rate against the rest of the world.

A critical point is often overlooked. The long-run position of an economy does not depend on the choice of the exchange-rate system. Exchange-rate systems determine how a country adjusts to external events or domestic policies. A fluctuating exchange-rate system adjusts by currency appreciation or depreciation. A fixed exchange-rate system adjusts by raising or lowering the domestic price level relative to foreign prices. The adjustment cannot be prevented in either system, and it occurs quickly with capital mobility.

Two important lessons of experience under many different exchange-rate regimes are: First, countries that follow stabilizing monetary, fiscal (and other) policies can successfully maintain either a fixed or a fluctuating exchange rate. Second, countries that adopt policies that are excessively expansive or contractive have difficulty maintaining a fixed exchange rate or avoiding appreciation or depreciation of a fluctuating rate.

Stabilizing policies are more important than the choice of exchange-rate regime. If domestic policies, or external events, destabilize a country, the country will have to adjust. It is not an accident, but instead a necessary consequence of the adjustment process, that countries with fixed exchange rates---China, Hong Kong, and Argentina---experienced deflation in the late 1990s, while Australia, Canada, the United States, and the Euro adjusted by allowing their exchange rates to appreciate or depreciate.

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[9] Stanley Fischer, "Presentation to the International Financial Institution Advisory Commission." Washington: International Monetary Fund, February 2, 2000, p. 12. The paper is available on the Commission's web site at http://phantom-x.gsia.cmu.edu/IFIAC.

The Commission recommends that countries avoid pegged or adjustable rates. The IMF should use its Article IV consultations to make countries aware of the costs and risks of pegged or adjustable rates.

Debt Renegotiation. The Commission does not approve of the IMF's policies in Latin America in the 1980s and in Mexico in 1995, or in many other cases. IMF loans to these countries protected U.S. and other foreign banks, financial institutions, and some investors at great cost to the citizens of the indebted countries. The loans delayed resolution of the 1980s crises by permitting lenders and borrowers to report the debt as fully serviced.

Many suggestions have been made to change contractual terms or to impose costs on private lenders in a crisis. Most of these proposals seek to share the costs of resolving crises between the public and private sector. The Commission believes that lenders who make risky loans or purchase risky securities should accept the true losses when risks become unpleasant realities.

Proposals for bankruptcy courts, collective action clauses and other contractual changes, or other attempts to share losses between private and public lenders and institutions, raise many unresolved problems. None is problem free. Unlike bank debt, there are often many holders of emerging market bonds, each interested in protecting their own, frequently divergent, interests.

Lee C. Buchheit, an expert on these issues, points out that debt renegotiation practices are evolving rapidly, without official intervention.[10] **The Commission believes that the development of new ways of resolving sovereign borrower and lender conflicts in default situations should be encouraged but left to the participants until there is a better understanding by debtors, creditors, and outside observers of how, if at all, public-sector intervention can improve negotiations.**

Finance and Accounting Reforms. **The IMF's accounting system should be simplified and rationalized to improve transparency. The recent use of gold sales and repurchases as an accounting device for forgiving HIPC debt is an example of budgetary obfuscation which is substantively unrelated to the act of forgiving debt.** Contrivances of this kind have no place in a multilateral lending agency dedicated to increasing transparency of member governments' policies and operations.

[10] Lee C. Buchheit. "Sovereign Debtors and their Bondholders". Prepared for the Commission and presented on February 1, 2000. The paper is available on http://phantom-x.gsia.cmu.edu/IFIAC.

IMF accounts should be reformed to mimic standard accounting procedures for representing assets and liabilities and income and expenses. Loans should be specifically identified in IMF accounts (as opposed to the current practice of including loans under currency and securities holdings), **and loans should be divided according to their maturity and delinquency status** unlike current practice. **Currency holdings should be divided into categories that make their usefulness as a funding resource clear. Currencies should be divided into G-5 currencies, other currencies considered useful for intervention purposes, and nonusable currencies.** Liabilities should be separated from equity. Undrawn commitments under operative credit arrangements should be disclosed. Quotas, reserves, and deferred income should be set forward under a separate heading as equity. Quotas should be divided according to whether they represent contributions from G-5 countries, other possibly useful subscriptions, or subscriptions from countries with nonusable currencies. Undrawn borrowing capacity should be similarly divided into three groups separating G-5 currencies, other usable currencies, and non-usable currencies. Income accounts should recognize all implicit subsidies to borrowers (which would no longer occur under the proposed lending rules.)

The "SDR Department" accounts should be incorporated into the IMF's overall accounts, recognizing countries with SDR holdings above cumulative allocations as net suppliers of credit and countries with holdings below cumulative allocations as net recipients of credit. These net positions should be combined with the countries' reserve positions in the "General Department" to obtain an accurate view of net providers and users of subsidized funding. The Appendix shows a recommended pro forma balance sheet for the IMF.

The Commission's proposal would make the IMF a stand-by lender. Lending would decline, so fewer resources would be required. In keeping with the greatly reduced lending role of the IMF, the Commission recommends against further quota increases for the foreseeable future. The IMF's current resources should be sufficient for it to manage its quasi-lender of last resort responsibilities, especially as current outstanding credits are repaid to the IMF.

In a crisis the Fund should borrow convertible currencies as needed to finance short-term liquidity loans. IMF members would be jointly liable for its borrowings, on a pro rata basis depending on quota shares. Borrowing could either be made from the private sector or from credit lines of member countries.

Transparency. The IMF should conduct its operations in a fully transparent manner. **The IMF should maintain and publish full details of its assistance to each country in a timely manner and should publish its Article IV consultations.**

The IMF should take and record votes at Executive Board meetings and publish summaries of its meetings after a reasonable lag.

Debt Relief. Debt of HIPC countries cannot be repaid under any foreseeable future developments. IMF or other lending to make debt service appear current repeats the mistake made in Latin America in the 1980s.

Private ownership, open markets, and the rule of law encourage growth and development. **HIPC debt should be forgiven in its entirety conditional on the debtor countries implementing institutional reforms and an effective development strategy.**

Appendix

Pro Forma Balance Sheet of the IMF
(amounts in billions as of 4/30/99)

General Department

Assets			Liabilities		
Loans to members		SDR 60.7	Borrowing (1)		SDR 0.0
Short term	19.3		Other liabilities (2)		0.6
Medium & long term	40.4				
Delinquent	1.0		Total Liabilities		SDR 0.6
Currencies & securities		144.3	Equity		
G-5	48.1				
Other usable	32.0		Quotas		SDR 208.0
Non-usable	64.2		G-5	85.0	
			Other usable	56.4	
SDR holdings		3.6	Non-usable	66.6	
Gold holdings		3.6	Reserves		2.6
Charges, interest & other receivables		1.7	Special contingent accounts		2.0
Other assets		0.3	Deferred income from charges		1.0
			Special Disbursement Account		0.7
Special Disbursement Account		0.7			
			Total Equity		SDR 214.2
Total Assets		SDR 214.8	Total Liabilities & Equity		SDR 214.8

(1) The IMF has credit lines totalling SDR 34 billion under the General and New Arrangements to Borrow. Of the total, SDR 19.0 billion represents credit lines from G-5 countries, SDR 11.2 billion represents other countries with usable currencies and SDR 3.8 billion represents countries with non-usable currencies.

(2) Undrawn amounts committed under operative Stand-By and Extended Credit Arrangements plus one-half of amounts committed under precautionary arrangements total SDR 13.1 billion.

Chapter 3
The Development Banks

At the entrance to the World Bank's headquarters in Washington, a large sign reads: "Our dream is a world without poverty." The Commission shares that objective as a long-term goal. Unfortunately, neither the World Bank nor the regional development banks are moving rapidly toward that objective or the lesser, but more fully achievable, goal of raising living standards and the quality of life, particularly for people in the poorest nations of the world.

Collectively, the World Bank Group and its three regional counterparts---the African Development Bank, the Asian Development Bank and the Inter-American Development Bank---employ 17,000 people in 170 offices around the world, have obtained $500 billion in capital from national treasuries, hold a loan portfolio of $300 billion and each year extend a total of $50 billion in loans to developing members.

Unlike financial institutions in the private sector that have measurable bottom lines and stockholders who can leave if performance is unsatisfactory, the Banks' shareholders are permanent and their objectives diffuse. Reviews of performance are subjective, but even the World Bank's self-audited evaluations reveal an astonishing 55-60% failure rate to achieve sustainable results.

There is a wide gap between the Banks' rhetoric and promises and their performance and achievements. The World Bank is illustrative. In keeping with a mission to alleviate poverty in the developing world, the Bank claims to focus its lending on countries denied access to the capital markets. Not so; 70% of World Bank non-aid resources flow to 11 countries that enjoy easy access to the capital markets.

The Banks claim that funding their activities is costless to donor members. We find that the costs to members reached $22 billion a year. The Banks claim that their interest-bearing loans are made at market rates. We find that borrowers in the aggregate benefit from a subsidy of as much as $31 billion annually, $13 billion on interest-bearing loans.

The past decade has seen large changes in the global economy affecting the development banks. The Cold War is over and, with its end, any rationale disappeared for aid to corrupt or unstable regimes that once had strategic importance. Private capital flows now dwarf any foreseeable value of future annual flows from the four multilateral banks.

The Banks have been slow to adapt to these changes by redrawing the line between public and private activities, by identifying their comparative advantage under the new circumstances, by increasing their effectiveness, and by exploiting their individual strengths in a global effort to reduce poverty. Reform is essential to assure that every dollar of aid carries with it incentives that encourage performance and achieve results that can be monitored by independent reviewers.

One new task is paramount if the poorest nations are to be empowered to join the global economic community. There must be an intellectual infrastructure that builds and sustains an environment in which productive investment flourishes, where goods and long-term capital flow freely across national boundaries, and where human and property rights are protected. Functioning legal systems, accounting rules, corporate and financial-system governance, and other institutional reforms will mobilize funds many times greater than all of the resources multilateral institutions will ever command.

The Commission recommends a major restructuring of the four multilateral development banks and the design of aid programs. Some will read our comments as criticisms of the individuals who work in these institutions or of their commitment to their tasks. That would mistake both our intent and our conclusions.

We have been impressed repeatedly by the dedication and concern shown by the staffs we met. Our criticisms are directed at the organization and the incentives under which people work. As evidence of the incentive problems, and the dedication of the staffs, we report that many current and former staff agree with the thrust of our recommended changes and volunteer that these steps would improve the effectiveness of their organizations and the lives of the poorest.

Origin and Description of the Development Banks

The origins of the development banks reach back into what now seems to be international financial pre-history. For the World Bank, at Bretton Woods in 1944, the universal view of the future was: a gold-based international monetary standard, capital controls, trade barriers in former colonies and less-developed economies, infant financial markets, and little private-sector interest beyond national boundaries. The Bank was to be the institutional meeting ground, where rich industrialized members would supply resources and AAA credit support to enable the Bank to gather money in the financial markets and redistribute the funds as loans to emerging members. The eventual goal: the alleviation of poverty worldwide.

Beginning at the end of the 1950s, members from each of the world's key borrowing regions, desiring more control of lending policy, united in three regional banks. Linked by geography, sympathetic by custom and culture, and staffed predominantly by their own citizens, they sought to serve their constituencies better than could a distant institution dominated by industrial countries. At first limited to local membership, all regional banks gradually acceded to the need for expanded funding by joining with the developed countries while retaining the majority vote in regional hands. All now have a roster of outside participants from the entire industrialized world.

Until the 1980s, the development banks were the dominant source of international resources to emerging economies. Knowledge and resource transfer went hand-in-hand to establish the conditions for productive investment. Each of the Banks adopted a similar structure. One part provided development loans to governments at interest rates equal to the institution's cost of capital. A second offered highly subsidized long-term credits to the poorest members. The third provided loans, equity capital and loan guarantees to private-sector firms in emerging economies. The World Bank also offered insurance against political risks. Appendix A names and describes these programs. Appendix B shows the U.S.'s share of investment in each bank.

The last decade of the twentieth century saw the political and economic landscape transformed. With the end of the Cold War, lending as a strategic gesture became outmoded. The need to commit large blocks of capital for containment ended. A new generation of public and private-sector leadership in developing nations, educated in the graduate schools of the West, grew into sophisticated policymakers eager to exercise more control over the use of funds and development. Influenced by successful development and industrialization, particularly in Asia, countries opened their markets; international trade burgeoned; human, technological and financial capital moved more freely. Most importantly, the explosion of the financial markets both in scope and in willingness to assume risk challenged the comparative advantage of the Banks in resource transfer. In the space of 10 years, the international bond markets quintupled—

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from $185 billion in 1988 to $977 billion in 1998. The single year 1998 witnessed 170 bond issues greater than $1 billion in value.

Countries that join a development bank make two financial commitments. They pay in 5% to 7% of their capital commitment on joining. The remainder is "callable capital," subject to call on demand by the development banks. Almost all countries pay their entire paid-in capital commitment in convertible currency. Most of the effective callable capital, if needed to honor the Banks' liabilities, would come from members with convertible currencies.

The Banks differ greatly in size. Currently, the World Bank holds more than 2/3 of outstanding loans and 50% of paid-in capital. The African Bank is by far the smallest -- 5 to 10% of the total on these measures. Table 3-1 shows the comparative data on size, membership, and date of organization.

Distribution of Aid and Lending

Annual World Bank Group lending continues to grow, rising from $1.8 billion in 1969 to $32.5 billion current dollars in 1999. After adjusting for inflation, the Bank has doubled in size in 30 years.

Despite this growth, the relative importance of the development banks has declined markedly. On average for the past seven years, lending and investments by the Banks represented 2% of total private-sector flows to developing countries.[11] In the past seven years, the World Bank provided $18 billion (net) to developing countries. This compares to the $1,450 billion provided by the private sector. The Banks must accept that they are no longer a significant source of funds to the emerging world and that they cannot provide more than a small fraction of what the markets offer.

Officials of the development banks claim that they devote the greater part of their efforts to countries denied access to market financing and to social projects that do not command the interest of private investors. In fact, all of the Banks lend mainly to the most credit-worthy countries, and they demand the host government's guarantee.[12] If the government offered the

[11] A World Bank: Global Development Finance, Washington, 1999.
[12] For the Inter-American Development Bank, replenishment documents attempt to limit the share of lending to the richer countries by setting a maximum target of 65% of lending to the large and rich countries in their region.

Table 3-1

Multilateral Development Banks
($ amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Year of Formation	1966	1959	1964	1945	—
Regional Members	41	28	53	181	—
Non-Regional Members	16	18	24	—	—
Borrowing Members	38	26	53	156	—
Total Loans & Investments Outstanding	$39.3	$39.5	$17.1	$210.4	$306.3
of which:					
government loans	$24.4	$32.3	$9.5	$117.2	$183.4
zero interest credits	$14.3	$6.9	$7.6	$83.2	$112.0
private sector	$0.6	$0.3	$0.0	$10.0	$10.9
Market Investments	$9.5	$12.7	$2.6	$50.9	$75.7
1998 Lending & Investments	$6.1	$10.1	$1.7	$32.5	$50.4
of which:					
government loans	$4.9	$8.8	$0.8	$22.2	$36.7
zero interest credits	$1.0	$0.7	$0.7	$6.8	$9.2
private sector	$0.2	$0.6	$0.2	$3.5	$4.5
Total Offices	15	29	1*	127	172
Total Employees**	2,300	2,200	1,100	11,500e	17,100
Administrative Expenses	$0.2	$0.3	$0.1	$1.6	$2.2
Debt Outstanding	$24.1	$32.9	$7.6	$131.4	$196.0
Paid-In Capital	$3.4	$4.2	$2.8	$14.0	$24.4
Concessional Capital Contributions	$20.6	$9.5	$13.1	$96.3	$139.5
Callable Capital	$45.0	$90.0	$19.6	$177.7	$332.3
Total Capital	$69.0	$103.7	$35.5	$288.0	$496.2
Retained Earnings	$8.6	$7.2	$2.0	$30.0	$47.8
Non-Borrower Member Callable Capital	$27.0	$44.6	$6.5	$103.4	$181.5
G-5 Share of Voting Rights	35%	40%	18%	38%	33%
G-5 Share of Concessional Capital Contributions	79%	63%	49%	72%	70%
G-5 Share of Non-Borrower Member Callable Capital	68%	80%	55%	66%	70%

Data for most recently available fiscal year.
* 25 offices are scheduled to open over the next 5 years.
** Including long-term consultants; World Bank employees: 10,000.

Sources: World Bank; Asian Dev. Bank; Inter-American Dev. Bank; African Dev. Bank same guarantee to a private lender, the private lender would be indifferent about the ultimate use of the funds. The private sector is prepared to finance socially desirable projects with limited cash flow, if the government guarantees to service the debt, as it does when countries borrow from the development banks.

The World Bank's internal auditor (OED) agrees with this conclusion. The auditor has questioned whether the Bank's loans merely substitute capital at advantageous interest rates without providing net additions to available resources (called additionality in Bank jargon), even for social-sector projects. For example, in its review of loans to Brazil's health system, the OED wrote:

> "While financing can be a valuable contribution, Brazil can access the private capital markets with relative ease; it is (therefore) difficult to know whether the [Brazilian] government would have obtained the funds for Bank-financed projects from other sources" [and carried out the projects without World Bank assistance].[13]

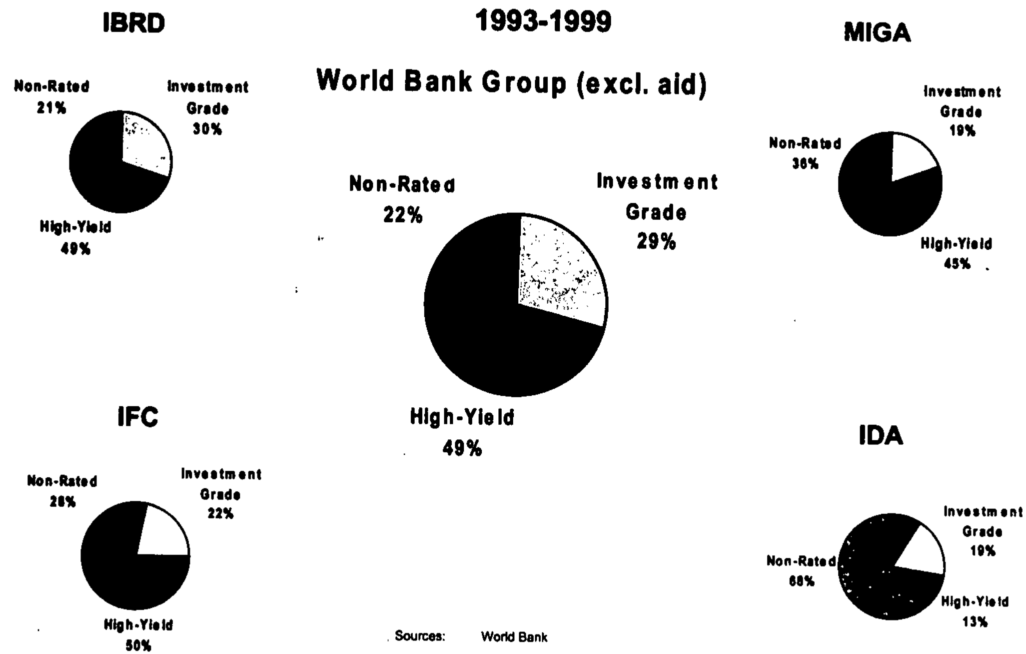
In practice, most World Bank lending goes to countries that borrow in the capital markets. These countries have access to capital at market interest rates. A review of the World Bank Group's 4,100 operations approved over the last 7 years reveals that almost 80% of resources (excluding aid transfers) went to countries with an international bond rating of B or higher. Approximately 30% of resources flowed to nations with an investment grade rating and an additional 50% to countries with high-yield ratings at the time the loan was made. More disquieting, the share of nonrated recipients in the World Bank's International Bank for Reconstruction and Development (IBRD) lending has fallen from 40% in 1993 to less than 1% in 1999. The average for the period was about 20%. See Charts 3-1 and 3-2 on following pages.

The World Bank's rhetoric faults the private sector for concentrating 80% of its loans in a dozen economies. It claims that its own lending provides resources to the entire developing world. In fact, official lending closely parallels private-sector choices. At the World Bank, 11 countries commanded 70% of total nonaid resources over the last 7 years, while the other 145 developing World Bank members were left to divide the remaining 30%. The share of the favored group grew from 63% to 74% between 1993 and 1999: China received 12%; Argentina

[13] World Bank Operations Evaluation Department, Impact Evaluation Report 18142: The Brazil Health System, Washington: June 30, 1998, paragraph 12.

Chart 3-1

Ratings Distribution of Recipients of World Bank Resources

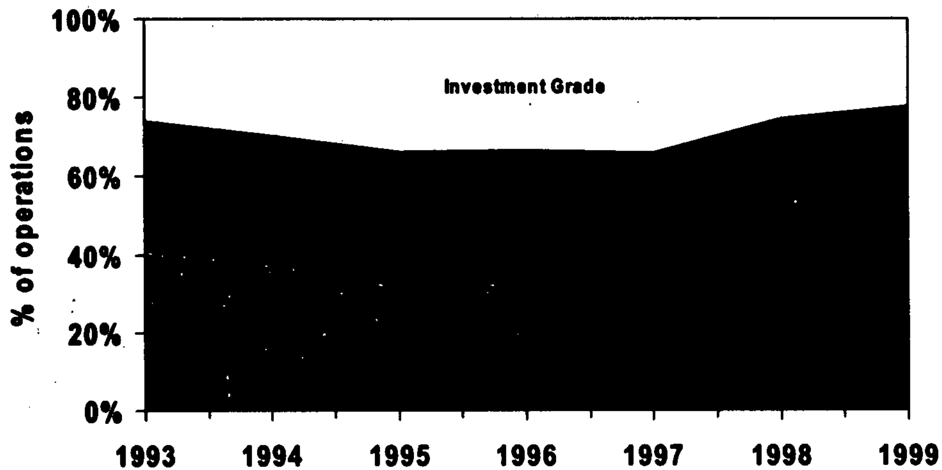


Sources: World Bank
Moody's Investors Service
Standard & Poor's

Chart 3-2

Ratings Distribution of Recipients of World Bank Resources 1993-1999

World Bank Group (excl. aid)



Sources: World Bank
Moodyis Investors Service
Standard & Poor's

10%; Russia 9%; Mexico 7%; Indonesia 7%; Brazil 7%; Korea 6%; India 4%; Thailand 3%; Turkey 3%; Philippines 2%. Though these nations account for a majority of the developing world's population, that criterion should not be decisive. The Banks must focus on the economies that lack access to private sector resources, not just countries with large populations.

Together, the eleven large borrowers received $13 billion in net nonaid resources from the World Bank Group during the last six years. Though a large share of the World Bank's loans, this amount is only 1.4% of the $880 billion originating in private-sector medium and long-term external debt, portfolio equity and direct investment in the same countries.[14] See Chart 3-3.

The skewed lending pattern is not significantly changed when the crisis lending of 1998-99 is omitted. Data for the 1995-96 period, the most prosperous period in the history of emerging economies, show the share of these 11 borrowers at 67% of all World Bank non-aid resources.

The World Bank and the Regionals

The three regional banks together supply an amount of resources equal to about 50% of World Bank offerings. Table 3-2 shows the distribution of loans and credits by bank and type of program. The dominant characteristic is the relatively unchanging size and composition of the individual programs, until a crisis occurs. Inter-American Development Bank (IDB) lending rose in 1995-96, the time of the Mexican crisis and concern about spillover into other Latin American countries. The World Bank, the ADB and the IDB increased their lending to clients during the spreading Asian crisis in 1997 and 1998, and the repercussions in Latin America of Asian and other crises in 1998. See Table 3-2.

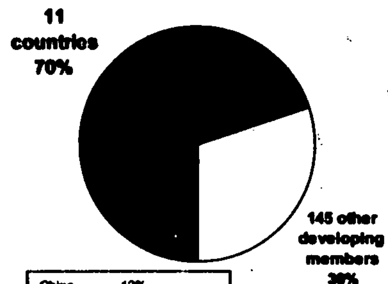
Crisis lending is the responsibility of the IMF, not the development banks. Some officials of these Banks explained that, with hindsight, their involvement in crisis lending was a mistake, an inappropriate use of limited funds justified only, if at all, as an expedient solution to a pressing problem.

[14] Data in this sentence are for the 6-year period (1992-97), most recently available.

Chart 3-3

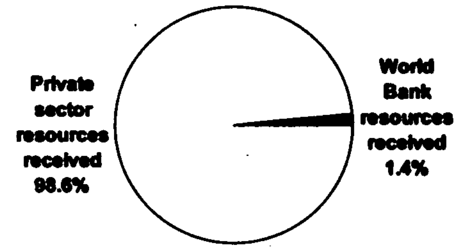
Major Recipients of World Bank Resources 1993-1999

Share of World Bank Non-Aid Flows



China	12%
Argentina	10%
Russia	9%
Mexico	7%
Indonesia	7%
Brazil	7%
Korea	6%
India	4%
Thailand	3%
Turkey	3%
Philippines	2%
11 countries	70%

World Bank vs. Private Sector Flows for 11 Major Recipients



Source: World Bank

Table 3-2

Multilateral Development Bank Activities
(amounts in billions)

	1992	1993	1994	1995	1996	1997	1998
World Bank Group:*							
IBRD Lending	$16.9	$14.2	$16.9	$14.5	$14.5	$21.1	$22.2
IDA Credits	6.8	6.6	5.7	6.9	4.6	7.5	6.8
IFC Investments	2.1	2.5	2.9	3.2	3.3	3.4	3.5
MIGA Guarantees	0.4	0.4	0.7	0.9	0.6	0.8	1.3
Asian Development Bank							
ADB Government Lending	3.8	3.7	2.5	4.0	3.5	7.7	4.9
ADF Credits	1.2	1.3	1.2	1.5	1.7	1.6	1.0
ADB Private Sector Investments	0.1	0.2	0.1	0.2	0.2	0.1	0.2
Inter-American Development Bank							
IADB Government Lending	5.5	5.5	4.7	6.3	6.2	5.3	8.8
FSO Credits	0.5	0.4	0.5	0.8	0.4	0.3	0.7
IADB Private Sector Investments	---	---	---	0.1	0.2	0.3	0.6
African Development Bank							
AfDB Government Lending	1.9	1.6	1.4	0.7	0.5	0.8	0.8
AfDF Credits	1.1	0.8	---	---	0.3	1.0	0.7
AfDB Private Sector Investments	---	---	---	---	---	---	0.2
Total	$40.2	$37.2	$36.5	$39.0	$36.2	$50.1	$51.6

*World Bank figures are for fiscal year ending June 30 of following calendar year.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

The Commission concurs; the mission of development banks should not include crisis lending. Their active participation in crises should be limited to institutional reform loans and poverty alleviation programs to reduce the costs borne by the poor and displaced.

The regional institutions overlap with the World Bank in several ways. They compete for donor funds, clients and projects. Their local offices are often in the same cities. The regionals repeat the World Bank organizational structure, which focuses on subsidized loans and guarantees to governments, zero-interest credits to the poorest members, and loans, guarantees and equity capital for private-sector operations. See Table 3-2. Recently, the World Bank expanded its field offices, increasing duplication and potential conflict in the regions. The Commission received no reasonable explanation of why this costly expansion was chosen instead of closer cooperation with the regional banks and reliance on the regional banks' personnel.

All the Banks operate at the country level, defining their objectives within the nation-states instead of the region. Their patterns of lending over the past 3 years are very similar: to the same countries and for the same purposes. Four to six of the most credit-worthy borrowers, all with easy capital market access, receive most nonaid resource flows: 90% in Asia; 80-90% in Africa; 75-85% in Latin America. Pure public-sector finance (excluding social expenditures on health, education, urban development, infrastructure, environment, and general social sectors) received 35 to 40% of total flows across all regions and among all institutions. Table 3-3 shows these data.

Countries with Little Market Access

Many countries have either very limited access to capital markets or none at all. IDA, the aid arm of the World Bank Group, assists mainly countries without capital market access. Countries not rated for capital market access receive 68% of IDA's loans and assistance. IDA's assistance was about 25% of World Bank Group lending in the years 1993-99. See Table 3-2.

More than half of the countries receiving IDA's assistance do not have the economic and political infrastructure needed to attract private lenders. Many of these countries remain poor because their political system is unstable, private property rights are very limited, the judicial system is weak or subservient, or the government is corrupt. Tariffs, duties, and taxes may be

Table 3-3

Overlap of Regional Development Bank and World Bank Lending: 1996-98
($ amounts in billions)

Asia

	ADB Amount	ADB Share	IBRD Amount	IBRD Share
Korea	$4,015	24.6%	$7,048	27.7%
Indonesia	3,767	23.1%	4,223	16.6%
China	2,920	17.9%	6,487	25.5%
India	1,576	9.6%	2,095	8.2%
Thailand	1,510	9.2%	2,068	8.1%
Philippines	1,419	8.7%	1,141	4.5%
Total	$15,207	93.1%	$23,062	90.7%

Latin America

	IADB Amount	IADB Share	IBRD Amount	IBRD Share
Argentina	$5,785	28.9%	$6,038	35.0%
Brazil	4,642	23.2%	4,296	24.9%
Mexico	1,829	9.1%	3,677	21.3%
Peru	1,493	7.4%	1,080	6.3%
Venezuela	1,030	5.1%	122	0.7%
Uruguay	882	4.4%	269	1.6%
Colombia	768	3.8%	302	1.8%
Total	$16,429	81.0%	$15,784	91.5%

Africa

	AfDB Amount	AfDB Share	IBRD Amount	IBRD Share
Morocco	$611	30.4%	$748	35.2%
Algeria	580	28.9%	239	11.2%
Tunisia	414	20.6%	658	30.9%
S. Africa	154	7.7%	46	2.2%
Total	$1,759	87.6%	$1,691	79.5%

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

high. Inadequate institutional frameworks are, of course, not the sole cause of poverty. Endemic health problems, population growth, and geographic location contribute as well.

Capital Remains Scarce

Much of IDA's assistance (and comparable programs at the regional banks) goes to such countries. At its best, it provides relief. At its worst, when IDA funds are misused, it supports corruption or programs that waste scarce local and external resources.

The IBRD also assists countries that are not rated for capital market borrowing; 22% of IBRD loans go to these countries. The total resource flow to public-sector activities in countries without capital market access, but with stabilizing policies and institutions, was $2.5 billion for the seven years 1993-99.[15] This is less than 2% of World Bank Group financing, excluding aid.

Counter-arguments

The Banks advance two claims to counter concerns about the misdirection of financing. One claim is that the private sector follows where the Banks lead. Without the Banks' signal of approval, private-sector funding would languish. That was a more plausible argument in the 1980s. The Banks' argument has lost its appeal now that private sector finance is fifty times the size of Bank offerings.

The signaling role, now shared by the private-rating agencies, need not entail resource transfer. The Banks could continue to signal through their reviews of institutional and policy environments by country. These reviews would be a useful supplement to IMF Article IV reports. In Chapter 2, we recommended that the IMF improve the quantity and quality of data, and publish the results, to remove this impediment to private-sector resource flows.

The second claim is that, in times of financial crisis, private lenders may run for the exits. In contrast, the Banks claim to offer a steady flow of official funding. It is true that private financial markets may close to emerging market borrowers when crises start. However, a review of the last two years, beginning with the Asia crisis in 1997, shows that the global marketplace recovers quickly. Three months after the crisis, Korea obtained $4 billion in the capital markets by selling debt with 5- and 10-year maturities. During the 3 months following Brazil's financial

[15] This is the residual after eliminating World Bank non-aid resource flows to countries with (1) capital market access, (2) private sector activities but no market access and (3) public sector activities without capital market access and without institutional infrastructure to absorb the resources.

disruptions, 20 issues totaling $12 billion were sold to international investors by Latin American sovereign borrowers, $2 billion by Brazil itself. These securities had medium- to long-term maturities, 5 to 20 years. Private equity and foreign direct investment have accelerated in recent years.

Foreign lenders were much more inclined to run in Asia, where financial systems in several countries collapsed as banks became deeply insolvent. The solution to this problem is not to increase the role of the development banks as crisis lenders or to encourage private lending to insolvent financial institutions. In Chapter 2, we recommended incentives to encourage countries to increase the safety and stability of their banking systems. The contrast between the viability of Brazil's financial system, after the 1998 devaluation, with the failures in Asia in 1997-98, supports this conclusion. Foreign banks that were long-term direct investors in Brazil did not run; they acted as safe havens for frightened residents. Banking stability reduced capital flight, thereby limiting currency depreciation and the crisis.

The Cost of Membership in the Development Banks

Multilateral agencies generally insist that the donor nations that provide the Banks' resources bear no cost. The development banks claim to be self-supporting, with operating expenses paid through surcharges on loans. More careful consideration shows that this claim is false. It ignores both the risk that member governments bear and the alternative uses for the funds the Banks receive or can call upon. A conservative estimate shows a current annual cost to members of about $22 billion; $15 billion of the total is cash outlays. The remaining $7 billion is based on a valuation of the annual allowance for risk on the portfolios of emerging market loans. The cost of risk will vary as the Banks' risk differs from one-half the market premium. The U.S. share of these costs exceeds $5 billion.

One way to assess the cost of these institutions is to ask: what would be the savings to world taxpayers if the Banks were liquidated and funds allocated to alternative uses? Table 3-4 answers that question. Table 3-5 shows the U.S. share of the Banks' costs to taxpayers. The tables show four components of total cost. We discuss them individually.

Table 3-4

Annual Cost of Multilateral Development Banks (1)

(amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Interest Cost on Paid-in Capital	$0.24	$0.29	$0.20	$0.98	$1.71
G-5 members	0.10	0.12	0.04	0.40	0.66
Interest Cost on Concessional Capital Contributions	$1.44	$0.67	$0.92	$6.74	$9.77
G-5 members	1.13	0.42	0.45	4.82	6.82
Risk Compensation on Callable Capital (2)	$0.53	$1.32	$0.50	$4.76	$7.11
G-5 members	0.36	1.06	0.28	3.14	4.84
Interest Cost on Retained Earnings	$0.60	$0.50	$0.14	$2.10	$3.34
G-5 members	0.29	0.20	0.03	0.92	1.44
Total	$2.81	$2.78	$1.76	$14.58	$21.93
G-5 members	1.88	1.80	0.80	9.28	13.76
% Share	67%	65%	45%	64%	63%

Notes: (1) 7.00% average annual long term interest rate.
(2) Compensation for risk on callable capital equal to 1/2 of capital market premium.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Table 3-5

Annual Cost of Multilateral Development Bank Participation to United States

(amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Interest Cost on Paid-in Capital	$0.04	$0.08	$0.01	$0.17	$0.30
Interest Cost on Concessional Capital Contributions	$0.19	$0.31	$0.10	$1.52	$2.12
Risk Compensation on Callable Capital	$0.14	$0.81	$0.08	$1.39	$2.42
Interest Cost on Retained Earnings	$0.09	$0.14	$0.01	$0.37	$0.61
Total	$0.46	$1.34	$0.20	$3.45	$5.45

Notes: (1) 6.50% average annual long term interest rate.
(2) Compensation for risk on callable capital equal to 1/2 of capital market premium.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank
Federal Reserve Board

Interest on Paid-in Capital

Member governments deposit 5% to 7% of their subscription to form the operating capital of the development banks. The first line of Table 3-4 uses a 7% long-term cost of capital and the $24 billion of paid-in capital to compute this annual component of total cost ($1.7 billion). The U.S. share ($0.3 billion) in Table 3-5 is a weighted average based on its share of the paid-in capital at each Bank.[16]

Interest on Concessional Capital

The development banks extend long-term, interest-free loans to the poorest members. To finance these concessional credits, the Banks ask member governments to replenish the concessional fund. The cumulative sum paid to date is $140 billion. Table 3-4 shows the $9.8 billion annual cost of maintaining this capital at the development banks. In Table 3-5, the United States has a larger share of the cost of concessional funds ($2.1 billion) than its share of paid-in capital. Leading industrial, G-5, countries pay 70% of the costs of concessional capital.

Compensation for Risk

Markets treat the Banks' debts as low-risk obligations because the Banks are unlikely to default. They have the right to call on member governments to furnish additional capital to repay the Banks' indebtedness. This "callable capital" was committed by the member governments and remains available in an emergency such as defaults by the Banks' borrowers. To date, the Banks have not called any of the capital, but the possibility remains. Although they explicitly deny doing so, the Banks avoid possible defaults by extending new loans to countries in financial difficulty.

Only a few of the richer members could supply convertible currencies on demand. These members would be the main resource in an emergency. Callable capital committed by the richer countries is $181 billion; the industrial countries bear the risk on the $183 billion pool of loans to high-risk sovereign borrowers. Accepted accounting principles for private financial management requires that allowances for potential loss be made annually.

A private-sector evaluation of the risk of medium- to long-term emerging market sovereign debt is obtained from the difference between the yields on riskless U.S. Treasury

[16] The weights are based on Appendix B.

securities and emerging market sovereign bonds. Over the 5-year period, July 1994 through June 1999, the average spread was 8.1% per annum. This premium varied from 4.3% for Asia, to 8.2% for Latin America, to 10.5% for Africa. Table 3-6 reviews the private-sector evaluation of sovereign risk. Based on a conservative per annum allowance for loss equal to one-half of the premium that capital markets assign, the value generated would be $7.1 billion per annum. The share of each member is determined by the risk of the total loan portfolio and the country's proportion of the callable capital supplied by non-borrowers. The conservative allowance for risk provision is in part justified by the Banks' preferred creditor position and reserves.

The G-5 countries provide 70% of this support. The U.S. share ranges from 17% for the African Development Bank to 62% for the Inter-American Development Bank, much larger than its 6% and 31% share of paid-in capital. The estimated U.S. cost of risk is $2.4 billion annually. This estimate varies with the assumed risk premium. A number higher (or lower) than 1/2 would change the values in Tables 3-4 and 3-5 in proportion.

Cost of Retained Earnings

The Banks receive donor funds and borrow in the market but do not immediately relend. In the interim, they hold earning assets unrelated to development lending and receive the difference between their borrowing cost and the return on investment. The Banks' lending rates only exceed their borrowing costs by an amount sufficient to cover administrative expenses, so there is not net income on loans financed by debt. Earnings come from assets financed by equity and the spread on market investments. Recently, the four Banks held $76 billion in investments, equivalent to 1-1/2 years of total lending. Of this total, the Banks hold as market investments $12 billion of the funds received for concessional lending, such as IDA appropriations. Unlike the borrowed funds, these funds have zero cost to the four Banks. The annual opportunity cost of foregone interest to the donors is $3.3 billion.

Subsidies: Another Measure of Cost

The Banks divide their lending into market-based and concessional loans. Both are subsidized. All recipients of "market-based" lending pay the same interest rate, equal to the

Table 3-6

Risk Evaluation by the Private Sector:

Medium-Long Term Emerging Market Bonds

Spread above U.S. Treasury Securities
July 1994 - June 1999

	Asia	Latin America	Africa	World
Average	4.34%	8.16%	10.50%	8.12%
Maximum	9.91%	17.82%	30.37%	16.62%
Minimum	1.48%	3.26%	3.94%	3.28%

Sources: Morgan Stanley Dean Witter
Salomon Smith Barney

Bank's cost of funds plus 1/4 to 1/2% depending on the Bank and year. There is no allowance for differences in a borrower's risk or credit rating. All borrowers at the "concessional window" receive a 100% interest subsidy. They pay no interest, but the Banks charge a fee of less than 1% to cover administrative costs.[17]

To calculate the subsidy on interest bearing loans, we take the difference between the average rate on medium- to long-term sovereign emerging market bonds for each region from July 1994 to June 1999, 10.5% to 16.7%, and the average rate on loans by the development banks, 6.9 to 7.4%. The difference is about half the market rate, so countries with market access received subsidies equal to half the market cost of funds on development bank loans. Using the four Banks' sovereign loan portfolios of $183 billion at the latest year-end as the base, the subsidy on interest-bearing loans is approximately $12.7 billion. See Chart 3-4.

Concessional credits of $112 billion pay no interest. Using a 16.7% interest rate on loans to the poorest countries gives an annual subsidy of $18.7 billion on these loans. Countries are obligated to repay the loans 30 or more years from the time of the agreement. Allowing for the present value of these prospective payments, and assuming they are made, leaves the subsidy on the concessional loans at about 85% of the face value. It is not surprising, therefore, that countries are reluctant to graduate from the concessional window.

Table 3-7 shows the total subsidies and the distribution by lender and type of loan. If the Banks used grants instead of loans to carry out part of their mission, as proposed in our recommendations, in time many of these subsidies would be available to fund future grants.[18]

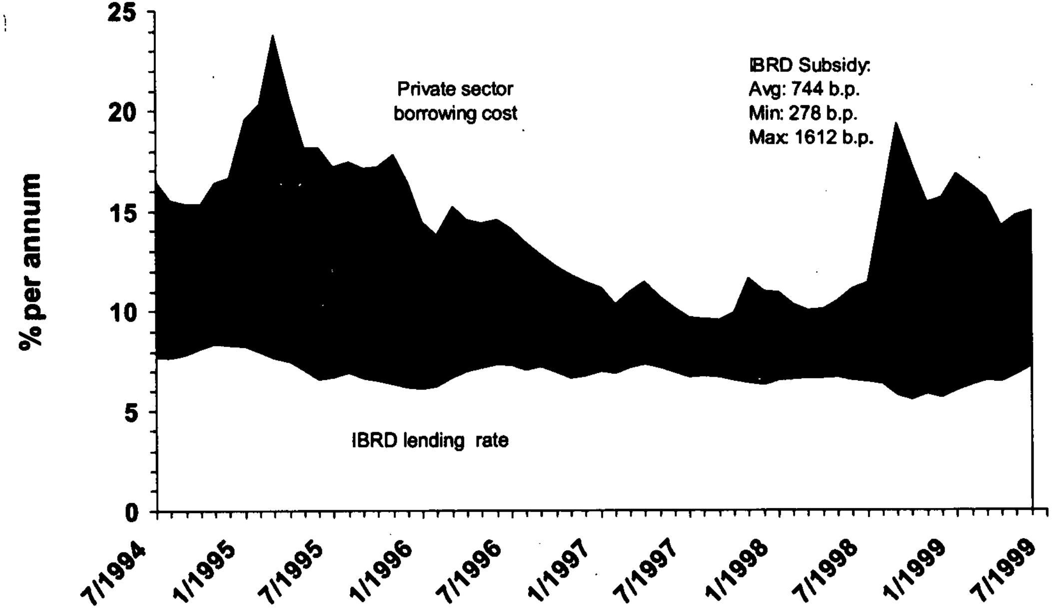
The principal beneficiaries of the subsidies are the countries with the largest outstanding debts to the development banks. The annual gift received by each of these borrowers is:

[17] The IDB charges 1-3/4% and calls the fee interest.

[18] There are now two measures of the subsidy, $31 billion in Table 3-7 and $22 billion in Table 3-4. The main source of the difference is the different evaluations of risk. The $31 billion, assuming the market prices these risks correctly, is the likely upper bound.

Chart 3-4

Subsidy Element in IBRD Lending
1995-1999
World



Sources: Morgan Stanley Dean Witter
Treasury Bulletin
World Bank

Table 3-7

Effective Subsidies on Development Bank Lending
($ amounts in billions)

	Asian Dev. Bank		Inter-American Dev. Bank		African Dev. Bank		World Bank			Total	Combined
	Bank	Fund	Bank	FSO	Bank	Fund	Bank	IDA	Banks	Concessional	Total
Loans Outstanding*	$24.4	$14.3	$32.3	$6.9	$9.5	$7.6	$117.2	$83.2	$183.4	$112.0	$295.4
Average Lending Rate**	7.12%	0%	7.22%	1%***	7.37%	0%	6.87%	0%	—	—	—
Average Private Sector Cost**	10.53%	16.69%	14.35%	16.69%	16.69%	16.69%	14.31%	16.69%	—	—	—
Effective Subsidy Per Annum Rate	3.41%	16.69%	7.13%	15.69%	9.32%	16.69%	7.44%	16.69%	—	—	—
as % Private Sector Cost	32%	100%	50%	94%	56%	100%	52%	100%	—	—	—
Amount	$0.8	$2.4	$2.3	$1.1	$0.9	$1.3	$8.7	$13.9	$12.7	$18.7	$31.4
U.S. Share	$0.2	$0.3	$1.4	$0.6	$0.2	$0.2	$2.5	$3.4	$4.3	$4.5	$8.8

* Government lending only as of 12/31/98 for all regional banks and 6/30/99 for World Bank.
** July 1994-June 1999
*** FSO charges an average interest rate of 1.80% but no administration fee.
Other Banks charge an administration fee of 0.75-1.00%.

Sources: Morgan Stanley Dean Witter; Salomon Smith Barney; World Bank; Asian Development Bank; Inter-American Development Bank and African Development Bank.

India	$2.5 billion
Mexico	1.1
Indonesia	1.1
Brazil	1.0
Argentina	1.0
China	0.8
Russia	0.5

Performance

Performance is one of the Commission's principal concerns. Ending or reducing poverty is not easy. The development banks cannot succeed in their mission unless countries choose to develop and grow their economies. Governments must be willing to make structural changes that attract foreign capital and reward domestic saving.

Internally, the Banks should change their incentives and improve their methods of evaluating performance. Externally, in their dealings with client countries, the Banks have a role in encouraging the institutional reforms that are necessary for sustained development. Their dedicated personnel and abundant expertise are important resources. But expertise and dedication are not enough, if there are poor incentive structures, weak managerial controls, or misdirected effort. The Banks' systems for project evaluation, performance evaluation and project choice must be improved.

Incentives

In 1992, the World Bank's Wapenhans Report pointed to the Bank's excessive interest in "moving money" as a main reason for the deterioration of project quality.[19] The report said the

[19] "Effective Implementation: Key to Development Impact." Washington: The World Bank, 1992. Internal document. The regional banks prepared internal evaluations.

Bank had developed a lending culture. Rewards were closely related to the volume of lending, not to a project's value or program accomplishments. Subsequently, an Asian Development Bank portfolio review found that dedication to client interest was undermined by an "approval culture" aimed at achieving yearly lending targets.

Incentives to lend for lending's sake are built into the structure of the Banks. Internal budget resources are awarded where loan volumes are high, not where the number of worthwhile projects is highest or where technical assistance and knowledge transfer are favored over funding. Long project cycles of 5-10 years render accountability at the operational level difficult to assess; those responsible for allocating funds will often have moved on before the results of lending are known. Often the staff is rewarded based on the amount of funds disbursed.

Although several of the Banks recognize the problem and call attention to the need for change, there is, at most, weak counterbalance to the incentive to lend. Host government guarantees, required on all loans, separate project failure from risk of loss to the Bank. Rewards for lending, and no penalties for project failure, dilute concern about project performance. The result of an open-handed and often uncritical disbursement is a 55-60% failure rate to achieve sustainable results based on the World Bank's own evaluation. Interim improvements in measured performance by the World Bank during the 1996-97 period were in large part due to general prosperity in emerging economies.

Project Evaluation

It has always been difficult to evaluate the outcome achieved with any particular loan. Money is fungible. The marginal project that a Bank loan makes possible is generally not the project that the Bank evaluates. When the Banks financed mainly infrastructure, they could, at least, assess the project's success. As the Banks moved away from project-based investment lending to adjustment financing and large-volume pure public-sector loans, now 63% of all World Bank operations, it has become easier to blur measures of project performance. By adding many new objectives in recent years the Banks made it possible to claim success on one dimension and ignore failures to improve living standards or reduce poverty.

The project evaluation process at the World Bank gets low marks for credibility: wrong criteria combine with poor timing. Projects are rated on three measures: outcome, institutional development impact, and sustainability. The latter, central to progress in the emerging world, receives a minimal average 5% weight in the overall evaluation. The Bank measures results at the moment of final disbursement of funds, a time which the Wapenhans Report criticized as "just the beginning of operations."[20] Final disbursement often occurs more than one year before the project begins full operations. The start of operations is too early to judge sustainability of achievements. For structural programs, improvements often develop slowly. Evaluation should be a repetitive process spread over time including many years after final disbursement of funds, when an operational history is available.

Table 3-8 shows the World Bank's evaluations of project performance for the 1990s. The Bank includes "marginally satisfactory" outcomes as successes. Using their ratings, 59% of investment programs failed in the years 1990-99. The Bank's Operations Evaluation Department audits 25% of its projects. Most audits occur between 6 months and 3 years after final disbursement. If it reevaluated projects using independent auditors a number of years later, Asian Bank experience suggests failure rates might worsen but would not improve.

As the prosperity of recipients falls, so does achievement. Table 3-8 shows that the vast majority of World Bank "successes" are concentrated in upper-income countries that have significant domestic resources and access to private-sector funding. Here, failure is in the 30-40% range.

In contrast, the poorest countries have failure rates between 65 and 70%. The same pattern is found regionally. The 40% failure rate in the strong economies of East Asia contrasts with the 60-75% failure rate in South Asia and Africa. For total project-based investment lending, failure rates reach 59%; more generalized adjustment loans have a 47% failure rate.

All Banks should improve monitoring and performance evaluation processes. The Banks' incentive systems should be closely tied to project performance.

The Banks seldom return to inspect project success or assess sustainability of results. The World Bank reviews only 5% of its programs 3 to 10 years after final disbursement. These Impact Evaluations focus on such important, but poorly defined and subjective, measures as improvements in the environment, the role of women, the interaction of societal institutions, income distribution and general welfare. It is difficult to relate Bank activities to these social

[20] World Bank, Portfolio Management Task Force: Effective Implementation: Key to Development Impact. Washington: September 22, 1999, p. 29.

Table 3-8

Performance of World Bank Projects

Failure Rate of Projects to Achieve Satisfactory Sustained Results

	1990-93	1994-97	1998-99	1990-99
Adjustment Lending	55%	45%	37%	47%
Investment Lending	60%	59%	56%	59%
Africa	75%	74%	68%	73%
South Asia	66%	56%	60%	61%
Latin America	51%	50%	37%	48%
East Asia	38%	36%	48%	39%
Low Income	73%	69%	66%	70%
Lower Middle Income	48%	50%	46%	49%
Upper Middle Income	45%	36%	31%	39%
High Income	27%	30%	28%	28%
Total	59%	56%	53%	57%

Source: World Bank

indicators. Thirty percent of the investigators found that lack of monitoring of project results precluded valid judgments. Though the agencies devote significant resources to monitoring the procurement of inputs, they do little to measure the effectiveness of outputs over time.

The Asian Development Bank is an exception. It is more concerned about sustainability, the sine qua non of success. Initial reports are made only after projects are fully operational. Presently, 30% of projects are audited 2 to 3 years later. The Asian Bank expects that all "successful" projects will soon be revisited to learn whether improvements continue. The Asian Bank has found that "unsuccessful" projects rarely improve, so later audits are not useful.

Banks' Self-Evaluation

In addition to evaluating the success of its lending, the World Bank evaluates its own performance using three criteria: project identification, project appraisal, and project supervision. On average for 1990-99, more than 40% of all projects failed to receive a satisfactory rating on all three criteria. Table 3-9 shows the Bank's self-evaluations.

Our study focussed on the World Bank's evaluation procedures because the Bank is generally the leader in the development field and its procedures are widely regarded as models for the other Banks.

Choice of Direction

The Banks have an important role in reducing poverty and promoting growth. Although their resources are a small part of global capital flows, more effective resource use can raise the Banks' contribution. This will happen only if the Banks gain a better understanding of their comparative advantage, where and how they can most effectively use their limited resources.

Assessing Aid, a 1998 World Bank report, concludes that aid can help a country develop only if the country adopts appropriate public policies that promote growth and encourage foreign investment. Earlier, the Wapenhans Report concluded: "Even very well designed projects cannot succeed in a poor policy...environment."[21]

[21] *Ibid.*, p. 7.

Table 3-9

World Bank Performance

Failure Rate of Bank Responsibilities

	1990-93	1994-97	1998-99	1990-99
Project Identification	12%	18%	22%	16%
Project Appraisal	33%	38%	38%	36%
Project Supervision	24%	28%	24%	26%
Overall	38%	44%	43%	42%

Source: World Bank

The World Bank has not embraced this message. A 1997 World Bank review found that among 41 low-income countries, only one had a satisfactory institutional environment.[22] Many of the Bank's failures result from lending to countries unprepared or unwilling to adopt wealth-creating policies.

The Banks can improve their performance and the living standards of their clients by asking three questions:

Will the private sector perform this function?

Will the local public sector perform this function?

Will the Bank provide resources not otherwise available?

To show how the World Bank answered these questions in recent years, we divide the developing world into two sets of countries and two types of activities:

	Countries with capital-market access	Countries without capital-market access
Activities directly profitable to private sector	A 48%*	C 16%*
Activities not directly profitable to private sector (public interest)	B 30%*	D 6%*

*Percentage of World Bank Group operations (excl. aid) during 1993-99 period. Lerrick, Adam: "Whither the World Bank" IFIAC, Washington: October 1999. Public interest activities include health, education, rural transport, environment, social sector, urban development, public sector, and balance of payments.

[22] World Bank, Operations Evaluation Department. 1998 Annual Review of Development Effectiveness. Washington, 1999, p. 21.

The Banks should provide resources for global public goods and socially valuable activities which the private sector would not finance in countries with positive institutional environments, but without capital market access. There is no role for any public-sector lender, including the development banks, in region A. The private sector can and should finance these activities. The World Bank should not continue to devote half its funding to projects of this kind. Region B, public-interest activities in countries with capital-market access, is the domain of local governments, financed by tax revenues and market borrowing. Regions C and D are the appropriate targets for Bank efforts. Region C includes profitable private-sector activities in countries without capital-market access. Countries should identify the obstacles that prevent the private sector from fulfilling its role and remove the impediments. These may take the form of a risk (including political risk) that private participants cannot assume efficiently, an institutional bottleneck, a distorted economic framework, a lack of information or an absence of clearly defined public policies. The development banks can help by financing the reforms that the government decides to undertake. Finally, region D has public-interest activities in countries without capital-market access. Often these require subsidization or the elimination of barriers to private-sector provision of services.

The World Bank's allocations show that only 22% of the activities it financed were in countries without capital-market access. Even if some allowance is made for incomplete or limited market access, most of the development banks' resources go to countries and projects that the market would finance.

Countries without capital-market access include those most in need of institutional reform. The Banks' goal should be to increase funding of activities in the poorest countries, while reducing funding of activities in regions A and B. The development banks should provide incentives for countries without capital-market access to reform their economies or political processes.

Recommendations

Evolution of the world economy since 1945 has changed the main suppositions and beliefs on which the World Bank and the regional banks were founded. The resources available for countries, that demonstrate by their policy choices that they desire to grow, greatly exceed any sums that the founders of the development banks imagined. The multilateral development banks have been slow to adapt to their changed relative position as suppliers of capital and to the lessons learned about development over the past half century.

An important role for development assistance remains. The development banks must increase their effectiveness in alleviating the consequences of poverty and encouraging institutional reforms that permit growth, development and release from poverty. Major reforms of the development banks are needed to increase effectiveness, accountability and transparency and eliminate overlapping responsibilities.

Five observations guide our recommendations:

- the dominant share of the Banks' resources is devoted to a small number of countries with ready access to private-sector capital;
- the total funding provided to these countries by the Banks is a small fraction of the resources received from the private sector;
- the host government guarantee, required to approve all Bank lending, would render private-sector investors indifferent to the end use of borrowing proceeds, whether they concern investment, institutional reform or social-safety nets;
- the fungibility of money eliminates any link between Bank financing and specific projects or promised policy changes;
- change cannot be imposed from the outside; countries implement and sustain only those reforms to which they are themselves committed.

To function more effectively, the development banks must be transformed from capital-intensive lenders to sources of technical assistance, providers of regional and global public goods, and facilitators of an increased flow of private sector resources to the emerging countries. Their common goal should be to reduce poverty; their individual responsibilities should be distinct. Their common effort should be to encourage countries to attract productive investment; their individual responsibility should be to remain accountable for their performance. Their common aim should be to increase incentives that assure effectiveness.

If the development banks remain as they are, they will be relegated to an insignificant role in the development process. If they reform, they can assume a valuable role that will justify the commitment of more resources by taxpayers in developed economies.

Targeting the Poorest Nations without Access to Private-Sector Resources

The Development Banks should be renamed Development Agencies.

The new name would underscore a change in the defining role of the development institutions -- no longer the lending of money but the alleviation of poverty in the developing world. Although the Banks would continue lending for structural reform, the advent of deep global capital markets, willing to bear risk and prepared to channel substantial resources to emerging economies, has destroyed the rationale for much of the costly financial intermediation function that has been the Banks' main activity.

All resource transfers to countries that enjoy capital-market access (as denoted by an investment-grade international bond rating) or with a per capita income in excess of $4000 would be phased out over the next 5 years. Starting at $2500 (per capita) levels, official assistance would be limited. (Dollar values should be indexed.)

The focus of institutional financial effort should be on the 80 to 90 poorest nations without access to private-sector resources. As the World Bank has noted: "Much of aid continues to go to middle-income countries that do not need it. It is possible to make aid more effectively targeted to poor countries..."[23] Table 3-10 lists the countries affected by this change in 1999.

When operations are confined to low income countries with little capital-market access, additionality of resource transfer is enhanced. Funds for the poor would grow dramatically if flows to countries with easy capital market access or high-income levels ceased and were reallocated to the poorest members: 100% at the Asian Development Bank; 640% at the Inter-American Development Bank; 70% at the African Development Bank. When concessional flows are included, augmentations are 63%, 390% and 40% respectively.

When inept policies and negative institutional frameworks restrict market access for middle-income economies, the absence of official assistance will be a powerful incentive to implement reform.

An investment grade rating (Baa/BBB or higher) is used to denote substantial capital market access. Countries with these ratings can finance projects without official assistance. They would continue to benefit from knowledge transfer and technical assistance, and the

[23] World Bank, Assessing Aid, op. cit., p. 4.

Table 3-10

Effect of Country Eligibility Phase-Out

Countries with Investment Grade Rating (9/1/99)			Countries with 1998 Per Capita Income					
			above $2,500 Begin Phase-out			above $4,000 Complete Phase-out		
Asia	Latin America	Africa	Asia	Latin America	Africa	Asia	Latin America	Africa
China	Chile	Egypt	Malaysia	Belize	Mauritius	Korea	Argentina	Gabon
Korea	Colombia	Mauritius		Colombia	S. Africa		Brazil	
Malaysia	El Salvador	S. Africa		Costa Rica			Chile	
Thailand	Uruguay	Tunisia		Panama			Mexico	
				Peru			Trinidad and Tobago	
				Venezuela			Uruguay	

Sources: World Bank; Moody's Investors Service and Standard & Poor's development banks would continue to operate, but not lend, in these countries. Poor countries with high-yield ratings (Ba/BB/ or B), which may have limited access to private sector financing during times of uncertainty, will continue to be eligible for aid if the availability of private sector resources declines.

Performance-Based Grants

For the globe's truly poor, the provision of improved levels of health care, primary education and physical infrastructure, once the original focus for development funding, should again become the starting point for raising living standards. Yet, poverty is often most entrenched and widespread in countries where corrupt and inefficient governments undermine the ability to benefit from aid or repay debt. Loans to these governments are too often wasted, squandered, or stolen.

Outright grants rather than loans provide a realistic vehicle for poverty alleviation. Grants would be funded openly as direct subsidies provided by the industrialized nations. Performance would be audited by independent agents. In contrast to the current system of subsidy transfer, concealed through below-market financing, an explicit approach to aid would be more willingly supported if donors were assured that funds are used for an effective poverty-reduction program.

Auditors can quantify improvements in primary education skills, vaccination rates, miles of passable roads, provision of electricity, delivery of water and sanitation. Skilled international suppliers in the service sectors are increasingly mobile. The domestic public sector would be aided by the development agencies, but its role would be limited to partial payment for services, the mitigation of political risk, and the provision of public goods.

The share of the cost paid by the country would depend on its per capita income level and credit ranking. The poorest nations without capital-market access would receive grants equal to 90% of the service cost, while the development agency's contribution would fall to 10% as the country's income level or capital-market access increased. For example:

> A country with $1,000 per capita income qualifying for 70% grant resources decides that vaccination of its children against measles is a desired goal. If the development agency confirms the need, the government would solicit competitive bids from private-sector suppliers, nongovernmental organizations such as charitable institutions, and public

sector entities such as the Ministry of Health. Suppose the lowest qualifying bid is $5 per child vaccinated, the development agency would agree to pay $3.50 (70%) for each vaccination directly to the supplier. The government would be responsible for the remaining $1.50 (30%) fee. Payments would only be made upon certification by an agent independent of all participants -- the government, the development agency and the supplier of vaccinations.

Under a system of user fees, grants are paid after audited delivery of service. No results, no funds expended. Payments would be based upon number of children vaccinated, kilowatts of electricity delivered, cubic meters of water treated, students passing literacy tests, miles of functioning roads. This system eliminates the distortionary effects of financing cost subsidies (traditional development bank loans and guarantees) by maintaining the relative prices of inputs. It creates a revenue guarantee for the vendor. Execution is substantially free of political risk. The supplier of the service, not the government, receives the payment. Since payment is directly ensured by the development agency's commitment, the supplier can borrow any required interim funding from the private sector. From the supplier's standpoint, the proposed system has the distinct advantage of giving them clear responsibility to deliver a product they understand, while eliminating the need to negotiate financing with several official lenders.

The same framework has the potential to extend beyond national projects to regional programs where cooperation between participating governments would provide economies of scale. Contractors would be compensated directly by the development agency for their share, on evidence of performance. Subsidies would vary according to the income and capital-market access of each country.

The development establishment resists grant-funding on two counts. First, they claim, the borrower would have no obligation to repay, leading to a lack of discipline. On the contrary, an obligation to pay an assigned portion of user fees on a current basis imposes discipline on the country that receives assistance. This current obligation replaces the deferred 20-50 year repayment schedules of the development credits now in use. Further, the receiving country initiates the program. It commits to a program that it finds valuable; it acquires "ownership" of an effective program. Decisions are made locally to meet local needs.

Second, for the multilateral development banks, grant-funding is a less certain source of funds than current arrangements that are based to a much greater extent on permanent capital commitments. As the share of grants rises, the development agencies would have to ask the legislatures of the donor countries for increased support.

The risk exists that legislatures would reduce funding. That risk has a positive aspect. The development agencies would have an incentive to improve performance. They would develop more careful procedures to assure the effectiveness of programs. This would strengthen accountability at the development agencies and concentrate their attention on results achieved, not dollars lent. Donor countries should be encouraged to increase aid for effective programs.

Many of the failures of development programs originate in perverse incentive systems created by the Banks in both the recipient countries and in the lending institutions themselves. As the Wapenhans Report remarked: "..the first measure of success for the [World] Bank [should] not [be] commitment of resources, but their effective use"[24] and "the cost of tolerating continued poor performance [of World Bank projects] is highest not for the Bank, but for its Borrowers."[25] The burden of irresponsible programs is unfortunately borne by taxpayers--by the poor recipient-country citizens if loans are repaid or by donor member constituents if the debt is forgiven.

In poor countries without capital-market access, poverty alleviation grants to subsidize user fees should be paid directly to the supplier upon independently verified delivery of service. Grants should replace the traditional Bank tools of loans and guarantees for physical infrastructure and social-service projects. Grant funding should be increased if grants are used effectively.

From vaccinations to roads, from literacy to water supply, services would be performed by outside private-sector providers (including NGOs and charitable organizations) or public-sector entities, and awarded on competitive bid. Quantity and quality of performance would be verified by independent auditors. Payments would be made directly to providers. Costs would be divided between recipient countries and the development agency. The subsidy would vary between 10% and 90%, depending upon capital-market access and per capita income.

The amount of money requested from legislatures to fund explicit grants should rise. Increased outlays will be offset partially as outstanding loans and credits, with hidden subsidies of $15-20 billion per annum in below-market interest rates, are repaid. Most of the repayments

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[24] Effective Implementation: Key to Development Impact; op. cit., p. 26.
[25] *Ibid.*, p. 5.

will be complete in the next 15 years. Grants would be given only to poor countries without capital-market access. This would increase funds available for bona fide poverty reduction.

Institutional Reform Loans

Institutional reforms lay the groundwork for productive investment and economic growth. They provide the true long-term path to end poverty. Reforms are more likely to succeed if they arise from decisions made by recipient nations. In the words of Gustav Ranis, a development expert, "It seems clear that the lending cum conditionality process works well only when local polities have decided, largely on their own... to address their reform needs...and approach the international community for financial help in getting there."[26]

Good intentions are not enough. Developing and emerging countries need incentives to continue long-term reform programs until they achieve sustainable results. In the past, the borrowers had access to total disbursement of funds long before execution. There were no means to enforce penalties for failure to perform and no incentives to continue, or even start, the reform process. Many countries have agreed to accept conditional assistance but either did not try or did not succeed in carrying through the reforms.

A new mechanism is needed to promote steady implementation rather than superficial change. It must create incentives to sustain reform programs until reforms have become established. The mechanism should also reduce financial costs of reform until benefits have been realized.

Institutional lending frameworks can be redesigned to fit the needs of the poorest countries that do not have capital-market access. As an example, each developing economy would present its own reform program. If the development agency concurs in the merit of the proposal, the country would receive a 10-year maturity, equal annual amortization loan, with subsidized interest rate based upon the agency's own cost of capital. The extent of the interest subsidy would vary from 10% to 90% as in the grant financing of user fees. Loans would be conditional upon a precise set of reforms, and disbursement would begin after legislative enactment, the first step in the process.

Continuing the example, auditors, independent of both the borrowing government and the official lender, would be appointed to review implementation of the reform program annually. If

[26] Ranis, Gustav. "On Fast Disbursing Policy Based Loans." New Haven: Yale University, 1995, p. 10.

performance is positive, repayment of the entire principal schedule would be deferred for one year. The loan would become an eleven-year loan with principal payments due in years 2 to 11. Interest would be paid on a current basis. Eligibility for deferrals, based on continuing implementation, would be renewable each year for up to ten years. In this example, if the program is successfully implemented and sustained, principal and interest would be paid on a fixed schedule in years 11 to 20. Continued execution can thus transform a 10-year loan with repayment spread over years 1 to 10 into a 20-year loan with repayments in years 11 through 20.

Failure to meet standards in any year would trigger a mandatory start on repayment of principal and the elimination of the interest subsidy. Repayments would continue until compliance resumed. The borrower would have an incentive to choose a program it wants to implement, and to continue it long enough to establish the new rules or procedures as part of the local policy environment.

Lending for institutional reform in poor countries without capital market access should be conditional upon implementation of specific institutional and policy changes and supported by financial incentives to promote continuing implementation. Results should be independently monitored to assess performance.

Division of Responsibility

Development Agencies should be precluded from financial crisis lending.

In the Commission's overview of all multilateral entities, the IMF has exclusive responsibility for financial crisis lending by multilateral institutions. Recently, the development institutions have been called upon to step outside their mandates and divert significant resources to crises in Korea, Indonesia, Thailand, Brazil, Argentina and Russia. Although this new role may have been a means for major shareholders to execute "off-balance-sheet" foreign policy without submitting to the budget process in the appropriate legislative venue, this use of development funds should not be repeated.

All country and regional programs in Latin America and Asia should be the primary responsibility of the Asian and Inter-American Development Agencies. The transfer should be accomplished within five years.

Costly duplication and confusion arise from the overlap of function and resource flows between the World Bank and its regional partners. The comparative advantage of the regional development banks resides in strong relationships with borrowing members based upon a mutual understanding, common language, and common culture. Both the Asian Development Bank and the Inter-American Development Bank have reached a level of maturity and professionalism which qualifies them to take responsibility for the tasks of poverty alleviation and structural reform in their respective regions.

The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East.

In the past, the development institutions have focused almost exclusively on country-specific agendas. Economies of scale and expanded results can be achieved from transnational programs that address shared issues of environment, natural resources, infrastructure and health.

Regional solutions that recognize the mutual concerns of interdependent nations should be emphasized.

The World Development Agency should concentrate on the production of global public goods and serve as a centralized resource for the regional agencies. Global public goods include improved treatment for tropical diseases and AIDS, rational safeguarding of environmental resources, inter-country infrastructure systems, development of tropical agricultural technology, and the creation of best managerial and regulatory practices.

The production of international public goods, as opposed to country and region-specific programs, has been conspicuous by its absence in the work of the Banks.

"Knowledge is costly to create but inexpensive to transmit," said Ann Krueger, former chief economist at the World Bank. And it is in the gathering of knowledge, subsidized by grants and revenue guarantees and shared in international forums, that a new and demanding role is found for the World Development Agency.

There is much to address in agendas that confer benefits across society and beyond regional boundaries. Technical and scientific knowledge must be produced for: environmental challenges of air, water, and earth; sustainable management of natural resources; diversification of agriculture in tropical climates; restoration of the agricultural base in Africa; forestalling of health epidemics; development of vaccines and treatments for AIDS and tropical diseases; and, for economic growth, the design of best practices that will facilitate the flow of private sector funds to the emerging world. The Bank should provide technical assistance on the creation of legal systems that support clearly defined property rights and fair judicial processes; transparent accounting, tax and public administration regimes; policies that promote the free flow of goods and long-term capital; and sound financial system regulation and corporate governance rules.

The World Bank's role as lender would be significantly reduced. Repayments on the World Bank's existing IBRD portfolio will amount to $57 billion (49% of loans outstanding) over the next 5 years and $102 billion (87% of loans outstanding) over the next 10 years.

In its reduced role, the World Development Agency would have less need for its current callable capital. Some of the callable capital should be reallocated to regional development agencies, and some should be reduced in line with a declining loan portfolio. The World Bank's paid-in capital and retained earnings would be used for its redesigned activities. The income from paid-in capital and retained earnings should be reallocated to finance increased provision of global public goods. Independent evaluations of the agency's effectiveness should be published annually.

National governments could redeploy the callable capital released to the regional development agencies, if the regional agencies' capital bases require augmentation to meet the needs of their expanded role. World Bank IBRD loan repayments over the next 5 and 10-year intervals are equivalent to 85% and 153% respectively of the $67 billion combined outstanding regional bank portfolio.

Private-sector involvement by the development institutions should be limited to the provision of technical assistance and the dissemination of best practice standards. Investment, guarantees, and lending to the private sector should be halted.

The International Finance Corporation should be merged into the World Development Agency to more closely integrate its function into the Bank's activities. Equivalent changes should be made at the regional agencies.

The International Finance Corporation should become an integral part of the redefined World Development Agency. Its capital base would be returned to shareholders as existing portfolios are redeemed. The U.S. share of the IFC's $5.3 billion capital is $1.3 billion. The capital of the Inter-American Investment Corporation should return to the ordinary capital of the Inter-American Development Bank.

MIGA should be eliminated. Many countries have their own national political insurance agencies. In addition, private-sector insurers have entered the market. The Commission did not find sufficient rationale for continuing MIGA.

The World Bank and the regional development banks should write off in entirety their claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy under the Banks' combined supervision.

The United States should significantly increase its support of effective programs to reduce poverty. The six dollars per capita currently spent is too much for ineffective programs but too little for effective programs.

Appendix A
Multilateral Development Banks:
Operating Financial Entities

World Bank Group:

the International Bank for Reconstruction and Development (IBRD) provides loans and guarantees to developing member governments;

the International Development Association (IDA) focuses on aid transfers (zero interest credits) to the poorest nations;

the International Finance Corporation (IFC) provides loans and equity capital to private-sector activities in emerging economies;

the Multilateral Investment Guarantee Agency (MIGA) provides political insurance to private-sector projects.

Asian Development Bank:

the Asian Development Bank (ADB) provides loans and guarantees to developing member governments;

the Asian Development Fund (ADF) focuses on aid transfers (zero interest credits) to the poorest members;

the Asian Development Bank provides loans and equity capital to private-sector activities in regional emerging economies.

Inter-American Development Bank:

the Inter-American Development Bank (IDB) provides loans and guarantees to developing member governments;

the Fund for Special Operations (FSO) focuses on aid transfers (1% interest credits) to the poorest members;

the Inter-American Development Bank Private Sector Program and the Inter-American Investment Corporation provide loans, guarantees and equity capital to private-sector activities in regional emerging economies.

<u>African Development Bank:</u>

the African Development Bank (AfDB) provides loans to developing member governments;

the African Development Fund (AfDF) focuses on aid transfers (zero interest credits) to the poorest members;

the African Development Bank provides loans and equity capital to private-sector activities in regional emerging economies.

Appendix B

U.S. Participation in Multilateral Development Banks

($ amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Paid-in Capital	$0.5	$1.3	$0.2	$2.6	$4.6
Callable Capital	$7.2	$27.5	$1.1	$30.0	$65.8
Concessional Capital Contributions	$2.9	$4.8	$1.6	$23.4	$32.7
Share of Voting Rights	13%	31%	6%	17%	17%
Share of Paid-In Capital	16%	31%	6%	19%	19%
Share of Concessional Capital Contributions	14%	51%	12%	24%	23%
Share of Non-Borrowing Member Callable Capital	27%	62%	17%	29%	36%

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Chapter 4
The Bank for International Settlements

The Bank for International Settlements (BIS) is one of the world's oldest international financial organizations. It started operating in 1930, mainly to facilitate Germany's reparations after World War I. The bank's other original tasks included acting as a bank for central banks and promoting central bank cooperation. It is viewed widely as a club of central bankers.

The BIS's main mission, reparations, ended at World War II. The 1944 Bretton Woods Conference considered liquidation but made no decision. Instead of expiring, the BIS undertook new duties.

Central bankers comprise the BIS membership and meet monthly to discuss matters of relevance to economic and banking policy. The success of the organization, it is often said, derives from the secrecy of its meetings and the trust created among central bankers through their frank discussions at their frequent meetings.

In the mid-1960s, the BIS started to analyze international financial markets, including the new Eurocurrency markets, and it developed new databases on international capital and currency stocks and flows. During the 1970s, the BIS began to study potential country risk in developing economies. It was among the first to warn of the possibility of a sovereign debt crisis.

The BIS also took a prominent role in establishing committees to recommend standards of practice in various areas. The most influential of these is the Basel Committee on Banking Supervision, formed by the G-10 central bank governors in 1974. The Basel Committee sets voluntary standards for the international banking industry, and operates as a semi-autonomous organization, located at the BIS.

Membership

The BIS is a publicly-owned international organization, located in Switzerland. Central banks own 86 percent of the bank's issued share capital. Private shareholders own the rest. The private shareholders do not have a right to attend, or to vote at, the BIS's general meetings.

BIS membership has expanded in the past five years. Since 1994, the members of the bank's board were drawn from the 11 countries that comprise the Group of 10 (G-10). After

1996 nine additional central banks from Asia, Latin America, the Middle East and Europe joined the BIS, reducing the previous heavy European concentration of members. As of March 1999, 45 central banks were represented and could vote at general meetings.

The bank has no legislative power; its committees simply offer guidance to financial institutions and their supervisors. After they are issued, BIS standards may or may not be adopted by each country's legislative or regulatory bodies.

Current Functions

BIS's current tasks can be divided into three categories: (1) international monetary and financial cooperation, (2) agent and trustee activities, and (3) financial assistance to central banks.

International Monetary and Financial Cooperation

The BIS plays a unique role in fostering international cooperation among central bankers and in setting financial standards through the facilities the BIS provides for various committees. Both standing and *ad hoc* committees meet "to promote stability and mutual understanding." [27] The BIS acts as secretariat for several committees, including the Basel Committee on Banking Supervision. These committees propose international standards and offer guidance on so-called "best practices." Other committees include the Committee on Global Financial Systems---a new name for the former Euro-currency Standing Committee---and the Committee on Payment and Settlement Systems. The three committees participate in the newly created Financial Stability Forum.

Except in a few instances, BIS officials are not active members of the Committee. The membership usually consists of national technical experts. The BIS staff performs secretarial functions and helps with organization.

In 1988, the Basel Committee on Banking Supervision issued minimum capital requirements (the Capital Accord). These are now under revision. The Capital Accord marked the first decisive step in the BIS's participation in setting minimum capital standards for

[27] See The Bank for International Settlements, "Profile of an International Organization," a presentation available at the bank's Web site.

international banks. Eventually more than 100 countries adopted the standards, not only for internationally active banks, but also for domestic banks.

The Accord called for linking capital requirements to a crude measure of the banks' risk by assigning different risk weights for different categories of bank assets or commitments. The quality of the standards set by the Accord has been criticized for years for its crudeness, lack of effectiveness in promoting the maintenance of adequate capital (as illustrated by Japan's recent banking collapse), and for politicization. Some critics also question whether establishing a "level playing field" for capital standards will promote fairer competition among banks, given that capital is only one dimension of bank regulation.

A new capital adequacy framework was first circulated in June 1999, as a draft to obtain comments by the industry and academics. A final document is expected by the end of 2000. The tentative plan calls for implementing the new standards around the end of 2001. The new approach is expected to give banks more choice in assessing credit risk by allowing them to adopt an internal rating system for setting capital requirements and by linking required capital, where possible, to credit-rating agencies' ratings of bank borrowers. The new proposals, like the preexisting standards, have received substantial criticism.[28] Despite the flaws in current and proposed capital standards, the Basel Committee's work has undoubtedly helped to advance the discussion of how to achieve more effective prudential regulation of banking.

A central concern of the BIS and the Basel Committee has been finding ways to limit systemic risk in international banking. In 1997, the Basel Committee on Banking Supervision issued 25 core principles for Effective Banking Supervision, applicable to all countries. The principles cover conditions for supervision, licensing, and structure of the banking system, prudential regulation, methods of ongoing supervision, information gathering and use, powers of supervisors and cross-border banking. G-10 central bank governors and G-7 finance ministers endorsed the document.

The BIS has created a very useful forum for central bankers and regulators of financial institutions by hosting frequent meetings for a common core of participants.[29] Once a month the governors of member countries' central banks meet. The central bankers discuss common

[28] For a review of criticisms of the Basel Standards, and suggestions for reform, see *Reforming Bank Capital Regulation*, U.S. Shadow Financial Regulatory Committee, Washington AEI Press, 2000.
[29] See Michele Fratianni and John Pattison, Oct. 31 draft of "An Assessment of the Bank for International Settlements." The paper is available at http: phantom-x.gsia.cmu.edu/IFIAC.

problems and exchange information about economic events in their countries. The stability of the international monetary and financial systems is a continuing concern at these meetings.

Agent and Trustee

The BIS acted as an agent (1986 to 1999) for the private clearing and settlement system of the European Currency Unit when the European Monetary Union was first established. The BIS also acts as an agent for some international loan issues and as the trustee, holding the collateral, for some international bond issues. The BIS served as agent in the rescheduling of the Brazilian external debt in 1993, and played a similar role for Peru in 1997 and Cote d'Ivoire in 1998.

Acting as agent, the bank arranges bridge loans for member states and emerging market countries. At various times since the early 1980s, the BIS has provided transitional or bridge funds to countries to which the IMF or World Bank has agreed to lend. These loans speed countries' access to IMF or World Bank credits. In addition, in late 1998, the BIS arranged a $13.28 billion credit facility for Brazil as part of a financial support program.

Financial Assistance to Central Banks

The BIS acts as a bank for central banks, assisting them in the management of their reserves. The banks' assets are invested in international bank deposits, securities, and government Treasury bills. BIS purchases and sales for central banks are confidential and are kept secret. Currently about 120 central banks and international financial institutions use the BIS as a bank. The total deposits placed with the BIS reached $112 billion on March 31, 1999, representing about 7 percent of world foreign-exchange reserves.

Two recent initiatives augment the mission and the global reach of the BIS. One, the Financial Stability Institute, provides a venue for international seminar-type discussions among senior financial sector officials to promote better and more independent banking, capital markets, and insurance supervision based on the implementation of core principles for financial-sector supervision.

The second is the Financial Stability Forum, a G-7 initiative. Andrew Crockett, General Manager of the BIS serves in his personal capacity as Chairman. The Financial Stability forum reaches countries not previously involved in the BIS or its various committees.

The BIS staff numbers 485 and is drawn from 32 countries.

Challenges and Recommendations

During its 70-year history the BIS has adapted well to large changes in the financial industry and central banking practices. Its ability to adapt was due largely to its limited and homogeneous membership. An example of such adaptation is the way the BIS quickly rose to the challenge of meeting regulatory deficiencies at the international level. The BIS has also demonstrated its ability to convince the most financially important countries to adopt its standards.

The Commission recommends that the BIS remain a financial standard setter. Implementation of standards, and decisions to adopt them, should be left to domestic regulators or legislatures. The Basel Committee on Bank Supervision should align its risk measures more closely with credit and market risk. Current practice encourages misallocation of lending.

The monthly meetings of central bankers are held behind closed doors. This is widely regarded as an advantage. It facilitates discussion and comments within the group. The BIS keeps a low profile and is not well-known outside the circles of central bankers. Its accounting--using the arcane "gold franc" as a unit of account---and its loosely defined strategies and objectives also limit transparency. The BIS would improve external understanding of the bank if it expanded the quantity and quality of information about its activities.

The BIS might benefit from significant restructuring.[30] The bank currently consists of a wide array of committees that report to different bodies, with different memberships and different sponsors. This structure creates confusion about the allocation of responsibilities and the particular missions of each committee or group within the BIS. It contributes, also, to the lack of transparency noted above. While it is difficult for the Commission to make specific recommendations about how to restructure the BIS, it is our sense that **some streamlining of the BIS organizational structure would be desirable.**

The BIS's success as a meeting ground for central bankers has been facilitated by its small, homogeneous and cohesive membership. For that reason, membership expansion through

[30] See testimony of John Pattison, Nov. 16, 1999 on the Commission's web site.

the Financial Stability Forum, or other means---while potentially useful as a way of facilitating communication across more countries---is a potentially disruptive development for the BIS, and should be undertaken cautiously. The risk is that inclusion may come at the expense of efficacy.[31] The Commission recommends that **any expansion of membership in the BIS or its committees or groups be undertaken gradually and deliberately to avoid disruption of the information exchange that central bankers find valuable.**

[31] See the testimony of Michele Fratianni, Nov. 16, 1999 on the Commission's web site.

Chapter 5
The World Trade Organization

At the end of World War II, officials in many countries shared two perceptions about tariffs and trade. Most considered that high average duties mandated in the U.S. Smoot-Hawley Tariff Act contributed to the depth and severity of the Great Depression. They believed, also, that countries would not reduce tariffs or trade restrictions unilaterally. Experience with most-favored-nation clauses in the 1930s showed, however, that countries could reach bilateral agreements that extended benefits to others based on the most favored nation clause.

From 1949 to 1995, GATT, the General Agreement on Tariff and Trade, was the institutional embodiment of this consensus. The GATT was an interim agreement, not a treaty. In the United States, its legal standing was based on the President's authority to negotiate reciprocal trade agreements. Congress retained the right to approve the agreements as Executive Agreements, not treaties, so they were approved by majority vote in both branches of Congress, rather than by a 2/3 vote of the Senate.

The GATT had two principal activities. Under its umbrella, a growing group of countries reached agreements on nondiscriminatory reductions in tariff duties, quotas and other quantitative restrictions on trade in goods. Also, it managed dispute settlement procedures arising under the agreements. In its later years, the GATT worked to reduce barriers to international trade in services and nontariff barriers to trade in both goods and services. These new activities raised more complex issues than the earlier negotiations limited to tariffs and other quantitative restrictions.

Despite the absence of a formal treaty structure, GATT played a very useful role in the world economy. By creating and, to a degree, enforcing rules for trade, it encouraged trade expansion. Countries that adopted a strategy of export-led growth looked for their comparative advantage, and adopted new technologies to develop or enhance their competitive edge, thereby encouraging practices that increased living standards.

Postwar recovery in Europe and growth in Asia owe much to the gains from specialization and trade. Countries receiving exports from emerging economies gained from the spur of increased competition in their markets, from lower import prices, and from the expanding world market for their exports.

Governments in some countries, particularly Latin American countries, chose a different strategy, known as import substitution. Instead of seeking competitive advantage in global markets, these countries restricted imports in the interest of developing home production. For a time Latin American countries grew about as fast as the developing Asian countries, in part because they invested in new industries to replace imports.

By the 1970s, growth in the more open Asian countries surpassed growth rates in the import-substituting Latin American countries. A main reason was the competitive test that trade imposed on Asian countries. Their capital was more productive, their production more efficient.

Start of the WTO

Under GATT, nations reduced tariffs on goods to very low levels. Nontariff barriers, quotas, and restrictions on trade in services became the frontier for further relaxation of barriers to trade. After almost a decade of negotiation, GATT members agreed to increase the role, expand the scope, formalize the constitution, and change the name of the trade organization. On January 1, 1995, the World Trade Organization (WTO) replaced GATT.

The WTO agreement incorporated and extended earlier GATT agreements. It made two important additions: the General Agreement on Trade in Services and the Dispute Settlement Understanding. Also, it reached agreement on trade related aspects of international property rights.

The WTO makes special provision for developing least-developed and transitional economies. These include technical assistance and training to enable these members to participate more fully in the work of the WTO. Here its role overlaps slightly with that of the development banks and to some extent that of the International Monetary Fund as it presently operates.

Structure of the WTO

The headquarters of the WTO is in Geneva, Switzerland. As of November 13, 1999, there were 135 members (states or, in exceptional cases customs territories like the European Union, Hong Kong, or Macao.) All of the large trading nations, except Taiwan, are members or have applied for membership. Some thirty applications for membership are pending.

The WTO is a relatively small organization. The Secretariat staff of around five hundred is responsible to the director-general, currently Mike Moore of New Zealand. Its 1999 budget was about 122 million Swiss francs, approximately $75 million. Unlike other international bureaucracies, the Secretariat has no decision-making role. It provides technical and legal support and a public voice for its activities. Top-level decisions are taken at Ministerial Conferences, held at least every two years, and other decisions are made by the General Council, three subsidiary councils that report to the General Council, and numerous specialized committees, working groups, and working parties.

Powers of the WTO

Trade in Services

The General Agreement on Trade in Services (GATS) took effect in 1995 covering areas such as banking, insurance, telecommunications, tourism, hotels, and transport. States that are signatories to GATS commit themselves to provide access to their markets in these services. GATS also contains lists showing where signatories are temporarily not applying the "most-favored-nation" principle of nondiscrimination. A full new round of negotiations will seek to extend the scope of these agreements no later than 2000.

The fifth protocol of GATS concerns financial services. This protocol seeks to eliminate or relax limitations on foreign ownership of local financial institutions in banking, securities, and insurance, limitations on the juridical form of commercial presence, and limitations on the expansion of existing operations. As of September 30, 1999, sixty-one signatories to GATS had accepted the protocol and ten had not.

Allowing foreign participation in the financial services sector improves the operation of local financial markets, lowers the costs of these services and reduces risk. Presence of competing foreign banks and financial institutions works to reduce corruption and favorable treatment of politically connected borrowers. Further, many economies are too small to diversify production over a wide range of activities. If domestic banks are limited to financing local industry, and foreign competition is prohibited, the portfolios of banks and financial institutions have too little diversification. There is too much risk that a decline in a major local industry, or other disruption, would weaken local financial institutions, increasing failures and capital flight, followed by a banking and exchange-rate crisis. Part of this risk would be avoided by opening local markets to foreign competitors.

International banks diversify their assets and liabilities by lending to a wider range of industries and countries and taking deposits in many places. This enables them to reduce risk. Further, diversified banks can absorb local losses. Defaults in one country are balanced by profitability elsewhere.

In Chapter 2, the Commission recommended that the IMF require countries to open their financial markets as a precondition for IMF assistance in a crisis. This would both prevent the IMF from lending to countries with weak financial systems and encourage countries to reduce risk. Thus it serves the interest of developing countries and the world economy to encourage governments to accept the fifth GATS protocol.

Foreign competition not only improves the variety and quality of financial services while making them available at lower prices, it also increases the productivity of nonfinancial enterprises by increasing access to credit markets and tailoring the types of lending more closely to the borrowers' requirements. Thus the WTO's program of opening up financial services to foreign competition contributes to the growth of international trade and investment, world output and living standards, and economic stability.

Employment Effects of Trade Agreements

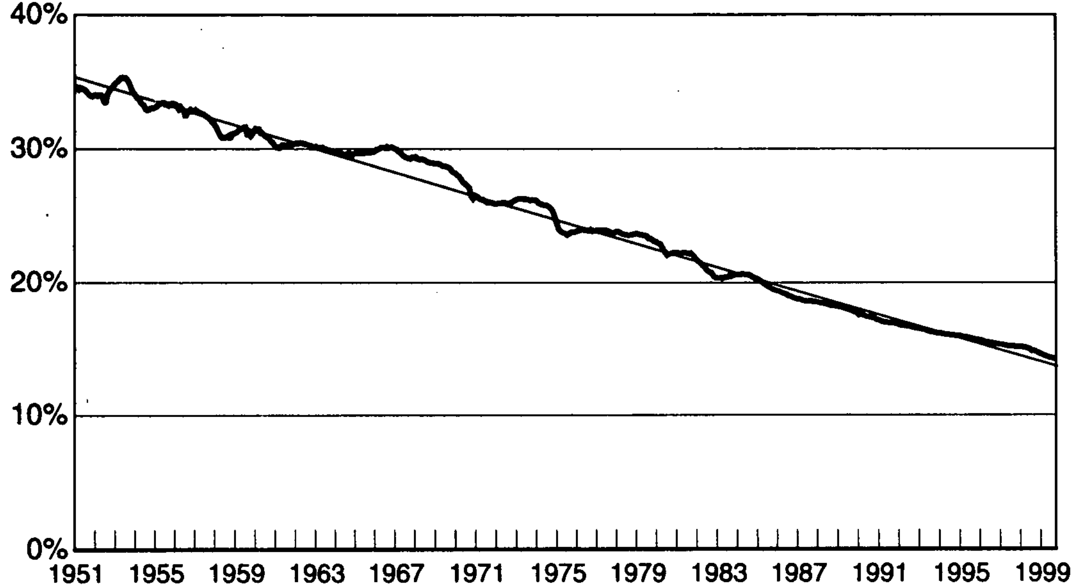
Critics of trade liberalization often argue that the adjustment to more liberal trading rules imposes a heavy burden on workers and firms that face increased competition from imports. By concentrating on firms and workers that are displaced, and neglecting consumers and those who gain, critics appear to deny that there are net benefits to a country from opening markets.

A common complaint is that the United States has lost manufacturing jobs. Chart 5-1 shows that the share of manufacturing workers as a percentage of the nonfarm labor force has, indeed, declined in the postwar years. In nearly fifty years, the share of manufacturing jobs has fallen from 35% to less than 15%. In the same period, the share of manufacturing output in total output declined much less. Manufacturing productivity increased: more manufacturing output is produced with fewer labor inputs.

Chart 5-1

Manufacturing Workers as a Percentage of the Nonfarm Labor Force

January 1951 - September 1999



The trend rate of decline in the share of manufacturing jobs is close to constant for the last fifty years. There is no indication that successive multilateral trade agreements, or passage of NAFTA, had any effect on the trend, contrary to frequent claims about job loss from this agreement. In fact, since the passage of NAFTA, the actual share of manufacturing jobs has been above trend. This is partly the result of the strong economy.

Trade liberalization does not affect the level of employment -- it does not create or destroy jobs in the aggregate. It affects the composition of the labor force and real wages. By making the economy more efficient, liberalization raises wages. Any resulting change in the composition of jobs is more accurately related to the ebb and flow of industry and commerce.

The Department of Commerce estimates that jobs supported by exports---jobs in trading companies and companies that export---pay 13 to 16% more than the national average of non-supervisory, production jobs. This supports the implications of the economic theory of trade: workers in the aggregate gain from trade expansion.

Dispute Settlement

Five hundred or more years ago, as trade expanded within nation states, rules for trade began to evolve. Courts developed procedures for enforcing rules and settling disputes within national boundaries. Trade agreements and enforcement encouraged the postwar expansion of trade by extending the rule of law to international disputes. With increased rules and laws, the need for interpretation, adjudication and dispute settlement encouraged the development of new institutions.

Dispute settlement activities developed slowly under GATT. Between 1947 and 1994, members brought only 300 disputes. Between 1995 and September 1999, members brought 179 cases. Three reasons explain much of the increase.

First, early GATT rules mainly regulated tariffs, so violations were more easily checked and settled. As GATT, and later WTO, expanded into nontariff barriers, beginning in the 1970s, different and more complex issues arose. Are health standards valid regulation or hidden protection? Does a restriction help mainly to preserve local culture or prevent foreign competition? Do foreign trucks meet local safety standards, or do local safety standards serve to protect local suppliers?

Second, the original GATT had 23 member states, many with broadly similar trading rules. Disputes were settled by negotiation among the contracting parties. As new countries entered after the 1960s, new problems arose. Countries had different standards of conduct and different orientations. For example, government procurement and subsidies to state-owned enterprises were much more important in some countries than in others. Some countries support or permit local cartels, and the local law may favor them. Other countries prohibit monopoly and cartelization.

Third, countries could veto adverse decisions, and they often did. Time to decision was long, procedures cumbersome, and decisions were often unenforceable.

In 1994, the Uruguay Round made major procedural and substantive changes. First, a more or less unified system replaced the fragmented system that had developed. Most disputes are now handled in a similar way, unlike the practices that developed in the 1980s. Second, an appellate body can review the legal basis for decisions made by the panels that adjudicate disputes. Third, decisions cannot be vetoed by a party to the dispute. Decisions stand unless there is a consensus of the members that the decision should not be enforced. Fourth, the length of time to settle disputes has been shortened.[32]

Recommendations

The WTO is a relatively new organization subject to change as experience with its strengths and weaknesses accumulates. The Commission had neither the time nor the expertise to evaluate all the changes that have occurred or the many proposals for future changes. It confined its recommendations to two areas: general principles of operation and the role of the WTO in promoting financial stability, safety and soundness.

Some General Principles

The WTO has two main functions. First, it administers the process by which trade rules change. Trade ministers (or their equivalent) negotiate agreements that legislative bodies can

[32] The United States brought 49 of 179 disputes in the first 4-1/2 years. Twenty-two were settled in favor of the U.S., by consultation or adjudication by panels. The United States lost six cases. The rest are in process.

approve or reject. Second, the WTO serves as a quasi-judicial body to settle disputes. Part of this process involves the use of sanctions against countries that violate trade rules.

Quasi-judicial determination, when coupled with the imposition of sanctions, can overwhelm a country's legislative process. As WTO decisions move to the broader range of issues now within its mandate, there is some risk that WTO rulings will override national legislation in areas of health, safety, environment, and other regulatory policies. The Commission believes that quasi-judicial decisions of international organizations should not supplant legislative decisions. The system of checks and balances between legislative, executive and judicial branches must be maintained.

Rulings or decisions by the WTO, or any other multilateral entity, that extend the scope of explicit commitments under treaties or international agreements must remain subject to explicit legislative enactment by the U.S. Congress and, elsewhere, by the national legislative authority. There should be no "direct effect" on U.S. (or other) law or the ability to impose fines or penalties until national legislative ratification is completed.

Enactment of this recommendation would limit the WTO's authority, and the authority of other international agencies, to impose sanctions on a country for violation of rules to which it did not agree. We recognize that this would weaken the application of the rule of law internationally. Its principal benefit is that it strengthens democratic accountability and precludes delegation and erosion of the legislative function.

If countries do not accept WTO decisions, injured parties have the right to retaliate by putting restrictions on imports from the offending country or region. The injured country then suffers twice—once from the restrictions on its exports, imposed by foreign governments, and again when tariffs or duties raise the domestic cost of the foreign goods selected for retaliation. To compensate for the injury done by others, we impose costs on ourselves as well as them.

The Commission proposes that, instead of retaliation, **countries guilty of illegal trade practices should pay an annual fine equal to the value of the damages assessed by the panel or provide equivalent trade liberalization.**

Retaliation is contrary to the spirit of the WTO. Sanctions increase restrictions on trade and create or expand groups interested in maintaining the restrictions. Domestic bargaining over who will benefit from protection weakens support for open trading arrangements.[33]

Rules for Financial Stability

The Commission recommends rules to enhance financial stability. Such rules can reduce risk, spread best managerial practices, increase competition, and reduce the role of government in the allocation of bank loans. The Commission recommends that explicit minimum financial standards be phased in as a condition for assistance from the IMF in a financial crisis. Chapter 2 discusses these preconditions. Enforcement of the preconditions should remain the IMF's responsibility.

We believe that proposals and recommendations to improve financial standards should be the responsibility of the groups on banking and financial standards associated with the BIS. Chapter 4 discusses the groups responsible for these proposals and recommendations. These responsibilities should remain with the Basel-based organizations, such as the Basel Committee on Banking Supervision.

The WTO is an adjudicative organization that has proved effective in settling disputes about tariffs and quantitative trade restrictions. **The WTO should not extend its procedures to set domestic policies and regulations, including regulation of banking services, accounting practices, or financial standards. These should remain the responsibility of specialized agencies.**

[33] A very useful discussion of these and related issues is in Claude Barfield, "More Than You Can Chew? The New Dispute Settlement System in the World Trade Organization," available from the Commission's web site, http://phantom-x.gsia.cmu.edu/IFIAC.

Supporting and Dissenting Statements

Dr. Lee Hoskins

I wish to express my appreciation to Allan Meltzer for his unfailing integrity, fairness and hard work as Chairman. Without his firm leadership, this Commission still could be wandering in a swamp of details, data and conflicting ideology. I fully support the recommendations included in the report for, if enacted, they would significantly improve the operations of the international financial institutions evaluated in the report. However, several of these recommendations I regard as "second best" solutions.

The best solution to international financial crisis is to allow markets to work their will. Intervention by the IMF or other crisis manager creates moral hazard, leads to less efficient financial markets and supports the continuation of bad economic policies in many countries around the world. A true world liquidity crisis, were it to occur, can only be dealt with by central banks since they are the source of base money. In short, I believe the United States and the world would be better off without the IMF.

Restricting the lending by development banks and focusing their efforts on the alleviation of poverty would be a significant improvement compared to current operations but why allow any lending at all. If a country can borrow in the market let it do so. If it cannot, then it is either too poor or too limited institutionally to qualify. Such a country does not need a loan, it needs direct aid or institution building. Eliminating all development bank lending would keep these banks from being distracted from their main mission, the alleviation of poverty.

I appreciate the opportunity to work with all those associated with this commission. I hope Congress gives this report the careful consideration it deserves.

Congressman Tom Campbell

"I commend my colleagues for an excellent report. I ask for my separate views to be noted in one regard. Whereas the Commission believes a limited role continues to exist for the IMF, as a 'quasi lender of last resort to emerging economies,' I remain concerned that fulfilling that role might actually deter the development of those institutions within the recipient countries that would make the IMF role unnecessary. Eventually, it is the commercial market that will determine credit-worthiness of enterprises within countries. The availability of a lender of last resort outside that commercial market may soften the drive toward the integration of the recipient country into the regime of international commercial lending. My concern in this regard has been accommodated somewhat by the phrase in the Commission's recommendation that the lender of last resort function is to be accomplished "under a system that would not retard the development of those institutions within the recipient country that would lead to the country attracting capital from commercial sources." It is fair to observe that I believe such conditions upon an IMF role would be very unlikely to be achieved, and hence, I believe the lender of last resort function should not be pursued."

DISSENTING STATEMENT

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

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

Misreading History

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

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

The history of successful development over the postwar period is even more dramatic. Never in human history have so many people advanced so rapidly out of abject poverty. The World Bank and the regional development banks contributed significantly to those outcomes. The report itself notes, at the outset of Chapter 1, that "in more than fifty postwar years, more people in more countries have experienced greater improvements in living standards than at any previous time." It ignores that reality for the remainder of the text, however, and the tone throughout is so critical as to convey the message that very little progress has occurred.

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

Promoting Financial Instability

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

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

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

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

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

- that the overwhelming systemic problem that needs to be addressed is moral hazard, despite a dearth of empirical evidence that this phenomenon had much to do with any of the three sets of crises in the 1990s (except for Russia, where the market's "moral hazard play" was related primarily to that country's being "too nuclear to fail" rather than to its economy or to prior IMF policies);

- that countries will be deterred from getting into crises, and hence having to borrow from the Fund, by according senior status to the IMF's claims on the country and by charging them "penalty interest rates"; the Fund already has *de facto* senior status and has already sharply increased its lending rates, however, and a crisis country in any event is motivated primarily by acquiring additional liquidity rather than by the terms thereof;
- that the IMF fails to require banking reform in borrowing countries, whereas it has done so in every crisis case in recent years;
- a misrepresentation of the extensive literature that assesses IMF conditionality, which reaches agnostic conclusions concerning its effectiveness rather than the negative verdict claimed in the report; and, closely related,
- a failure to compare actual outcomes in crisis countries with what would have happened in the absence of IMF programs; crisis countries obviously experience losses of output and other negative developments but the issue is whether they would have fared even worse without IMF help and the report, while noting the need to consider the "counterfactual," does not even attempt to address that central issue.

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

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

Undercutting the Fight Against Poverty

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

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

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

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

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

Fourth, the report wants the more advanced developing countries to henceforth rely wholly on the private capital markets for external finance. But those markets are enormously volatile as we have seen in the crises of both the 1980s and 1990s; the private money can flow back out, deepening crisis conditions, even faster than it came in. Moreover, the markets do not care if their funds are used for developmental purposes, especially poverty alleviation.

Unsubstantiated Proposals

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

- elimination of the World Bank's Multilateral Investment Guarantee Agency on the basis of three lines of assertions;
- elimination of the International Finance Corporation, one of the most successful components of the World Bank family, and the parallel entities at the regional development banks, without a shred of evidence that such actions would be desirable (and without acknowledging that such a step, along with the elimination of MIGA, would undercut the report's stated goal of increasing the flow of private sector resources to the poor countries);

- a shift of funding for all country and regional programs for Latin America and Asia from the World Bank to the Inter-American and Asian Development Banks, respectively, solely on the basis of cryptic assertions that the latter would do a superior job—which run counter to the judgments of most observers.

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

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

<u>Additional Problems</u>

There are numerous other flaws in the report:

- there is no reason to preclude the IMF from future assistance to high-income countries, which might need its help in future crises if global consequences are to be minimized;

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

The report also fails to address some of the central issues that must be part of any serious reform of the IMF. It should advocate, for example, much more effective "early warning" and "early action" systems to head off future crises. It should offer a formula for "private sector involvement" in crisis support operations, to assure sharing their financial burden between private creditors and official leaders (including the IMF), rather than simply "leaving that issue for participants." It should address the cardinal practical issue of how emerging market economies will manage their floating exchange rates, rather than simply reiterating that these countries should either fix rigidly or float freely—which very few now or ever will do. It should promote more stable exchange-rate arrangements among the major industrial countries, which are crucial for global stability and without which the emerging markets will continue to have severe problems whatever their own policies.

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

C. Fred Bergsten, Director, Institute for International Economics

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

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

Esteban Edward Torres, US House of Representatives, 1983-99

ADDITIONAL VIEWS OF RICHARD HUBER

I have signed both the majority report and the dissenting statement with Messrs. Bergsten, Levinson and Torres.

I agree with the basic thrust of the report that there is a need to recast the relative roles of the IMF and the World Bank. At the same time, I agree with the dissenters that the report is too negative in its appraisal of those institutions and that some of its recommendations might not work to benefit either the world economy or the national interests of the United States.

While I fully support the core recommendations of the report, I feel compelled to point to several areas where I am less than totally comfortable. To begin, I agree with the dissenters that the tone of the report should be more evenhanded in describing the half-century history of the IMF and the World Bank. It is easy to point to their failures and shortcomings, but there also have been many successes and achievements. I believe that the world is a better place that it would have been had the two institutions not existed.

I have consistently expressed my discomfort with the debt forgiveness recommendation for HIPCs. I would have much preferred a mechanism like Chile's Chapter – 18/19 debt-for-equity scheme of the late 1980s and early 1990s. Such mechanism would help kickstart the privatization process with the aim of prying the means of production in the HIPCs from the often larcenous hands of corrupt governments and putting them in the hands of entrepreneurs, domestic or foreign, who could operate them effectively and invest in them to create growth.

As to our proposed reforms for the IMF, I heartily endorse the narrowing of focus and the other steps in the report. Whole I also agree with the desire to make it more rules-driven, I am still concerned about making it totally mechanistic. In other words, since none of us can foresee the future, I continue to believe in giving considerable latitude to the executive board of the institution to react to future crises. I recognize that the final draft of the report remedies this in part, but I would have gone further.

I fully support leaving developmental, lending and poverty reduction grants to the World Bank (Perhaps under a new name) and the regional development banks. I also agree that these institutions should not be involved in balance-of-payment lending or financial crisis assistance. However, I do not think that the Commission had adequate time to study the various entities, especially the regional banks, well enough to support the recommendation that for Latin America and Asia the IADB and the ADB should be the sole institutions, respectively, with the World Bank keeping this responsibility for the rest of the developing world. While I certainly agree that the overlaps that exist today are wasteful and often counterproductive, I am not completely convinced that the sweeping division of the world in the report is the only or best way to achieve the goals of greater effectiveness and accountability.

When the Commission met on March 2, I mentioned my concern that any suggestion of "returning the capital" of the developmental institutions to their shareholders might not only appear unseemly, but really have a negative impact on the whole effort of poverty alleviation. It is easy to say that such withdrawals would be replaced by new monetary allocations to grant funds; in the political reality of the legislative bodies of donor countries, however, this could be very difficult to achieve.

Finally, I share the dissenters' concern about our treatment of the WTO. I think that all (or almost all) of us agree that scrutiny of it did not fit into our mandate to review the IFIs, I concur in our single meaningful recommendation about it (that penalties and fines are much better enforcement tools than retaliation), but I am afraid that anything we say may be "used against us" or, what is worse, be used against the WTO in the politically charged debate that will take place soon. I would prefer simply to leave out the part on the WTO with a comment as to how it did not really fall within the scope of our study and should be left for future consideration.

In closing, I want to echo the words of many of my fellow Commissioners who have complimented Alan Meltzer on his leadership and even temper throughout the long process of doing work that all of us hope will have some impact. I am proud to have been a member of the Commission.

Richard L. Huber
Hartford, Connecticut
March 3, 2000

SEPARATE DISSENTING STATEMENT OF

JEROME I. LEVINSON

I. SUMMARY

I join with Commissioner Bergsten in his statement and recommendations with respect to a revised role for the IMF and the World Bank. The majority proposal (Hereafter Majority), in contrast, effectively eviscerates the IMF, the World Bank, IDB and the ADB; it does not discuss, much less make recommendations, as to whether core worker rights (and environmental protection) ought to be incorporated into the main body of the WTO agreement, despite the fact that extensive testimony was taken on this issue.

This separate dissent to the Majority is to (i) elaborate in greater detail the implausibility of the Majority proposal for the IMF and World Bank (ii) register my disagreement with the Bretton Woods institutions one-sided labor market intervention policies; and (ii) propose the need for core worker rights and environmental protection to be incorporated into the main body of the WTO agreement.

I make four specific recommendations for consideration by the Congress:

RECOMMENDATION #1:

CONTINUED U.S. SUPPORT FOR THE BRETTON WOODS INSTITUTIONS SHOULD DEPEND UPON:

(A) THE U.S. EXECUTIVE DIRECTORS IN THESE INSTITUTIONS VOTING AGAINST FINANCING PROPOSALS FOR COUNTRIES THAT ARE EGREGIOUS ABUSERS OF CORE WORKER RIGHTS;

(B) A STATED POLICY BY THE USED'S IN THESE INSTITUTIONS THAT CREDITORS AND INVESTORS MUST MAKE A SUBSTANTIAL CONTRIBUTION BEFORE PUBLIC MONEYS ARE DISBURSED IN ANY FUTURE BAILOUT;

(C) A FORMAL STATEMENT BY THE USED'S IN THE BOARD OF EXECUTIVE DIRECTORS OF THE WORLD BANK AND THE IMF THAT THE U.S. CONSIDERS SETTLED THE RIGHT OF WORKERS TO FREEDOM OF ASSOCIATION AND COLLECTIVE BARGAINING AND THAT THESE RIGHTS ARE NOT OPEN TO FURTHER STUDY.

RECOMMENDATION #2:

AMEND THE WTO AGREEMENT TO INCLUDE A CORE WORKER RIGHTS PROVISION;

RECOMMENDATION #3:

AMEND THE WTO AGREEMENT TO CREATE A NEW CHAPTER IN THE MAIN BODY OF THE AGREEMENT INCORPORATING THE PROVISIONS OF ARTICLES XX (b) AND (g), THE "HEALTH AND SAFETY" AND "ENDANGERED SPECIES" PROVISIONS OF THE EXCEPTIONS CLAUSE OF THE WTO.

RECOMMENDATION #4:

ALLOW UNCONDITIONAL DEBT RELIEF FOR THE HIPC COUNTRIES, ALLOWING THEM A FRESH START: FUTURE ASSISTANCE CAN BE ASSESSED IN LIGHT OF HOW WELL THEY USE THAT FRESH START

II. THE IMF, THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS

A. THE IMF (Chapter 2)

The Majority recommendations are based upon two propositions, both of which are of dubious validity: (a) the 1995 Mexican bailout circumvented the Congress and encouraged "moral hazard", leading directly to the 1997 East Asian financial crisis;[34] (b) access to IMF resources is too attractive and easily available for member countries. Based upon these two propositions, the Majority conclude that the IMF should continue to exist, but only with a much reduced mandate: that of a quasi-lender of last resort for countries that are pre-qualified

[34] References are to chapters but as this was written, page references were not settled.

and can therefore automatically draw upon IMF resources for short- term financing by paying a "penalty" rate of interest and providing collateral for the resources drawn.

The IMF would be divested of discretionary judgment; it would be barred from imposing conditions on its financing designed to address the balance of payments problems which occasioned the need for IMF financing. Article IV consultations with member countries, by which the IMF informs itself and advises member countries as to economic issues relating to the balance of payments, would continue but not as a basis for "conditions" related to IMF financing.

1. The Mexican Bailout: Circumventing the Congress?

The Administration, initially, sought a $20 billion authorization of funds from the Congress to fund the Mexican bailout so as to avoid that crisis spreading to other emerging market economies. The Congressional Leadership of both political parties supported the proposal, but when it became evident that the funds would be used primarily to payoff the investors, including wealthy Mexicans, in short-term Mexican bonds-- tesobonos-- the Congress balked. Then U.S. Secretary of the Treasury, Robert E. Rubin, resorted to the Exchange Stabilization Fund (ESF) and requested the assistance of the IMF. (Sanger).

After an initial burst of Congressional criticism, that criticism dissolved. Constituents had invested in the emerging market funds that had promised a higher rate of return than they could then realize on more conventional U.S. investments. As Congresspersons began to hear from these constituents, a tacit bargain emerged: the Congress would mute its criticism of the Administration's actions and the Administration would ask nothing specific of the Congress. The bailout would go ahead but without explicit Congressional authorization. Investment by ordinary American citizens in emerging market funds had transformed the domestic politics of international finance.

The tesobono investors were overwhelmingly American investors. European Central Bank officials were openly skeptical of the contagion effect of the Mexican crisis, but they agreed to participate in an international effort which eventually amounted to $50 billion. The United States no longer had at its disposition a ready source of foreign aid funds as it did in the decade of the 60s; nor was there the urgency of the Cold War with the former Soviet Union to scare Congress into action. The Treasury, and the other Finance Ministers of industrialized countries, "raided" the IMF and World Bank funds for the Mexican, East Asian, and Brazilian 1990s bailouts because that's where they could find easily accessible money and there was no chance that the U.S. Congress and Parliaments of other countries would appropriate money for these purposes.

In an ideal world, such a raid on the funds of the IFIs for the purpose of bailing out imprudent lenders and investors, would not have been necessary. But we do not live in such a world. The Administration did not circumvent the Congress; on the contrary, it did the responsible thing in first seeking direct Congressional funding of the bailout. Both the Administration and the Congress understood the political reality that such funding was not going to happen. The raid on the funds of the IFIs reflected that reality.

2. Moral Hazard:Mexico Leads to East Asia?

Nor is the accusation of increasing moral hazard any better founded. In contrast to the tesobono investments, the East Asian commercial bank lenders were primarily Japanese and European banks, not American. It stretches credulity to believe that the Japanese and European banks engaged in their East Asian lending in expectation that, on the basis of the

Mexican tesobono experience, if those loans turned sour, a similar bailout would be organized on their behalf. They must have been well aware that their own government authorities were the ones most skeptical of the claim that the fear of contagion justified intervention in the Mexican case. There is no smoking gun memo from within any of the banks which as yet has surfaced, one which states, in effect, that, based upon the Mexican experience, if the borrowers cannot repay, the banks can count on an IMF led bail out similar to what occurred with Mexico.

The Chairman states that, in 1997, the Thai finance Minister, knowing that he lacked sufficient funds to support the value of the currency, nevertheless, committed himself to do so; he must have expected, like the Mexicans, that Thailand would also be bailed out by the IMF. (Meltzer Tr. Feb 2, pp.135-139). But this is speculation; no evidence is cited in support of the Chairman's statement. If the banks in Thailand expected to be bailed out, why did they pull their loans as rapidly as they did when the crisis commenced? (Council on Foreign Relations Task Force (hereafter CFR), p. 9). It is not unprecedented for finance ministers to hope that the mere statement that they will not devalue their currency will be sufficient to stop a run on the currency. That is what the Mexican Finance Minister did in December 1994, knowing full well, like the Thai Minister, that his country was hemorrhaging reserves. The result was equally futile.

After first detailing the efforts of U.S. officials to pry open Asian capital markets for the benefit of American firms, Kristof and Sanger summarize the responsibility for the East Asia short-term banking fiasco:

> "Responsibility can be assigned all around: not only to Washington policymakers, but also to the officials and bankers in emerging market countries who created the mess; to Western bankers and investors who blindly handed them money; to Western officials

> who hailed free capital flows and neglected to make them safer; to Western scholars and journalists who wrote paeans to emerging markets and the Asian century." (Kristof with Sanger).

Stanley Fischer, Deputy Managing Director of the IMF, candidly noted: "I see very little sign that the capital flows to East Asia bore any relationship to what happened in Mexico....nobody, including me, believed that those [the East Asian] countries, which had been growing at 8 to 10 percent, were structurally weak." (Fischer, Tr. p. 218).

Unable to establish with any degree of certainty that the Mexican bailout led to the East Asian crisis, the Majority assert that in Mexico, Asia and Russia, the IMF "did little to end the use of the banking and financial systems to finance government favored projects, eliminate so-called "crony capitalism" and corruption , or promote safer and sounder banking and financial systems." But, until the 1997 crisis, South Korea had "graduated" from IMF and World Bank funding; the World Bank East Asia Miracle report had praised the Korean credit system; Korea had followed a development model based upon the Japanese experience of directed credit by the government to foster specific industries. "Crony capitalism" only made its appearance as an explanation of the Korean problems in the aftermath of the 1997 crisis.

It is true that the Russian and Mexican banking sectors represent two of the greatest asset steals of the century:

> " In his bid to increase capital inflows, [Mexican President Carlos] Salinas [de Gortari] has put state banks on the block at three times their book value and often more...But in exchange for high prices, Salinas offered their buyers sweet regulatory deals and long term promises of fabulous riches through Nafta, which would soon allow some of the new owners to sell their monopolies corporations at record profits...Through a policy of "directed" or selected liberalization, Salinas paved the way for the formation of more than a dozen monopolies that would control industries such as copper mining and telecommunications. (Oppenheimer, p. 91).

John Lloyd describes a privatization process in Russia similar to what occurred in Mexico (Lloyd, p. 35). To attribute to the IMF responsibility for the corruption and favoritism that characterized the banking scandals in Mexico and Russia is either naive or cynical. The distribution of banking assets to favored players was an integral part of the political power system in both countries. The IMF could no more stop that process than King Canute could part the waters. What it is fair to say is that uncritical praise for Mexico's reforms and Russia's progress in achieving a "market" economy provided a mantle of legitimacy for a thoroughly corrupt process in both countries of privatization of state assets, but the IMF was hardly alone in its failure to blow the whistle: virtually all of the industrialized country officials looked the other way. The geo-political stakes in both cases were simply too great. To blame the IMF alone in both Mexico and Russia for the outcome is wrong. It is a reflection of the schizophrenic approach of the Majority to the IMF: it is either too interventionist or did not intervene effectively enough.

3. The IMF: Too Easy?

Equally implausible is the Majority assumption that countries are tempted to resort to the IMF for financing because such resort has been made too attractive for them. This assertion is as plausible as asserting that someone goes to the dentist to have root canal work done on his mouth because he enjoys it. Countries, more often than not, resort to the IMF too late because they fear that IMF conditions will be too burdensome.

4. IMF Conditions

The Chairman set forth the central belief of the Majority that the conditions imposed by the IMF do not advance democratic governance:

> " We believe that the interests of developing democratic government abroad, that the first step in that procedure must be to get the country to take responsibility for doing things that are in its own best interest. And that those can't be imposed from abroad and shouldn't be imposed by any international institution, even though we recognize that there's a useful role for advice." (Meltzer, Tr. Feb 2, pp. 200-1).

The Chairman is certainly right that if conditions are perceived in a country to have been imposed from without, they are unlikely to be effectively implemented. But the conditions that accompany IMF financing must be agreed with the country. It is the country that submits a letter of intent to the IMF, stating the country's proposed program. In practice, the content of the program incorporated in the letter of intent is negotiated with the IMF staff before it is formally submitted to the IMF. It is also true that countries, particularly small countries, desperate for assistance, may too easily agree with IMF staff suggestions. If that program departs too radically from what the political traffic in the country will bear, the program will certainly fail. The fact that a program is agreed with the IMF does not, by itself, undermine democratic government.

It is not unreasonable for the international financial community, in providing financing for a country with balance of payments difficulties, to want some assurance that the conditions that led to the need for such financing will be addressed. It is the content of the program that more often than not is the subject of dispute: is there an accurate diagnosis of the source of the problem? Is the burden of adjustment equitably shared within the society and between external creditors and the debtor country? These are contentious, but inevitable issues that accompany IMF assistance.

Mr Fischer was asked to speculate as to what would have happened had the IMF not intervened in 1997/8 in the East Asia:

> " I believe that the crises would have been bigger, not smaller. That is, each country, at the moment the crisis broke out, would not have had the external financing available...would have had to stop external payments. I do not believe that could have been done in an orderly way.. And I think you'd have turned off financing for developing countries all over the world...In addition, I believe that without the international assistance effort, the policymaking solutions, responses, in those countries would have been much weaker...." (Fischer, Tr. p. 217).

There is plenty of room to differ as to whether the IMF analysis as to the source of the problem in the East Asian countries was mistaken (Fischer, LA; Sachs, American Prospect); and whether the burden of adjustment was equitably distributed among creditor banks, debtor countries, and within both debtor and creditor countries. Rather than confront these issues in the future, the Majority has opted for an impractical and implausible solution.

5. IMPLAUSIBLE AND IMPRACTICAL

(a) Who Certifies as to Pre-qualification?

The Majority does not identify who is to certify that a country has met the pre-qualification criteria. The Majority do not wish to entrust this responsibility to the IMF staff; there is no indication that the Bank for International Settlements (BIS) has the capability or the desire to assume this task. Nor is it likely that an international consulting firm could perform this function. Countries are unlikely to accept a foreign firm, with other international clients, having access to sensitive national financial data.

(b) Opening to Foreign Banks

The Majority states that, among other criteria, a borrowing member country of the IMF would have to agree to open its banking system to foreign banks: "eligible member countries must permit freedom of entry and operation for foreign financial institutions in a phased manner over a period of years." Fernao Brasher, a former Brazilian central bank president who now heads a Sao Paulo bank with Austrian shareholders, though majority owned by Brazilians, urges the Brazilian government to limit the entry into Brazil of foreign financial institutions: " The richest countries of the world are wise enough to realize that national interests coincide with a strong, domestically led financial system...Why should Brazil, a developing country, be run rough-shod over?." Domestically owned Brazilian banks,

> " tend, in some instances, to support the stability of the financial system in times of crisis. For instance, in the tumult that followed the devaluation of the currency nearly a year ago, some foreign banks counseled their clients to avoid purchasing Brazilian government bonds and other securities, citing the risk of default." (Romero,a).

Despite Brazil having a strong domestic banking sector, if it were to impose limitations upon foreign ownership of domestic banks, under the Majority criteria, Brazil would be ineligible for future IMF funding. It is a technocratic approach. There is no room for national interests.

(c) Countries Most in Need Ineligible for IMF Assistance

If only countries that are pre-qualified are eligible for IMF funding, the Majority would cut off those countries that are probably most in need of such funding. Often, the crisis itself is what precipitates needed reform. Yet, the Majority would bar the IMF from conditioning its funding upon the implementation of a program designed to address the conditions that led to the crisis.

(d) Short Term Finance

The Majority assumes that a country which has resorted to IMF financing will quickly (weeks or months) regain voluntary access to the financial markets. (Majority, Ch. 2 p. 18). But what if it does not? What if the measures necessary to restore credibility in the market require legislative action, a time consuming and difficult process? The Majority assumes an almost automatic restoration of credit access in the private markets, but for countries for whom such access is, to begin with, already fragile, such an assumption might not be warranted.

Divested of any discretionary judgment, the IMF doesn't need a prestigious Managing Director, but a high level clerk, a couple of disbursing officers and a few lawyers to draw up the necessary legal documentation.

B. THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS

(1) The Financing Scheme in Detail (Chapter 3).

With respect to the World Bank, and the regional development banks, the Majority concludes that development financing displaces private market financing and, consequently, should be substantially curtailed. The World Bank would convert itself primarily into a non-financial development agency, with two tasks: (a) coordinating donor aid by individual countries and non-governmental agencies; (b) addressing issues not now being adequately addressed by any of the international agencies in the United Nations complex and without, finding innovative solutions for seemingly intractable problems.

The Majority recommends that poverty reduction programs and infrastructure projects be financed exclusively with grant funds. The grantee would not receive or administer the funds; the development banks would disburse directly to a vendor selected by the grantee. Loan funding would be confined to structural adjustment lending. In order to create an incentive for implementing agreed reforms, repayment of principal, under a structural adjustment loan, can be deferred for as much as ten years, provided that an independent third party certifies that the reforms have been implemented in a satisfactory manner, or, are still in place. If such a certification is not forthcoming, repayment of principal recommences.

The World Bank would cease operations (lending or grant) in its borrowing member countries in Latin America or Asia; that responsibility would be delegated to the IDB and ADB:

> "The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East."

However, the IDB and ADB would only be able to extend assistance (structural adjustment loans or grants) to countries without capital market access (as denoted by an investment grade international bond rating), or with a per capita income less than $4,000; starting at $2,500 levels, official assistance would be limited.

It proposes that, the "World Bank's role as lender would be significantly reduced." Repayments on the World Bank's existing IBRD portfolio will amount to $57 billion (49 % of loans outstanding) over the next 5 years and $102 billion (87 % of loans outstanding) over the next ten years." In vague terms, it proposes, "[s]ome of the callable capital should be reallocated to regional development banks, and some should be reduced in line with a declining loan portfolio." In other words, it should be returned to the shareholders; in the case of the U.S., it would be returned to the Treasury and would require Congressional appropriation for other uses.

Since the Majority recommends discontinuing World Bank lending in Latin America and Asia, the bulk of the repayments from borrowing member countries of the Bank in these regions will not be compensated by new loans from the World Bank; it is highly unlikely that the regional development banks will realize a commensurate increase in resources to be able to make-up for the loss of World Bank resources. There is likely to be a net loss of development resources for these countries. For five major borrowers of the World Bank--Argentina, Brazil, Mexico India and Indonesia--net repayments (that is amortization and interest less World Bank disbursements) over a five year period will be an estimated amount slightly in excess of $20 billion. (Salop/Levinson). Under such circumstances, repayment by borrowing member countries of the World Bank is almost certain to meet domestic political resistance. It is not in the interest of the United States to force a confrontation with major World Bank borrower countries in Asia and Latin America, many of whom have deep internal social unresolved problems.

(1) Displacement of Private Financing

The charge that the World Bank financing is concentrated in countries that have been market eligible and displaces private market financing is misleading. The Majority lumps all forms of foreign capital together, but Ernest Stern notes,

> " a very large part of private flows is directed to foreign investment, which is very important but serves a somewhat different function. A substantial portion of the rest is trade...and short term bank credits...You have a third element...which is portfolio equity investment and finally you have...long term debt financing...and it's only that part you can reasonably compare with the flows of the World Bank, because that's the same objective, sovereign Government borrowing on medium term." (Stern, Tr. pp. 111-112).

It is true that World Bank financing (and IDB lending) has been concentrated in the larger countries, many of which, at various times have been able to directly access the international financial markets. Those markets, however, have been highly volatile. Between 1983 and 1989, countries in the Western Hemisphere borrowing member countries of the

World Bank experienced a cumulative net outflow of $ 116 billion. (Folkerts-Llandau and Ito, p. 2). Only after the March 1989 Brady debt reduction initiative, did capital in significant amounts return to Latin America. In the period 1990 to 1994, Western Hemisphere countries received a net inflow of $200 billion albeit in a form different than syndicated bank loans: On average since 1990, 41 percent of capital inflows to all developing countries has been in the form of portfolio investment in tradeable bonds and equity shares, and 37 percent has been FDI. (Folkerts-Landau and Ito, p. 2).

The portfolio investments have, during the decade of the 90's, been particularly unstable, reversing course at the first sign of trouble. Over $220 billion of public resources in the decade of the 90's has had to be mobilized to bailout imprudent investors and lenders. A significant part of those resources has come from the development banks. The Majority, as does the CFR, rightly questions the desirability of use of the resources of the development banks for bailout purposes. But, given the fact that those resources were mobilized for this purpose, it is not surprising that, for the past two decades, the lending portfolio of the World Bank and the IDB, in particular, have tended to concentrate in their larger borrowing member countries. (That concentration is also a consequence of the limited implementation capacity of the smaller countries).

The displacement argument also misconceives the nature of development finance. President James Wolfensohn of the World Bank testified from his own personal experience as to the difference between commercial or investment banking and development financing:

> " I used to raise money for lots of countries...And I can tell you that I never had a discussion with them about their social policies or their economic policies...When we go in from the [World] Bank we go in on the basis of trying to look at what's happening to the country and what's happening to the people in the country and what's happening to social stability and what's happening on issues like governance,

> on openness of financial systems...Can you imagine the head of Goldman Sachs or Merrill competing for business, going in and talking to them about whether they should have a bigger education program?" (Wolfensohn, Tr. pp. 240-1).

In order for advice to be credible to the country authorities, it must be coupled with financing. (Wolfensohn Tr. p. 241; Stern, Tr. pp. 94/95). That dialogue between the Borrower and the development bank depends upon a relationship of trust and confidence, which is expected to continue over an extended period of time. The Majority proposed disbursement scheme, in which the borrower is divested of responsibility for administering the financing evidences a distrust of public sector officials that is not compatible with that relationship. It also largely defeats the purpose of development financing: that financing is not only concerned with achieving physical targets; equally, if not more importantly, it is concerned with policy and leaving the borrower institutionally stronger when the relationship ends. Not trusting the borrower with administration of the financing undermines this objective. (That distrust does not reflect my own experience, over a thirty year period, in dealing with high level officials throughout the Latin American region).

The private markets are not a dependable source of development finance. The development banks, in contrast, provide such a source of long-term finance for high value human capital investments. However, it is also true that for many of the more advanced middle income countries, it is time for the World Bank (and regional development banks) to begin, with them, to plan for reduced access to development bank resources, but that planning must be coordinated with market access experience over the next decade and take into account the financial consequences for both countries and institutions.

(2) Structural Adjustment financing

With respect to structural adjustment financing, the Majority rightly observes that reform is most effective when the country has made the political decision to undertake such reforms; it cannot be bribed from outside, or forced by "conditionality", to do it. And yet, the Majority proposes to do just that with a financing scheme that is both impractical and unwise. It is proposed that the borrower be given an "incentive" to carry out its obligations under an agreed structural adjustment program: deferral of repayment of principal for as much as ten years, provided that an independent third party, on an annual basis, certifies that the reform program is being implemented, or is still in place. If reform lags, or backslides, then, repayment resumes. Again, discretion is vested in an "independent" third party that would have the responsibility to determine whether the government is complying with its reform obligations, and enjoy the financial advantages of deferral of repayments, or must resume such payments. As with the IMF, the World Bank and the regional development banks, are divested of discretionary judgment for determining compliance.

Who are the 'independent" third parties that are vested with such extraordinary powers? Foreign accounting, consulting firms, academics? What borrowing member country of the World Bank is going to cede such discretionary power to foreign consultants or academics? The proposal is justified on the basis of creating an" incentive" for the country to comply with its reform commitments. It is conditionality by another name, but it is not even necessary. The incentive for the borrower complying with its commitments, as the Majority originally wisely said, is its decision that the reform is in its own interest, and the prospect of future funding from the IFIs.

<u>(3) A World Development Association?</u>

The World Bank changes its name to the World Development Association, a symbol of the diminished role of development financing. It may be true that not enough is being done in areas of public goods identified by the Majority, but it is hard to see why the new Association, largely divested of its financing function, should be any more effective as a coordinator of aid than the UN Development Agency. Or, why, for example, it should be more effective in addressing tropical disease research than the World Health Organization

(4) Relationship to Regional Development Banks

The Majority is preoccupied with duplication between the functions of the World Bank and the regional development banks. Undoubtedly, there is some overlap, but each of the development banks arose out of a specific history, often, as was the case with the IDB, in reaction to the priorities of the World Bank. That conflict has largely dissipated, but it is undesirable, as the IDB itself recognizes, to return to a situation where only one institution is the basis for assured long term development financing. Such monopoly breeds arrogance. The institutions do a pretty good job of working out priorities among themselves. The Majority's preoccupation with duplication is exaggerated. (Stern, Tr. pp. 102-3).

(5) Repayments and Grant Financing

The World Bank (and the IDB) are now, in their ordinary operations, on a self sustaining basis, that is present levels of lending for the foreseeable future, can be financed out of earnings and loan repayments by their borrowers. The proposal to return World Bank loan repayments to the shareholders, and to substitute grant financing for this self sustaining revolving loan fund, is a reckless gamble. The majority members of the Commission are not naive. President Wolfensohn testified as to the historic difficulty in obtaining Congressional appropriations for IDA financing (Wolfensohn, Tr. p. 234). The Clinton Administration abandoned any attempt to obtain from the Congress modest amounts of funds for the IDB soft loan fund. To return World Bank loan repayments to the shareholders and expect some substantial part of those repayments to reemerge from the domestic legislative processes as grant financing for the development banks is not credible. Whether intended or not, the return of capital to the shareholders can have only one result: undermine, discredit and ultimately terminate the World Bank, the IDB and the ADB. The Congress should reject the Majority proposal.

C. AN ALTERNATIVE

1 THE IMF-A MORE LIMITED ROLE

And yet, the Majority has a point. Like an archeological dig, layer upon layer of often competing and conflicting policy mandates have been imposed upon the Bretton Woods institutions: from limited and well defined functions in the first three decades of their existence, they have been: (i) entrusted with overseeing the debt workout of the 80s; (ii), the arbiters of internal structural reform within their borrowing member countries; (iii) the front line agencies of the international financial community in combating world poverty; (iv) entrusted with the responsibility for guiding into market economies the former Soviet Union and Eastern European countries ; (v), the lead agencies, particularly the IMF, in the decade of the 90s, in dousing the successive financial crises that appeared to threaten the stability of the international financial system.

They are, to a very great extent, the victims of their own success for, they are perceived by their major shareholders to be the only international institutions competent enough to be entrusted with these tasks. It makes sense to reconsider these multiple, and too often, conflicting mandates.

The first issue with respect to the IMF is should it continue to be a financial crisis manager, or should future crises be resolved by the market? Eichengreen and Portes are candid as to the risks involved in a market strategy:

> " Clearly life would go on in the absence of the IMF (or with a greatly reduced role for IMF lending). Lenders would still lend; borrowers would still borrow. But to say debt problems would be resolved by the consenting adults involved without additional costs being imposed on the principals and innocent bystanders is a leap of faith...without other institutional innovations that reduce the pain..." (Eichengreen and Portes pp. 15-16).

Eichengreen and Portes are equally candid in their paper as to the difficulties involved in accomplishing the institutional innovations to which they refer. A continued crisis managing role for the Fund is the most likely outcome, but that role has to change.

Secretary Summers states , " The basic principle is clear: programs must be focused on the necessary and sufficient conditions for restoring stability and growth. Intrusion in areas that are not related to that goal carries costs that exceed the benefits." (Summers, 1999). The CFR notes that the IMF "is still needed to see that balance of payments problems, be they under fixed or flexible exchange rates, are resolved in ways that do not rely on excessive deflation, competitive devaluations , and imposition of trade restrictions, and to respond to liquidity crises when neither private capital markets nor national governments can handle those problems well on their own." (CFR p. 115). And it is still more specific as to the limits of IMF conditionality: " The IMF should limit the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies." (CFR p. 116).

This more limited mission is contrary to the expansive terms in which the IMF has conceived its mission. In addition to the traditional concern with fiscal, monetary and exchange rate policy, the IMF also reviews,

> "the growth and welfare implications of a country's macroeconomic and structural policies have increasingly been taken into account, since they may strongly affect the credibility and sustain-ability of a country's overall macroeconomic policy. In addition, social, industrial, labor market, and environmental issues have increasingly been taken into account if these have significant implications for macroeconomic policies and performance."(IMF Survey, 1995).

It is difficult to see what element of domestic policy would not be a proper subject of IMF conditionality. The difference between the more limited role outlined by the Secretary and the CFR and the expansive mandate conceived by the IMF is the difference between night and day. It is reasonable to require of the IMF that as it assesses a country's proposed program, it make a judgment as to whether the program allocates the burden of economic adjustment equitably, and, if not, to negotiate for changes in the program. In more recent years, that is what the IMF has been doing. But it is unreasonable to expect the IMF, on a continuous basis, to be actively engaged in poverty reduction programs. It is not consistent with the more limited role envisioned for the institution by the Secretary. The IMF should continue to defer to the World Bank and the regional development banks with respect to poverty reduction programs.

2. THE WORLD BANK (AND THE REGIONAL DEVELOPMENT BANKS)

With respect to the World Bank, the CFR recommends: "The Bank should concentrate on the longer-term structural and social aspects of economic development. It should expand its work on social safety nets. But it should not be involved in crisis management, in emergency lending, or in macro-economic policy advice." (CFR p. 116). These are sensible general principles, but it is unlikely they can withstand the heat of actual crises such as the successive ones that occurred in the decade of the 90's. Absent an identified alternative source of public financing, which does not now seem to be on the horizon, the temptation will remain to do what every U.S. Treasury Secretary (and his counterparts in the other industrialized nations) has done since the 1982 Mexican default: resort to the Bretton Woods institutions as sources of funds and as crisis managers.

The issue, then, is how can these institutions carry out this function in a more equitable way than has been the case to date? In 1998, the IDB, as part of the Brazil bailout package, loaned Brazil $4.5 billion, one half of the IDB $9 billion annual lending program. The IDB coupled its financing with a commitment from the Brazilian government to maintain an agreed level of funding for human capital development in education and health. The linking of the IDB financing with the Brazilian Government's financial commitment for these two sectors was a way for the international financial community to say that the economic adjustment program that it supported should not sacrifice investment in the human capital of the country.

3. DISTORTED PRIORITIES: ONE-SIDED LABOR MARKET INTERVENTION

(a) The Successive Financial Crises

Like the movie Ground-Hog Day, the essential elements of the successive crises of the past twenty five years repeat themselves so that we seem to be reliving the same experience again and again. The syndicated bank lending of the decade of the 70's, the tesobono and East Asian financing fiascos, all have common characteristics: in each instance, banks and investors, awash with liquidity, seek a higher financial return than they can obtain in their home bases; without "due diligence", they invest (tesobonos), or loan (East Asia, 1970's, syndicated bank loans) to governments or banks and corporations in the developing countries; much of the resources are not used for productive investments; a combination of external and internal shocks leads to an international financial crisis, which is perceived to put at risk the international financial system.

The IMF and the World Bank are charged with overseeing the workout; the financial institutions, who were equally responsible for the crisis by their imprudent lending or investing, are bailed-out and rewarded: they are enabled to buy into local banks and financial institutions at bargain basement prices (Mexico and East Asia); the debtor countries are counseled to export their way out of the crisis, which, in practice, means flooding the U.S. market with goods and services because that is the only market that is effectively open to them; and, in order to make their goods more internationally competitive, the IMF and World Bank require governments in the debtor countries to adopt labor market flexibility measures--making it easier for companies to fire workers without significant severance payments, weakening the capacity of unions to negotiate on behalf of their members, all for the purpose of driving down labor costs and benefits.

Workers in both the industrialized and developing countries, particularly in the unionized part of the labor market, bear a disproportionate part of the burden of adjustment. (U.S. workers may, as consumers, have benefitted from lower prices as a consequence of lower cost imports, but that benefit is likely to be ephemeral; the increasing U.S. trade deficit, as both former Secretary of the Treasury, Rubin and Secretary Summers have repeatedly said, is not, economically, or politically, sustainable; manufacturing jobs lost to imports or FDI, are not likely to return).

Professor Joseph Stiglitz, former Chief Economist at the World Bank, observes:

> "[e] ven when labor market problems are not the core of the problem facing the country, all too often workers are asked to bear the brunt of the costs of adjustment. In East Asia, it was reckless lending by international banks and other financial institutions combined with reckless borrowing by domestic financial institutions–combined with fickle investor expectations–which may have precipitated the crisis; but the costs in terms of soaring unemployment and plummeting wages were borne by workers." (Stiglitz).

Professor Stiglitz's comment is an apt summary of not only the East Asia crisis but of each of the successive financial crises of the past twenty five years.

It should be a requirement in the future that before public funds are disbursed, the financial institutions involved in such crises must make a substantial commitment to the resolution of the crisis. Bondholders are not accustomed to such a requirement and, in contrast to the syndicated bank lending of the decade of the 70's, there are legal and practical problems in obtaining such a commitment. (Bucheit, Tr. pp. 460-74). But it is also true that a stated policy by the Bretton Woods institutions would put such bondholders on notice that in the future they cannot assume that they will be bailed out by the official financial community. The fear that such a requirement will retard market access for developing countries is exaggerated. The story of the past twenty five years is that, in the financial markets, greed trumps all other considerations. Indeed, the Latin American debtor countries only regained substantial voluntary access to the financial markets after the markets perceived a greater credit worthiness on their part after the Brady debt reduction initiative of March 1989.

(b) Labor Market Intervention

Joanne Salop, Vice President, Operations Policy and Strategy, World Bank, explains that, "with respect to freedom of association and the right to collective bargaining, the Bank is in the process of analyzing the economic effects in order to form an informed opinion." (Salop/Levinson). Robert Holzmann, Director, Social Protection, the World Bank, in a seminar jointly sponsored by the IMF and the AFL-CIO, elaborates on the Bank's reservations with respect to core worker rights, particularly the right of freedom of association:

> " And on both accounts we have a problem with some of the core labor standards, in particular, one which deals with freedom of association which concerns an important human right which has economic dimensions, but most importantly, also has a political dimension. This political dimension, which prevents us from simply using it as an instrument during our programs and to impose it on countries, because this would be considered as a breach of our rules."(Holzmann).

The "political" argument invoked by Mr Holzmann is a bogus argument: it is based on the idea that World Bank intervention for the purpose of addressing abuses of the right of freedom of association contravenes the provision of the Articles of Agreement that prohibits taking into account "political considerations" in the Bank's decisions". (Article IV, Section 10 of the IBRD Articles of Agreement).

To claim that result is required by Article IV, Section 10 of the Articles of Agreement, is a blatant distortion of the intent of the authors of the Charter, John Maynard (Lord) Keynes and Harry Dexter White. (Levinson). The Bank feels no such inhibition with respect to intervention in a country's labor market to condition its financing upon a member country taking measures–labor market flexibility– that make it easier for firms to fire workers, weaken the capacity of unions to negotiate on behalf of their members and drive down urban unionized wages. Nothing is more politically charged than such a one-sided labor market intervention that so blatantly favors the interests of employers.

Holzmann continues:

> "The second one has to do with the economics of core labor standards, in particular again, the freedom of association, because while there are studies out–and we agree with them that trade union movements may have a strong and good role in economic development– there are studies out that also show that this depends. So the freedom by itself does not guarantee that the positive effects are achieved." (Holzmann).

The Bank appears to be reopening in the year 2000, the debate, which we thought had been settled in the 1930s, about the desirability of allowing workers the right to form unions of their own choosing as a means of equalizing bargaining power between the individual worker and the enterprise.

Professor Stiglitz summarizes his experience with the labor issue in the World Bank:

> "I am just completing serving three years as Chief Economist of the World Bank. During that time, labor market issues did arise, but all too frequently, mainly from a narrow economics focus, and even then, looked at even more narrowly through the lens of neo-classical economics; a standard message was to increase labor market flexibility–the not so subtle sub-text was to lower wages and lay off unneeded workers." (Stiglitz).

We would not accept as a basis for domestic labor policy in our own society, at least the great majority of Democrats would not, the "narrow neo-classic economic lens" to which Professor Stiglitz refers. We should not accept it within the World Bank. The U.S. Executive Director (USED) should have read a clear and forceful statement in the Board of Executive Directors of that institution stating that the United States considers settled the right of workers to freedom of association and collective bargaining. (In the protocol of these institutions, reading a written statement signals that it carries the imprimatur of the Treasury, not just the USEd).

Mr Fischer denies that the IMF is one-sided in its labor market intervention. In Indonesia, in 1998, after the fall of the Suharto Government, Fischer observes, the IMF intervened with the new government to press for adoption of core worker rights, including the right of freedom of association and collective bargaining; Nazi Germany would not, he notes, on political grounds be eligible for IMF assistance. (Fischer, Tr. p 189). (The IMF Charter does not have a "political" clause, but the IMF has previously invoked, by means of a legal opinion, the same inhibitions as are asserted for the World Bank).

Mr Fischer's assertion of IMF intervention to assure freedom of association in Indonesia, and candid acknowledgment that there are limits to political tolerance, is a welcome departure from the continued invocation of the political section of its charter by the World Bank as a basis for failing to address labor market abuses; but there was also a disturbing aspect of Mr Fischer's testimony: he was relieved that the De La Rua government, elected in Argentina in 1999, has submitted its own labor flexibility measure legislation and therefore, a potential conflict with the IMF had been avoided.

The IMF intervention with respect to the Argentine labor market is, according to the IMF, a consequence of the Argentine currency regime that prevents the Country from using the exchange rate as a means of adjusting relative international prices. (IMF Submission, p. 21). The IMF— and successive Argentine Governments— seek to make Argentine goods more competitive in international markets by lowering labor costs. Achieving that objective, requires diminishing the social and economic gains of workers, and that requires weakening the unions that won those gains for their members.

The labor relations system in a country like Argentina is more than a question of optimum economic efficiency considerations: the union movement in that country is a result of a long history of social conflict; it is an essential component of the social compact of Argentine society. Any change in that compact ought to be negotiated within Argentine society free of pressure by the IMF or the World Bank. It should be no part of the "conditionality" of either institution in Argentina, or anywhere else in the world. It is not in the national interest of the United States to be associated with a policy that involves such a one-sided labor market intervention on behalf of employers. It is creating an increasingly alienated and embittered urban working class in both Argentina and other countries.

C. Does Growing Income Inequality Matter?

Income inequality in Latin America, already the worst in the world, increased in the past two decades, the period in which the Latin American countries embraced the market liberalization strategy. (Birdsall). A number of members of the Commission believe that growing income inequality is not important.

Commissioner Calomiris:

> "What I care about is poverty and, as Mr Huber mentioned, exiting from poverty, and I don't care very much about inequality. I don't think it's part of our objective as a Commission to be talking much about inequality" (Calomiris, Tr. Jan. 4, 2000, p. 78).

But the issue will not disappear:

"In Latin America today, all countries except President Fidel Castro's Cuba are free of military rule, but polls show that only two nations, Uruguay and Costa Rica, indicate a rate of satisfaction with democracy of over 50 percent. Although massive government corruption has prompted much disillusionment, analysts say it also stems from the fact that the benefits of the new free market have gone disproportionately into the hands of the rich." (Faiola).

Reporting on the prolonged strike at the National University in Mexico City, Julia Preston observes:

" But the student strikers were also a product of globalization...The government has stimulated growth by restraining inflation, mainly by depressing workers' wages. Official figures show that the minimum wage today buys 48 percent of what it did in 1982. So, while export enclaves have thrived, workers have been drawn into a spiral of downward mobility...[I] n today's increasingly impoverished urban working class, even small tuition costs can break a family."

Ms Preston concludes with a caution: "The damage to education and the division among Mexicans could serve as a cautionary tale to anyone who thinks the changes that globalization brings will only reinforce democratic institutions." (Preston). A far sighted leadership in the World Bank and IMF would have realized that market liberalization and privatization of state owned assets, required strong institutional counterweights. A strong labor movement, at its best, has been in the forefront of the fight for social justice; it might have provided such an institutional balance. (Stiglitz). But that is not the view that has prevailed in the Bretton Woods institutions.

4. The HIPC Initiative

The Majority observes that the debt of heavily indebted poor countries (HIPC) "cannot be repaid under any foreseeable future developments." (Majority, Ch. 2). Yet, they condition forgiving such debt on "debtor countries "implementing institutional reforms and an effective development strategy". The HIPC's are then the only ones, under the Majority proposal, that are subject to IMF conditionality. It makes more sense to accept the implications of the Majority observation that the debt cannot be repaid; unconditionally forgive the HIPC debt, and let the debtor countries start over with a clean slate. Future resources can be determined on the basis of an assessment of whether they have used well the opportunity gained by unconditional debt relief.

II. THE WTO

A. CORE WORKER RIGHTS

The Commission heard extensive testimony, including that of John Sweeney, President of the AFL-CIO, with respect to whether core worker rights should be incorporated into the main body of the WTO agreement and the role of labor flexibility in the Bretton Woods institutions. Yet, there is no discussion of the testimony or the issues in the Majority Report. (Majority, Ch. 5). The Commission colloquy with the witnesses is both provocative and illuminating. It is too important an issue to be ignored.

1. THE NORTH AMERICAN AGREEMENT ON LABOR COOPERATION AS PRECURSOR TO CORE WORKER RIGHTS AND THE WTO

The demand that core worker rights be integrated into the WTO agreement must be understood in light of the experience with the North American Agreement on Labor Cooperation (NAALC), the labor side agreement to the Nafta. The Nafta, like the WTO, is misnamed; both agreements are trade and investment agreements. Chapter 11 of the Nafta, designated the INVESTMENT chapter, prevents a party to the Nafta, read Mexico, from imposing restrictions on FDI. Both the Nafta and the WTO contain provisions dealing with intellectual property protection. The WTO, additionally, includes trade related investment measures (TRIMs) and a separate protocol in which countries agree to open their financial services market to foreign capital. Dispute settlement provisions in both agreements are detailed and allow for either trade sanctions or monetary penalties for violations of provisions assuring corporate property rights.

First, we ought to be clear about what we mean by core worker rights. Ms Thea Lee of the AFL-CIO, in her testimony of December 14, 1999, emphasized the qualitative nature of these rights: " The prohibitions, the three prohibitions on child labor, forced labor and discrimination and then the two affirmative standards that affirm the right to collective bargaining and the right to freedom of association. These standards do not in any way place quantitative restrictions on countries. They do not require that countries set minimum wages or hours limitations or anything of that nature." (Lee, pp.7-8).

Mexico has based its development strategy on attracting FDI. (Lustig). The Salinas de Gortari administration (1988-1994) evidenced its determination that it would brook no interference by Mexican workers in creating a climate conducive to attracting that investment. When a labor leader, a member of the governing political party, in Matamoros, in Mexico, which is across the border from Brownsville, Texas, tried to negotiate aggressively with largely U.S. owned maquiladora plants, he was arrested by Federal Police, bundled on a plane to Mexico City where he was held incommunicado for weeks. The companies then imposed their own contracts upon the leaderless workers. (Cody). In order to prepare the ground for privatization of the Cananea copper mining and smelting company, historically viewed in Mexico as the birthplace of Mexican trade-unionism, the government crushed the union by declaring the enterprise bankrupt, abrogating the collective bargaining contract with the union, and sending in the army to subdue worker protests. (Foreign Labor Trends, 1989-90).

In 1992, Volkswagen (VW), anticipating the enactment of the Nafta, determined that in order to be competitive it needed to lower wages and revise work rules, which it proceeded to unilaterally impose. The VW union, affiliated with the Confederation of Mexican Workers (CTM), closely allied with the governing party, approved without any consultation with the membership, the company's actions. The workers reacted with work stoppages and demands for the creation of a union not affiliated with the CTM:

> "After weeks of a bitter strike, Salinas gave VW permission to rip up the union contract. The company promptly fired 14,000 workers and rehired all of them, minus some 300 dissidents, under a new contract. Within days, VW revamped its entire Mexico operations–the German car maker's first such experiment anywhere." (Business Week, a).

By sending in the army to intimidate the workers at Cananea, symbolically so important in Mexico's union history, intimidating the too aggressive union leader in Matamoros, and allowing VW to unilaterally recast its operations, the message to Mexican workers was clear: don't get in the way of the government's determination to attract FDI, or you will be crushed.

Candidate Bill Clinton in 1992 understood that if these abusive practices continued at the same time that the Nafta dismantled the barriers to FDI, the temptation for American companies to relocate production to Mexico could be irresistible:

> " For a high wage country like ours, the blessings of more trade can be offset at least in part by the loss of income and jobs as more and more multi-national corporations take advantage of their ability to move money, management, and production away from a high wage country to a low wage country. We can also lose incomes because those companies who stay at home can use the threat of moving to depress wages, as many do today." (Clinton).

Candidate Clinton conditioned his approval of the Nafta upon complementary agreements that would assure that each party to the Nafta would effectively enforce its own labor and environmental laws. The NAALC contained no enforcement provisions for a violation of the core worker rights of free association and collective bargaining. Nor is there any legal bridge between the NAALC and the Nafta, so that violation of the NAALC brings no trade sanction or financial penalty under the dispute settlement provisions of the Nafta..(The WTO contains a provision on prison labor, but no other provision relating to core worker rights).

In summing up the results of the first proceeding alleging denial by the government of Mexico of the right of free association, the U.S. National Administrative Office (USNAO), which administers the NAALC on behalf of the U.S., observed:

> :"...Despite pursuing every legal means of redress, the attempts to register an independent union failed......interested workers who signed the original petition were subsequently dismissed from their employment and remain unemployed to date...It appears that such dismissals were intended as punishment and a warning to other Sony workers... (USNAO, 1995).

Three years later, in another maquiladora case (Han Young), involving the right of freedom of association, the USNAO concluded:

> "[t] he placement by the Tijuana CAB [a form of labor court in Mexico] of obstacles to the ability of workers to exercise the right of free association... is not consistent with Mexico's obligation to effectively enforce its labor laws on freedom of association in accordance with Article 3 of the NAALC...not one independent union had been registered or had obtained collective bargaining rights in Tijuana and only one other exists in the entire maquiladora sector." (USNAO, 1998).

The risk that candidate Clinton foresaw has materialized: American manufacturers increasingly seek to take advantage of the low wage business climate enforced by the Mexican government:

> "Mexico is now home to more than 3,000 export-processing plants, or maquiladoras, which produce everything from cars to pharmaceuticals to electronics. And new ones are sprouting up each day....Foreign direct investment, which averaged $5 billion a year under former President Salinas, has jumped to more than $10 billion a year under Zedillo." (Business Week, b, pp. 61-2).

Tens of thousands of auto parts manufacturing jobs have gone to Mexico. (Bradsher).

The General Electric Company has undertaken a new "super aggressive round of cost cutting"; in order to meet the stiff goals, "several of GE's business units–including aircraft engines, power systems, and industrial systems–have been prodding suppliers to move to Mexico...Migrate or be out of business; not a matter of if, just when. This is not a seminar just to provide information. We expect you to move and move quickly. " (Business Week, b, p. 74).

The NAALC and the Nafta were submitted to the Congress as a single package; the demand that core worker rights be included as a part of the WTO does no more than build on the experience of the NAALC. Based upon what we have learned in the NAALC, instead of ineffectual side agreements, those core worker rights must now be incorporated into the main body of any trade agreement.

2. OBJECTIONS

(a) Imposition from without

Chairman Meltzer observes that he is only opposed to imposing such rights from without (Meltzer Tr. Dec 14, p. 36). It is difficult to see why incorporating such worker rights into the WTO is any different than any other requirement that countries must adhere to as the price of admission to the WTO. Countries must accept national treatment of imported goods and services and an agreed intellectual property standard. Witnesses Daniel Tarullo and Professor Jagdish Bhagwati, strong supporters of globalization, both candidly admit that there is no basis for distinguishing core worker rights from an intellectual property standard in the WTO. (Tarullo, Tr. p. 188; Bhagwati, Tr. p. 26).

(b) The ILO Alternative

The Chairman and Commissioner Johnson both refer to a "strengthened" ILO as a substitute for including core worker rights in the WTO. (Meltzer Tr. Dec. 14, p. 65; Johnson, Tr. Dec 14, p. 87); but the ILO has no enforcement power. Neither the Chairman nor Commissioner Johnson make a concrete proposal as to how the ILO should be strengthened.

(c) Union Self Interest

Throughout the Commission Hearing on worker rights there is a suggestion by some members of the Commission that the advocacy by American labor leaders on behalf of workers is tainted by self interest. (Meltzer-Sweeney Tr. Oct 20 p. 29; Sachs Tr. Dec. 14, p. 116). That self interest, however, may also be a powerful force in initiating change which benefits the disadvantaged worker. A worker in Mexico, Salvador, Indonesia, or wherever, who can exercise the right of freedom of association and collective bargaining as a consequence of advocacy of these rights by American and European unions, is not less advantaged because these unions acted, in part, out of self interest. There are very few saints in the world. The fact that there is a coincidence of interests between American unions and workers abroad, denied their core worker rights, does not invalidate the efforts to assure such rights to all workers.

In the words of Gibson Sibanda, president of the Zimbabwe Congress of Trade Unions, "They tell us that African trade unions will be used by the trade unions of the industrialized countries to undermine the comparative advantages of African workers. It is vital that we insist that this is a question of fundamental human rights, and has nothing to do with protectionism." (ICFTU, November 1999).

(d) Protectionism: The "Bloody Shirt"

When the issue of core worker rights is raised by its proponents, the almost invariable response is that it is merely a disguised form of protectionism. The cry of protectionism has become the "bloody shirt" of trade politics. In the decades immediately after the conclusion of the Civil War in the United States, rather than debate pressing social questions arising out of the post-civil war industrialization, Republican politicians would resurrect against their Democratic opponents, who had been divided on the war, Civil War issues: was the opponent for or against the Union? This tactic was known as waving the "bloody shirt". In contemporary trade politics, rather than discuss a distorted international trade, finance and investment regime, and its social consequences, the defenders of the status quo wave the contemporary "bloody shirt" of protectionism.

In 1998, in Geneva, Switzerland, the ILO adopted a Declaration on Fundamental Principles and Rights at Work. The Declaration was initially opposed by the employer group in the ILO and most of the same nations that oppose incorporating core worker rights in the WTO. They contended that the Declaration would be used for protectionist purposes. Replying on behalf of both workers in the developing and industrial countries, the vice-chairperson of the Workers' delegation stated:

> "The Workers' group is quite clear that to ask to belong to a trade union and for it to bargain on your behalf is not protectionism; to seek an end to child labor is not protectionism; to wish to eradicate discrimination in the workplace is not protectionism; to call for an end to slavery or forced labor is not protectionism; but to deny those rights to workers in the name of comparative advantage–that is truly protectionism." (United Nations Association p. 57).

(e) Death in Africa and Responsibility for Poverty

In an exchange with Ms. Lee, Commissioner Sachs states,

> " I ...agree with you that international trade costs jobs in textiles and apparels. ...and that is what should happen in the kind of economy the U.S. has...I also see it as a huge benefit for the rest of the world to be able to produce textiles and apparel and sell them to the U.S. market...I will use the word nothing less than immoral how the textile lobby fought

liberalization of apparel from Africa. Because their people are dying for lack of access to the markets." (Sachs, Tr. Dec 14, p. 105).

Commissioner Calomiris framed the issue in blunt terms:

> " ... [i]s it true that core worker standards would help very poor people? Just to remind you, we're not dealing with the overfed teamsters here..I think that is a big problem and I really don't care very much , to be honest, compared to that problem whether employees in the United States have wages that go up or down by five or ten percent or whether anyone in the United States has wages or incomes that go up or down by five percent compared to that problem." (Calomiris, Tr. Dec. 14, p. 131).

For both Commissioners Sachs and Calomiris, the villains in the piece are the American workers, who stubbornly refuse to immolate themselves in the cause of poverty alleviation in the poorer countries, but this charge is a vast oversimplification. The Commission heard extensive testimony from Professor Ayyiteh on the endemic corruption and mismanagement in African countries.(Ayyiteh, Tr,. Sept. 28, 1999). (Commissioner Sachs did not identify specific African countries but painted with a broad bush.). Africa is afflicted with an AIDs problem of epic proportions. Until very recently, commodity prices for major exports from the African countries have been severely depressed. Many African countries had preferential access to the European market through the Lome Convention with the European Community, but that access did not result in a vigorous textile trade. To place the onus for "people dying" in Africa on the American textile worker is disproportionate to the facts.

Commissioner Calomiris elaborates:

> There simply is no basis aside from gross violations of human rights for a country to be told that it cannot participate as a trading partner with the rest of the world... denial of freedom of association and collective bargaining are not such gross violations: they don't come close". (Calomiris, Tr. Dec 14, p. 135).

According to the International Confederation of Trade Unions, 123 workers who tried to exercise these rights were murdered in 1998, 1,650 were attacked or injured, and 3, 660 were arrested. (ICFTU, January, 2000). Governments may not have been directly responsible for all of these abuses, but too many have been indifferent, amounting to complicity, in such abuses. We ought not to be equally indifferent, for we too then become accomplices.

(f) Jobs Lost: A Wash For the Economy as a Whole

In his dialogue with President Sweeney, the Chairman noted that if 500,000 jobs, as alleged by Mr Sweeney, had been lost in manufacturing, they had been more than made up for in other parts of the economy; Mr Sweeney was seeking to defend unionized jobs, but from the point of view of the economy as a whole, it was a wash. (Meltzer-Sweeney. Tr. Oct. 20, 1999, pp. 26-27; Majority, Ch. 5). But not all jobs are equal: " You keep referring to our members. I'm not talking about our members. I'm talking about the difference between good jobs and bad jobs. I'm talking about the high road versus the low road, and 500,000 manufactured jobs, organized, unorganized, whatever they are, are the issue here." (Sweeney Tr. Oct 20, 1999, p. 29).

The Majority state that the Department of Commerce estimates that jobs supported by exports pay 13 to 16 percent more than the national average of non-supervisory, production jobs. (Ch. 5, p.5). Other studies note that, "[i]n reality, imports are doing more damage to wages than exports are doing to raise them. At the economy's margins, where current rather than past trade is having its largest impact, imports have been destroying better- than-average jobs". (Economic Policy Institute, p.2). Even if one assumes, as does the Majority, that employment levels are controlled by macroeconomic factors (such as the intervention of the Federal Reserve), the effect of large chronic trade deficits "will present itself in the shifting composition of jobs (i.e, a shift from manufacturing to service sector jobs) and in deteriorating job quality (i.e falling wages for large segments of the workforce)" (Id at p. 5).

(h) Technology

The conventional wisdom is that technology accounts for whatever changes have taken place in the workplace that disadvantage workers. But there have always been technology innovations and there is no reason to think that contemporary technological change is any more disruptive than in the past: " Technology historians remain skeptical that the Internet age can match the period from about the 1880s to 1910 in terms of its impact on peoples lives. Inventions and new products from that period of technological dynamism included Bessemer steel making, refrigeration, the light bulb, the phonograph, the telephone, the radio, the automobile and the airplane." (Lohr).

(I) Not a Panacea

International worker rights is not a panacea. Where land tenure arrangements are as distorted as in Brazil, or, where, as in Mexico, the government encourages large land holdings for efficiency reasons, migration from rural areas to the great urban metropolitan centers will continue to put downward pressure on urban unionized wages. But such rights would eliminate, or, at least mitigate, the most egregious abuse in the international economic system: the deliberate use of the coercive power of the state to deny workers the most basic worker rights in order to gain a competitive advantage in attracting FDI.

B. THE ENVIRONMENT

There are two relevant provisions relating to (a) " measures necessary to protect human, animal or plant life or health" and (b) "to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption" Both provisions are contained in Article XX, (b) and (g), the General Exceptions clause of the WTO. Both provisions are carried over from the GATT, drafted over fifty years ago.

Under the dispute settlement provisions of the WTO , panels are established whose members are drawn from a WTO roster of trade experts. A permanent Appeals Body is also established to oversee the panels. The United States has invoked Article XX (b) and (g) as a defense for measures it has taken to protect exhaustible natural resources-- Dolphins, Sea Turtles and clean air. In all three cases, the invocation of the exceptions provisions under Article XX have been rejected. In each of the three cases the U.S. position was weakened because it could not demonstrate to the satisfaction of either the panels or the Appellate Body that it had made a serious attempt to reach an agreement with the other parties. It can, hence, be argued that to the extent the decisions encourage negotiation before resorting to the exception provisions of Article XX, they are not unreasonable.

A close reading of the cases, however, leads to the conclusion that it will be virtually impossible for any party invoking Articles (b) and (g) to ever prevail. Article XX has been given a narrow reading:

> "The Panel observed that Article XX provides for an exception to obligations under the General Agreement. The long-standing practice of panels has accordingly been to interpret this provision narrowly, in a manner that preserves the basic objectives and principles of the General Agreement. " (Tuna/Dolphin, June 16, 1994, p. 59).

More recently, the Appellate Body has confirmed this restrictive interpretation: "..[.t]he negotiating history of Article XX set forth limited and conditional exceptions from the obligations of the substantive provisions of the GATT." (Shrimp/Sea Turtle, p. 61).

Under these restrictive interpretations the environmental considerations are considered subordinate to the trade objectives. Yet, the Appellate Body in the Shrimp/Sea Turtle case notes:

" While Article XX was not modified in the Uruguay round, the preamble attached to the WTO Agreement shows that the signatories to that Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy. The preamble of the WTO Agreement–which informs not only the GATT 1994, but also the other covered agreements–explicitly acknowledges "the objective of sustainable development". (Shrimp/Sea Turtle p. 48).

In the Decision of Ministers at Marrakesh to establish a permanent Committee on Trade and Environment, the Ministers expressed their view that,

"there should not be, nor need be, any policy contradiction between upholding and safeguarding an open, non-discriminatory and equitable multilateral trading system on the one hand, and acting for the protection of the environment, and the promotion of sustainable development on the other..." (Shrimp-Sea Turtle, p. 58).

There is an evident tension between these expressions of the need for a balanced approach between trade, environment and sustainable development considerations and the continued highly restrictive interpretation given to the exceptions provisions of Article XX. That tension should be resolved by amending the WTO Agreement to transfer Articles XX (b) and (g) from the exceptions clause to a new chapter in the main body of the Agreement.

Without a change in the expertise of the roster from which panel members are selected however, neither a core worker rights or environmental amendment to the WTO can be effective. The roster from which experts are drawn for dispute settlement panels should be expanded to include individuals expert in environmental and labor matters.

This statement has not attempted to address the more profound issues of national sovereignty involved in decisions of the WTO. I would only note that any international agreement involves some limitation on national sovereignty. But the WTO does not have the legal authority to require a country to change its laws; as the frontier between more traditional cross border trade violations and policies previously considered internal to a country becomes increasingly blurred, this issue will certainly become more acute. I interpret the Majority's cautions in Chapter 5 of the Majority report to be a recognition of this fact.

III CONCLUDING REMARKS

If the IMF and World Bank are to play the essential role in the international economy that I believe is desirable they are going to have to accept that the high water mark of their role in overseeing structural transformation in their borrowing member countries has now passed. Professor Stiglitz reminds us that they approach issues from an "excessively economic" view, and, within an even more narrow neo-classical economic lens. That approach is singularly unsuited to the complexity of the kinds of transformations now in train in the East Asian countries as well as in Latin America. Each one of these countries is going to have to work out a new social compact within society. How they balance out economic efficiency considerations with social and political stability is for them to decide, just as it is for Argentina to determine how to revise its labor markets, an essential component of Argentina's social compact.

And a new social compact is going to have to be negotiated internationally that balances minimum standards of equity with economic efficiency criteria and national sovereignty. It is no good any longer waving the contemporary "bloody shirt" of alleged protectionism to avoid having to come to terms with the need for such a negotiation. The immediate battleground is in the IFIs. We are forced to try and persuade, or to coerce, existing institutions–the WTO, the World Bank and the IMF–to adopt minimum standards of equity for which they have little or no sympathy.

Is there any reasonable prospect that we can achieve such standards within these institutions? We cannot know the answer to this question so long as the United States sounds an uncertain trumpet. The President in Seattle, admirably, did not dissemble as to the United States objective with respect to the WTO: inclusion in the main body of the agreement of a core worker rights clause. His Trade Representative undermined this position, assuring other governments that the U. S. objective is limited to the establishment of a working group. (Dugger).

In the Bretton Woods institutions, despite the Congressional mandate included in the legislation establishing this Commission, to use the voice and vote of the United States in support of core worker rights, the USEDs' in these institutions have never voted against a financing for a government which is a notorious and egregious abuser of such rights. Countries opposed to core worker rights and environmental protection might well be excused for thinking that the U.S. commitment to these values is suspect.

It may be that the resistance in these institutions to such minimum standards is so great that no policy, no matter how consistent, will make a difference. In that case, the trade, investment and finance system, as now constituted, does not deserve further support. That is not blanket opposition to trade, development finance, or even globalization. It is opposition to a system that is now so profoundly inequitable that it is a travesty of what it ought to be.

A brief note on process

The Chairman refused to appoint, as is the custom in a bi-partisan commission, a deputy chairman from among the minority appointees. I believe this was a mistake. The Chairman was receptive to suggestions for witnesses and, even where it was evident that he did not agree, to subject matter. The Chairman briefed individual members of Congress; he was accompanied by staff, but there were no memoranda of conversation circulated to other members of the Commission. Nor was there any verbal briefing. As is evident from my own, and other, separate statements, there are strong disagreements, not necessarily along partisan lines, on substance among the members of the Commission. I would not have wanted my views represented to others by the Chairman. A Vice-Chairman would, I believe, have forced a more balanced consultation and communication process. For future reference, I would suggest that the Congress, in authorizing such Commissions, specify that a vice-chairman be appointed from among the minority appointees.

Unfortunately, neither the Majority, nor my own statement can do justice to the testimony of all of the witnesses who testified before the Commission; for those who wish to take the time to peruse the record, it is rich, if often contentious, as it should have been, in substantive discussion. I believe it initiated the beginnings of a constructive debate as to the future shape of the architecture of an international finance, trade and investment regime that can assure self sustaining growth with a greater degree of equity in distribution of the fruits of that growth than is now the case.

I would like to thank Gerald O'Driscoll, staff Director, and his assistant, Ferdinand von Galen, for their invariable courtesy and helpfulness.

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Development Grant Financing: More Aid per Dollar

Statement Presented to the Joint Economic Committee

of the Congress of the United States

by

Adam Lerrick

Senior Advisor to the Chairman of the

International Financial Institution Advisory Commission

April 12, 2000

It is a privilege to address the Joint Economic Committee.

One of the most controversial of the Meltzer Commission's proposals is the change in the format of development aid – the replacement of traditional subsidized loans (zero-interest credits) by grants for infrastructure and social service projects. This is a core issue in the discussion of the effectiveness of aid. Although the concept of grants is familiar, the new model is a hybrid variety.

Grants are a gift, but a gift with strings attached. They make possible the funding of a program in full, but are paid only after audited proof of concrete results. They reinforce discipline by demanding a current co-payment by the recipient. And they leverage every dollar of scarce aid resources by drawing upon the capacity and skills of the private sector. Even a decade ago, the capital markets did not imagine what they offer routinely today – sheer size, sophistication in instruments, and the willingness to tolerate the risk which once deterred projects in the developing world.

Loud and determined voices have risen in protest of the grant concept, all with one recurring theme: Grants will mean less money for the world's poorest.

Secretary Summers wrote in the Financial Times: "This would dramatically reduce the total amount of resources that can be brought to bear in these (developing) economies and require an unworkable system for delivering such assistance." World Bank President Wolfensohn in a letter to Commission Chairman Meltzer deemed grants "unrealistic" and went on to write: "In a time of severely constrained foreign aid budgets, it is highly doubtful that donors would be able to provide and to sustain the needed level of funding."

Clearly, the analysts at the Treasury and the World Bank have misunderstood the economics of grant financing and have ignored the potential of the private sector. A $100 million World Bank loan does not require $100 million in grants to achieve the same result. Every dollar of annual grants replaces 17 dollars of loans for the nations that need it most. The effective use of the $133 billion in equity resources already at the World Bank will generate an annual grant stream of $10.4 billion and support $185 billion in aid programs or 78% more than is currently provided to the poorest nations. Each new appropriation will yield 140% of its dollar value.

<u>How do grants replace loans?</u>

The economics of the Commission's grant financing proposal permits the development banks to leverage resources by drawing upon the vast capacity of the private sector. The only true aid component of development assistance and the only cash requirement of this new format in a world of sophisticated financial markets is the small grant or subsidy that fills the gap between what impoverished recipients can afford to pay and the real cost of supplying the service. This ranges from 90% of cost to 10% depending upon the nation's per capita income and capital market access.

An example will clarify the grant-loan equivalency. A $100 million 20 year project can be financed through a traditional World Bank 20 year subsidized credit. This would

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require $100 million of aid resources. Alternatively, the project could guarantee annual payments of $13 million upon delivery of results. If the income level and capital market access of the recipient qualify for 50% grant aid, the World Bank would enter into a direct contract to pay $6.5 million per annum to the provider upon delivery of service. The recipient government would enter into a similar contract with the provider to pay the remaining $6.5 million per year. The service provider would utilize the two contracts as security to obtain private sector funding. The financeable value of the direct World Bank revenue stream at a 9% yield is $59.3 million. The financeable value of the recipient country revenue stream at a 15% yield is $40.7 million. The private sector will provide the requisite $100 million in funding with only a $6.5 million per annum commitment of the World Bank.

Financing role of the private sector

Some may fear that the private sector will not provide the requisite resources because most truly poor countries are not creditworthy. This impediment is eliminated by the structure of the Commission's tools. The supplier is paid directly by the development bank upon independently verified delivery of service for its share of the cost. In the case of very poor countries with no access to the capital markets, the direct payment obligation of the World Bank will equal 90% of total cost. This eliminates 90% of the political/credit risk for the provider and hence its banker. A contract directly with the World Bank is eminently financeable in the private sector. The credit risk for the capital markets is therefore that of the service provider -- major international contractors and non-governmental organizations – not the aid recipient. The favorable cost of this funding will be incorporated into the user fee rates.

As the income level or capital market access of the recipient nation increases, the share of the World Bank payment in total cost declines but the ability to finance the recipient's contractual obligations in the private sector rises.

<u>Where will the grant funding come from?</u>

The World Bank has $133 billion in paid-in equity resources. Paid-in capital and retained earnings on the Bank's balance sheet amount to $29 billion. IDA, its aid arm, holds $104 billion in resources. If this endowment is invested in market instruments at a conservative 8% return, an income of $10.6 billion will be earned annually. After deducting $200 million in administrative expense, the existing resources in the Bank will generate a stream of $10.4 billion in annual grants in perpetuity.

The Commission has proposed two development bank tools: loans to promote institutional reform with subsidized interest rates based upon the Bank's cost of financing and grants covering a portion of user fees on infrastructure and social service projects. The extent of the interest and user fee subsidies will vary between 10% and 90% based upon the income level and capital market access of the recipient. The institutional reform loans would funded through the issuance of debt secured by the Bank's investment portfolio.

The $10.4 billion annual grant flow would be utilized to pay the interest subsidy on institutional reform loans and the user fee subsidy on infrastructure and social service projects. Utilizing the Bank's guideline of 25% of programs devoted to institutional reform, the grant system under existing resources will support $185 billion in aid programs for the world's poorest countries. This is 78% more than the current $104 billion maximum under IDA's prevailing system of subsidized credits. The proposed structure has the additional benefit of reducing the Bank's capital at risk to the poorest countries by 55% because the endowment and grant revenue stream are unaffected by the financial condition of the recipients. The current level of IBRD non-aid lending can be maintained and supported by the callable capital of its industrialized members and a portion of the Bank's equity and investment portfolio.

The endowment would start at $50 billion representing the IBRD equity capital and undisbursed funds at IDA. As each $100 of existing IDA credits is repaid, instead of relending it, it would be added to the endowment. This would create investment income of $8 and provide grants that would leverage $140 in new development programs. Similarly, each new appropriation would increase the endowment and raise total aid programs by 140% of the new funds provided.

Any modifications of the assumptions underlying the analysis including changes in financing rates, investment returns and amortization schedules will not alter the basic results significantly.

Effective Financing of World Bank Programs

Based Upon Existing Resources
($ amounts in billions)

	IDA Existing System of Credits	Proposed Grant System
Total World Bank paid-in capital	$133	$133
IBRD loans	$117	$117
Return on capital	n.a.	8%
Annual income	n.a.	$10.6
Administrative expense	n.a.	$0.2
Net income available for grants	n.a.	$10.4
World Bank borrowing for aid institutional reform loans	n.a.	$46
Capital at risk	$104	$46
Institutional reform resources	$26 (25%)	$46 (25%)
Project resources	$78 (75%)	$139 (75%)
Total aid resources	$104	$185

Assumptions:
1) Private sector financing costs: World Bank direct payment: 9%
   Recipient payment: 15%
2) World Bank cost of borrowing: 7% (incl. administrative expenses)
3) Internal World Bank amortization schedule of grants: 20 year level total payment
4) Average grant element: 50% of user fee/interest cost

From a financial standpoint, the Commission's proposal is straightforward. The proposal is making effective use of scarce development funds and of sophisticated financial markets.

The appendix provides an analysis of the sources of World Bank income. In contrast to the Bank's public statements, its income does not arise from lending activities. Interest rates on loans only cover the Bank's borrowing costs plus administrative expense. There is no link between loans to middle-income countries and transfers to the poorest members. The Bank's net income is derived from two sources unrelated to its development mandate: the investment of its equity capital and donor funds and the profit from the reinvestment of borrowed funds in market instruments.

APPENDIX

Sources of World Bank Income

It is a well-kept secret, but open to anyone who cares to scan the group's Annual Reports, that, totally independent of its development mandate, the Bank has been quietly accumulating earnings each year that now total over $27 billion. This income does not arise, as spokesmen aver, from proceeds on traditional lending programs. Interest rates on loans only cover the Bank's borrowing costs plus administrative expense. The link is fictitious; loans to Poland and Mexico are not bankrolling transfers to Burkina Faso and Nicaragua. Instead, like a foundation with an endowment, the Bank has been placing the funds provided by member nations in interest bearing assets.

The Bank costs its members a hefty $9 billion in cash each year, yet it pays no interest or dividends to the nations that own its resources. Instead, the investment of the zero-cost $29 billion of equity capital garners $1.8 billion in net income per annum. Then there are the "spread banking" profits. Based upon the guarantees of its industrialized members, the Bank enjoys very favorable interest rates in the financial markets. The proceeds of Bank debt issues are then reinvested at higher yields in mortgage-backed securities, commercial bank deposits, and government and agency bonds. As of June 30, 1999, $30 billion in market investments were held on its books, equal to 1½ years of lending programs. Arbitrage profits were $300 million last year. IDA is also an active investor in market instruments prior to disbursement to poor countries. Total holdings amounted to $8 billion in June 1999 and generated a $500 million profit in fiscal 1999.

It all adds up to $2.5 billion each year in income independent of the Bank's development mandate. If World Bank lending were to cease entirely, these three profit centers would continue to provision resources for the global poor.

Statement before the Joint Economic Committee

of the United States Congress

Charles W. Calomiris

Professor of Finance and Economics, Columbia Business School

April 12, 2000

Mr. Chairman, thank you for inviting me to appear here today. I want to begin by commending you and the Joint Economic Committee for having maintained over the last several years an open and lively forum for debate on reforming the IMF and the development banks.

It was a privilege for me to serve on the Meltzer Commission. We considered a remarkably broad range of issues, unearthed significant new information pertaining to the international financial institutions' policies, and made what I think are a set of careful and creative suggestions for reform. Others may disagree with us on the details of our recommendations, but I hope they will agree that our deliberations were a good faith effort, as is apparent in the strong bipartisan majority that voted for the Commission report.

In my previous testimony before the House and Senate Banking Committees, I outlined the Commission's recommendations, explained the rationale behind them, and responded to Secretary Summers' preliminary reactions to our report. Given the substantial common ground between Secretary Summers and the Commission, it is my hope and belief that most or all of the Secretary's doubts about our recommendations will be resolved by a fuller consideration of the logic that underlies them. I will not reiterate my previous testimony here today, but I am happy to answer any questions you or members of the Committee may have on these topics. I do, however, want to emphasize one point that received less attention in the earlier Congressional hearings.

A basic premise of our report is that the international financial institutions should be transformed into effective *economic mechanisms*. To be effective as economic mechanisms – that is, to avoid being employed merely as political slush funds for broad foreign policy objectives – they must have clearly defined goals, and they must meet disclosure and governance standards that ensure that they stay true to those goals.

Some members of the Commission – notably Mr. Levinsohn – have disagreed with the majority's view on this point. This, rather than the details of the economic reasoning of the majority, I believe, lies at the heart of the disagreement between the majority of the Commission and our critics. I think it is fair to say that Mr. Levinsohn, in particular, sees the multilateral agencies largely as vehicles of American foreign policy. Some observers might be forgiven for concluding from his remarks that he intends to use the IMF, WTO, and development banks as tools to further the protectionist interests of America's labor unions. I note, however, that this is not what Mr. Levinsohn says motivates his statements, and I think it would be wrong to question his motives. Rather, I want to question his central premise: that the IMF and the World Bank should be used as tools to pressure countries to adopt particular policies in pursuit of American interests.

I think, instead, that foreign aid should serve that function, and in so doing, aid should be subject to parliamentary oversight – consistent with the essential balance of power envisioned by our Constitution.

The role of the multilateral institutions should be fundamentally different from that of foreign policy. The multilateral institutions should improve the world economy by providing (first) global public goods (e.g., liquidity, the rule of law in international trade, and improvements in public health technology), (second) solutions to problems of negative externalities across countries (e.g., pollution and economic instability that spill across national boundaries), and (third) an effective means for coordinating the attack on poverty in the poorest countries.

These are sufficient challenges for the IMF, the development banks, the BIS, and the WTO. Adding a broad, discretionary foreign policy role to that list of challenges is highly counterproductive. It crowds out scarce resources that are needed for bona fide economic objectives. It distracts the management of the institutions, and forces them to depart from clear rules and objectives. It makes it hard to establish norms for the conduct of management and mechanisms to ensure accountability, and thus erodes the institutional integrity and credibility of the multilaterals.

The IMF's Russian fiasco of 1997-1998 illustrates that point nicely, as does the IMF's current program with Ecuador. No knowledgeable observer of Ecuador with whom I have spoken believes that Ecuador will adhere to the fiscal or regulatory reform conditions that the IMF is attaching to its proffered loan subsidies. Nor does anyone regard Ecuador's problem as one of illiquidity. Ecuador has been suffering a deepening fiscal crisis for several years, caused by the combination of an unresolved internal political struggle, weak banking system regulation, and severe adverse economic shocks.

Under current circumstances it is very hard to argue that channeling IMF loan subsidies to Ecuador makes sense either as a means of mitigating an illiquidity crisis or of spurring institutional reform. Some observers have argued that IMF aid is probably better understood as a means of sending political payola to the Ecuadoran government at a time when the U.S. wishes to ensure continuing use of its military bases there for monitoring drug traffic. I am not sure if that perspective is correct, but if the United

States wishes to provide foreign aid to Ecuador because of its value as a strategic military base for monitoring drug trafficking, let that policy be debated in Congress, and let our government decide whether to do so. Dragging the IMF into this affair only further weakens that institution's already damaged credibility.

I emphasize that I am not arguing against foreign aid, but rather for a separation between foreign aid broadly defined and the mandates of the international financial institutions.

That principle also explains why I do not think that the development banks, the IMF, or the WTO should require member states to adhere to specific rules governing their domestic economies, *unless those rules are necessary for the successful implementation of the narrowly defined economic objectives of the international institutions.* Let me clarify this point. Prudential regulatory standards for banks are a reasonable requirement for the IMF to impose on would-be borrowers, since that requirement reduces the possibility of the abuse of IMF loans. That goal, not a general desire to impose bank regulatory standards, motivates the Commission's recommendations in this area.

In this light, it is clear why so called "core labor standards" were not an element of our suggested prequalification requirements for the IMF. Similarly, because we saw the role of the multilaterals as confined to providing global public goods, poverty alleviation, and solutions to externalities across countries – and not to encroaching on national sovereignty for its own sake – we did not recommend that the World Bank or the WTO encourage (either through carrots or sticks) the adoption of core labor standards.

In this regard, I would like to clarify a statement that I made during the Commission hearings, which Mr. Levinsohn has repeatedly quoted – one which pertains to U.S. trade policy as well as to the appropriate use of conditionality by the multilateral institutions. In my view, the effect of imposing core labor standards on other countries through threats of protectionist policies is both disadvantageous to Americans and immoral. It is disadvantageous to us because it raises the cost of U.S. consumer goods. It is immoral because the effect of those standards in developing economies would be to prevent poor people (especially under-age poor people) from earning essential income necessary to feed, clothe, and house themselves.

Nonetheless, I would not argue (and did not argue during our hearings) that the United States should always be willing to trade with any country, or that countries should be allowed to participate in the multilateral institutions no matter what their domestic policies. For example, I specifically noted that countries like Nazi Germany were clear examples of evil, abusive regimes, which so violated the basic human rights of their citizens that it would be unconscionable to trade with them, much less to support them. There may be examples in today's world that cross that line. But permitting starving ten-year olds to work should not be sufficient to place a country on that black list.

Mr. Chairman, again I thank you and the Committee for inviting me, and for your attention. I look forward to your questions.

STATEMENT

PROFESSOR JEROME I. LEVINSON, DEMOCRATIC APPOINTEE CONGRESSIONAL ADVISORY COMMISSION ON INTERNATIONAL FINANCIAL INSTITUTIONS, BEFORE THE JOINT ECONOMIC COMMITTEE, APRIL 12, 2000

I am grateful to the Committee for giving me this opportunity to testify today in connection with the Majority Report and dissenting statements, including my own, of the Congressional Advisory Commission.

The international financial institutions (IFIs), as defined by the Congress--the World Bank, the International Monetary Fund (IMF), the World Trade Organization (WTO) and the three principal regional development banks--have been the principal means by which the wealthier countries collaborate with the less developed member countries of these institutions for the purpose of facilitating the economic and social development of the latter. It should be a noble enterprise. Yet, as the demonstrations taking place this week in Washington, and those that occurred in connection with the WTO meeting in Seattle in November 1999, evidence, that enterprise, for many in both the industrialized countries, including our own, and in the developing countries, has turned sour. Why?

In a meeting last week at the State Department with four leading mainstream non-governmental organizations (NGOs), in response to a question as to what they want, the answer given was a more just, open, democratic and transparent development policy. Who can quarrel with those objectives? So, what is all the controversy about? It is, in my view, about the lack of equity in the evolution over the past 15 years of the international trade, investment and financial system.

More specifically, it is about a two track international trading system, a rule based system for the protection of corporate property rights and no protection for core worker rights and the environment. It is about conditions imposed by the World Bank and IMF to assure the mobility and security of capital, without reference to income distribution effects; it is about these institutions setting conditions for labor market "reform"in their borrowing member countries to make it easier for firms to fire workers and weaken unions for the purpose of driving down urban unionized wages for competitive advantage, but ignoring the use of the coercive power of the state by many of these same countries to deny such core worker rights as freedom of association and collective bargaining, the foundation for all other worker rights. It is a distorted view of labor markets which pits unorganized workers against workers in the organized sector of the economy, and workers in developing countries against those in industrial countries. It is, in short, about an economic system, and the institutions, the IFIs within it, that have elevated the interests of capital as the priority objective of policy to the detriment of equity.

The issue has been stated most directly by the Inter-American Development Bank (IDB) in its 1999 Annual Report:

> "The inequality in evidence in Latin American society is one of the most pronounced in the world, and is one truly formidable barrier to the region's advancement....The notion of socially responsible economic policy is key to achieving more equitable development in the region. Such a policy means creating and evening out opportunities, looking at the distributional implications of all economic policy measures, not just those specifically designed to protect the poorest, averting economic crises, and fostering adjustment with equity."(IDB 1999 Annual Report, p. 7).

Reporting on the 1999 Chilean presidential election, the Washington Post observed, that in

Latin America, disillusion with democracy is widespread and not only attributable to corruption: "it also stems from the fact that the benefits of the free market have gone disproportionately into the hands of the rich." (Faiola, W Post, Jan 18, 2000). Explaining the prolonged and bitter strike over seemingly modest tuition increases at the National University in Mexico City, Julia Preston, the New York Times, observes:

> "...the student strikers were also a product of globalization...The government has stimulated growth by restraining inflation, mainly by depressing workers' wages. Official figures show that the minimum wage today buys 48 percent of what it did in 1982. So, while export enclaves have thrived, workers have been drawn into a spiral of downward mobility...[I] n today's increasingly impover. ;hed urban working class, even small tuition costs can break a family."

. Yet, the Majority is not only indifferent to the issues of equity, core worker rights and environmental protection as an integral part of the system of international trade, investment and finance; it is hostile to even considering such issues.

Commissioner Calomiris: "What I care about is poverty...and I don't care very much about inequality. I don't think it's part of our objective as a Commission, to be talking much about inequality". (Transcript, Jan.4 2000, p. 78).

With respect to core worker rights, Commissioner Calomiris is equally explicit:

> ..."[i]s it true that core worker standards would help very poor people? Just to remind you, we're not dealing with the overfed Teamsters here. ...and I don't care very much, to be honest, compared to that problem [poverty] whether employees in the United States have wages that go up or down by five or ten percent or whether anyone in the United States has wages or incomes that go up or down by five percent compared to that problem." (Transcript, Dec 14, 1999, p. 131).

Commissioner Calomiris continues:

> "There simply is no basis aside from gross violations of human rights for a country to be told that it cannot participate as a trading partner with the rest of the world...denial of freedom of association and collective bargaining are not such gross violations: they don't

come close." (Transcript. Dec. 14, 1999, p. 135).

This, despite the fact that, according to the International Confederation of Trade Unions, 123 workers who tried to exercise these core worker rights were murdered in 1998, 1, 650 were injured, and 3, 660 were arrested. The sentiments expressed by Commissioner Calomiris were endorsed by other Majority Members of the Commission.

The issues of growing income inequality, core worker rights and the environment (if cursorily), and the role of the IFIs in that development, were addressed by witnesses before the Commission: John Sweeney, President of the AFL-CIO, Thea Lee, Tom Palley, and Elizabeth Drake, also of the AFL-CIO, Professor Jagdish Bhagwati, a distinguished trade economist from Columbia University, New York City, Daniel Tarullo, former National Security Council aide, Claude Barfield, American Enterprise Institute, Professor James Galbreath, University of Texas, Professor Robert Barro, Harvard University, Jeff Faux, President Economic Policy Institute, John Cavanagh, Director, Institute for Policy Studies, Douglas Hellinger, President, Development Gap, and Brent Blackwelder, Friends of the Earth.

But you would never know from the Majority Report that the Commission heard this testimony. Indeed, one of the great virtues of the terms of reference for the Commission established by the Congress is that those terms recognized that in the era of globalization the traditional separation of trade, investment and finance into watertight separate compartments is no longer adequate. By defining the WTO, for purposes of this Commission, as an IFI, the Congress clearly indicated that the issues of international finance should be considered within a more ample context of trade, investment, and finance, considered as a whole. The Majority Report, however, could not break out of the traditional paradigm in which finance is set in a box apart from trade and investment. Within that paradigm, income inequality, core worker rights and the environment are not relevant.

One of the delicious ironies of the deliberations of this Commission is that the indifference of the Majority to core worker rights and income inequality is shared by the World Bank, which the Majority would, in effect, abolish. Professor Joseph Stiglitz, former Chief Economist of the World Bank, notes that during his time "labor market issues did arise, but all too frequently, mainly from a narrow economics focus, and, even, then, looked at even more narrowly through the lens of neo-classical economics; a standard message was to increase labor market flexibility--the not so subtle sub-text was to lower wages and lay off unneeded workers." In the year 2000, the World Bank cannot bring itself to support the most important core worker rights of all: freedom of association and collective bargaining. Apparently, they have concluded that the economic studies are inconclusive as to whether freedom of association advances economic development. The President of the Bank cannot get through the Executive Board measures that address abuse of core worker rights, but he can easily pass through the Board the labor flexibility measures to which Stiglitz refers.

It is that same neo-classical economics approach, in which a free competitive environment is uncontaminated by government regulation or intervention, that informs the Majority Report. They have concocted a scheme that is so implausible, impractical and conceptually unsound that it must fall of its own weight. In a more extensive separate dissenting statement , I have analyzed in detail, the one-sided and misleading nature of much of the Majority Report. That statement should be available on the Commission web site. In this abbreviated statement, I will highlight the principal deficiencies in the Majority recommendations.

With respect to the IMF, the Majority proposal is that only countries which are pre-qualified after a five year transition period , would be eligible for IMF financing; the pre-qualification criteria are financial and fiscal (the fiscal criteria were added as an afterthought after Commissioner Fred Bergsten's trenchant critique in the last meeting of the Commission). The IMF is specifically barred from attaching program conditions to such financing. (During the transition period countries that have not met the pre-qualification criteria would continue to be eligible for IMF financing but only upon paying a steeply penalty rate of interest).

Stanley Fischer, Acting Managing Director of the IMF, in a refreshing departure from World Bank rigidity on the subject of political constraints, admitted that there are, in fact, political considerations that would limit a member's access to IMF resources; he cited as an extreme example that Nazi Germany would not have been eligible for such financing. But under the Majority criteria, which are strictly financial (and fiscal) in nature, to use Mr Fischer's admittedly extreme example, a contemporary Nazi Germany, would, if it met the financial and fiscal criteria, be automatically eligible for IMF financing.

The Majority scheme misunderstands the nature of the problem in many of the developing countries; it is not merely a short-term liquidity crisis that countries face and leads them to the IMF. Very often, the balance of payments crisis is symptomatic of deep divisions within society which prevent coherent economic policy. The crisis is what often precipitates reform, but under the Majority criteria, the country which is not pre-qualified is hung out to dry; the IMF is barred from working out with the country a program that addresses the underlying conditions that led the country to seek IMF assistance. Such a program, in a context of representative political institutions, will often involve political negotiations among the different groups within society. Markets will wish to see a credible program, and performance over a reasonable time, before resuming market access for the country. That will take time, but the Majority proposal assumes an almost automatic resumption of market access.

The premise of the Majority Report is that access to IMF resources is too easily available for member countries, but this is like assuming that people go the dentist for root canal work because they enjoy it. No country willingly goes to the IMF for upper tranche level resources, with its stringent conditionality; rather, precisely because the conditions are so onerous, countries often wait too long before going to the IMF for assistance. So, the premise from which the Majority proceeds is fundamentally flawed..

The recommendations with respect to the World Bank are no more plausible. The World Bank is divested of all operations in Latin America or Asia. Development finance in these two regions is devolved upon the regional development banks, the IDB and the Asian Development Bank. The World Bank, or, as the Majority propose, renamed the World Development Association (WDA), becomes a super-development agency for African countries, at least for such time as the African Development Bank is judged not to be capable of assuming responsibility. Under this proposed scheme, the WDA ultimately becomes a source of technical assistance, a research agency for solution of previously insoluble problems, such as tropical diseases afflicting Africa, and a disseminator of best development practices.

Although, the regional development banks in Asia and Latin America are supposed to assume the responsibility for development finance in these regions, the only countries eligible for such financing are those with a per capita income less than $4, 000 (at $2,500 per capita income, access to such financing substantially declines), and those without access to capital markets. Financing is proposed on a grant basis for infrastructure and poverty reduction; structural adjustment programs would continue to be financed on a loan basis.

What is being proposed is not reform, but demolition of these institutions. The great strength of the World Bank, whatever disagreement may exist over specific policies, is its universal character. It is the one forum where all developing and developed countries discuss development issues related to a concrete issue: development finance. Without that finance, the World Bank becomes another United Nations Development Program (UNDP). It is unrealistic, without development finance, to expect it, as a source of technical assistance, to have the same credibility. Both James Wolfensohn, President of the World Bank, and Ernest Stern, former Executive- Vice-President of that institution, were explicit on this point. And it is difficult to see why the "reformed" World Bank is going to be more successful in addressing public health problems and research in Africa than the World Health Organization (WHO).

The IDB arose originally as a reaction to the World Bank priorities. That difference, to a very large extent, no longer exists. On a regional level, however, the IDB is a truly regional development finance institution. On the basis of the Majority criteria, however, in Latin America, the only countries eligible for financing (of whatever nature) would be the Central American countries, less Costa Rica, and Guyana, Haiti, Bolivia and Paraguay. The other countries are ineligible for per capita income reasons or because they have recourse to the private financial markets Without that development financing function, for the great majority of its countries, the IDB loses its identity as a regional development financing institution. Like the World Bank, politically, and realistically, it will increasingly become irrelevant for the region. The IDB cannot survive as the truncated organization proposed by the Majority.

The Majority does not believe in the legitimacy of development finance. For them, there is no difference between development and commercial financing. Hence, if a country has access to the private financial markets, there is no basis for its continued access to the development banks for development finance. I believe this is a mistaken view. Development finance is fundamentally different from commercial bank financing. Mr Wolfensohn testified from his own personal experience as to the difference between the two:

> "When we go in from the [World] Bank we go in on the basis of trying to look at what's happening to the country and what's happening to the people in the country and what's happening to social stability and what's happening on issues like governance, on openness of financial systems...Can you imagine the head of Goldman Sachs or Merrill competing for business, going in and talking to them about whether they should have a bigger education program?"

Moreover, access to the financial markets, over the past twenty five years, has been highly volatile. The development banks provide a reliable source of financing for high value projects and programs, particularly for human capital investment in health, education and technology related programs and projects. In times of financial crisis such financing becomes particularly invaluable. For example, in Brazil, in 1998, the IDB coupled its financing related to the then financial crisis, with a commitment by the Brazilian government, in contrast with past practice, to maintain an agreed level of investment in the education and health sectors.

The IDB 1999 Annual Report notes that net capital flows to the region peaked at $80 billion in 1997 but in 1999 "totaled only an estimated $50 billion. The decline in private capital was even more pronounced, but was offset in part by funding from multilateral institutions. The most volatile component of the capital flows was portfolio investment." (P.1).

Development finance provides both a qualitative difference and a balancing element to the high volatility of the private financial markets. At present levels, for both the World Bank ($25 billion per annum) and the IDB ($9 billion per annum), the annual lending programs are self financing from loan repayments and earnings. Counterpart financing by the borrowers to projects and programs financed by the development banks is roughly equal to the amount of such financing, more for more economically advanced countries and less for less developed ones. For the Latin American regions, the combined level of financing for the World Bank and the IDB, is approximately $15 billion; with counterpart financing from the borrowers, the region then has an assured level of long term development finance, insulated from the vagaries of the private financial markets, for high value human and physical infrastructure investment of approximately $30 billion.

Yet, the Majority proposes to abandon this self financing mechanism and substitute for it grant financing, an increase of which is certainly desirable, but, realistically, is also subject to the fiscal and political uncertainties of member governments. The only reason for doing so, in my opinion, is to undermine and, ultimately, abolish the development banks as a reliable source of development finance. The Congress may wish to endorse the Majority proposal, but there should be no uncertainty about what is involved: the abandonment of that cooperative effort at development that these institutions, with all of their deficiencies, now represent.

There is no balance in the Majority report; there is no balance in the WTO rule based system for the protection of corporate property rights, but no protection for core worker rights or the environment; there is no balance in the passion of the World Bank and IMF for driving down wages and benefits for unionized working people and their indifference to abuse of core worker rights. There is no balance in pushing indiscriminately for privatization of state owned assets, without considering the accompanying increase in the concentration of economic power and income inequality. Reform of the policies and priorities of the IFIs is in order, indeed indispensable, if they are to engender widespread public support, but the not reforms proposed by the Majority Report. What is required is reform that restores some minimum equity to the international trade, investment and finance system that does not now exist.

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April 26, 2000

The Honorable Fortney Pete Stark
239 Cannon HOB
US Congress
Washington, DC 20515-0513

Dear Congressman Stark:

At the Joint Economic Committee hearing on April 12, you asked me to explain the meaning of "rational" environmental programs as used in the Report of the International Financial Institution Advisory Commission.

A rational environmental program takes account of both costs and benefits. As an example, the Kyoto treaty is unlikely to meet this standard.

I would like to take this opportunity to respond also to your insulting remarks about the majority members of the International Financial Institution Advisory Commission. It should not be necessary to remind you that you should read the report before you condemn it, but apparently it is. I believe you would find many proposals that you could support, if you made the effort to inform yourself.

Be assured that I and others would be glad to answer any questions you might have after you have read the report.

Sincerely yours,

Allan H. Meltzer

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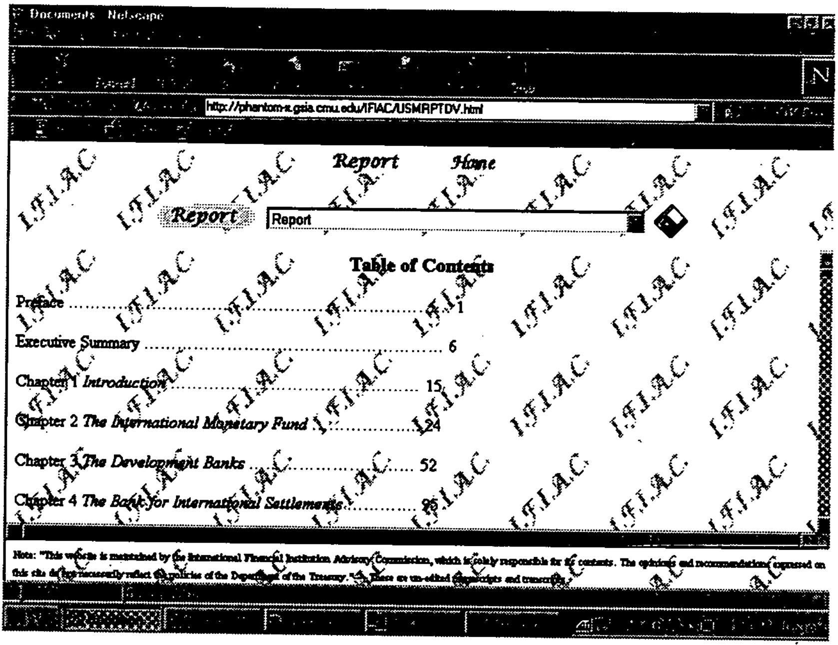

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SEPARATE DISSENTING STATEMENT OF

JEROME I. LEVINSON

I. SUMMARY

I join with Commissioner Bergsten in his statement and recommendations with respect to a revised role for the IMF and the World Bank. The majority proposal (Hereafter Majority), in contrast, effectively eviscerates the IMF, the World Bank, IDB and the ADB; it does not discuss, much less make recommendations, as to whether core worker rights (and environmental protection) ought to be incorporated into the main body of the WTO agreement, despite the fact that extensive testimony was taken on this issue.

This separate dissent to the Majority is to (i) elaborate in greater detail the implausibility of the Majority proposal for the IMF and World Bank (ii) register my disagreement with the Bretton Woods institutions one-sided labor market intervention policies; and (ii) propose the need for core worker rights and environmental protection to be incorporated into the main body of the WTO agreement.

I make four specific recommendations for consideration by the Congress:

RECOMMENDATION #1:

CONTINUED U.S. SUPPORT FOR THE BRETTON WOODS INSTITUTIONS SHOULD DEPEND UPON:

(A) THE U.S. EXECUTIVE DIRECTORS IN THESE INSTITUTIONS VOTING AGAINST FINANCING PROPOSALS FOR COUNTRIES THAT ARE EGREGIOUS ABUSERS OF CORE WORKER RIGHTS;

(B) A STATED POLICY BY THE USED'S IN THESE INSTITUTIONS THAT CREDITORS AND INVESTORS MUST MAKE A SUBSTANTIAL CONTRIBUTION BEFORE PUBLIC MONEYS ARE DISBURSED IN ANY FUTURE BAILOUT;

(C) A FORMAL STATEMENT BY THE USED'S IN THE BOARD OF EXECUTIVE DIRECTORS OF THE WORLD BANK AND THE IMF THAT THE U.S. CONSIDERS SETTLED THE RIGHT OF WORKERS TO FREEDOM OF ASSOCIATION AND COLLECTIVE BARGAINING AND THAT THESE RIGHTS ARE NOT OPEN TO FURTHER STUDY.

RECOMMENDATION #2:

AMEND THE WTO AGREEMENT TO INCLUDE A CORE WORKER RIGHTS PROVISION;

RECOMMENDATION #3:

AMEND THE WTO AGREEMENT TO CREATE A NEW CHAPTER IN THE MAIN BODY OF THE AGREEMENT INCORPORATING THE PROVISIONS OF ARTICLES XX (b) AND (g), THE "HEALTH AND SAFETY" AND "ENDANGERED SPECIES" PROVISIONS OF THE EXCEPTIONS CLAUSE OF THE WTO.

RECOMMENDATION #4:

ALLOW UNCONDITIONAL DEBT RELIEF FOR THE HIPC COUNTRIES, ALLOWING THEM A FRESH START: FUTURE ASSISTANCE CAN BE ASSESSED IN LIGHT OF HOW WELL THEY USE THAT FRESH START

II. THE IMF, THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS A. THE IMF (Chapter 2)

The Majority recommendations are based upon two propositions, both of which are of dubious validity: (a) the 1995 Mexican bailout circumvented the Congress and encouraged "moral hazard", leading directly to the 1997 East Asian financial crisis;[34] (b) access to IMF resources is too attractive and easily available for member countries. Based upon these two propositions, the Majority conclude that the IMF should continue to exist, but only with a much reduced mandate: that of a quasi-lender of last resort for countries that are pre-qualified and can therefore automatically draw upon IMF resources for short- term financing by paying a "penalty" rate of interest and providing collateral for the resources drawn.

The IMF would be divested of discretionary judgment; it would be barred from imposing conditions on its financing designed to address the balance of payments problems which occasioned the need for IMF financing. Article IV consultations with member countries, by which the IMF informs itself and advises member countries as to economic issues relating to the balance of payments, would continue but not as a basis for "conditions" related to IMF financing.

1. The Mexican Bailout: Circumventing the Congress?

The Administration, initially, sought a $20 billion authorization of funds from the Congress to fund the Mexican bailout so as to avoid that crisis spreading to other emerging market economies. The Congressional Leadership of both political parties supported the proposal, but when it became evident that the funds would be used primarily to payoff the investors, including wealthy Mexicans, in short-term Mexican bonds-- tesobonos-- the Congress balked. Then U.S. Secretary of the Treasury, Robert E. Rubin, resorted to the Exchange Stabilization Fund (ESF) and requested the assistance of the IMF. (Sanger).

[34] References are to chapters but as this was written, page references were not settled.

After an initial burst of Congressional criticism, that criticism dissolved. Constituents had invested in the emerging market funds that had promised a higher rate of return than they could then realize on more conventional U.S. investments. As Congresspersons began to hear from these constituents, a tacit bargain emerged: the Congress would mute its criticism of the Administration's actions and the Administration would ask nothing specific of the Congress. The bailout would go ahead but without explicit Congressional authorization. Investment by ordinary American citizens in emerging market funds had transformed the domestic politics of international finance.

The tesobono investors were overwhelmingly American investors. European Central Bank officials were openly skeptical of the contagion effect of the Mexican crisis, but they agreed to participate in an international effort which eventually amounted to $50 billion. The United States no longer had at its disposition a ready source of foreign aid funds as it did in the decade of the 60s; nor was there the urgency of the Cold War with the former Soviet Union to scare Congress into action. The Treasury, and the other Finance Ministers of industrialized countries, "raided" the IMF and World Bank funds for the Mexican, East Asian, and Brazilian 1990s bailouts because that's where they could find easily accessible money and there was no chance that the U.S. Congress and Parliaments of other countries would appropriate money for these purposes.

In an ideal world, such a raid on the funds of the IFIs for the purpose of bailing out imprudent lenders and investors, would not have been necessary. But we do not live in such a world. The Administration did not circumvent the Congress; on the contrary, it did the responsible thing in first seeking direct Congressional funding of the bailout. Both the Administration and the Congress understood the political reality that such funding was not going to happen. The raid on the funds of the IFIs reflected that reality.

2. Moral Hazard:Mexico Leads to East Asia?

Nor is the accusation of increasing moral hazard any better founded. In contrast to the tesobono investments, the East Asian commercial bank lenders were primarily Japanese and European banks, not American. It stretches credulity to believe that the Japanese and European banks engaged in their East Asian lending in expectation that, on the basis of the Mexican tesobono experience, if those loans turned sour, a similar bailout would be organized on their behalf. They must have been well aware that their own government authorities were the ones most skeptical of the claim that the fear of contagion justified intervention in the

Mexican case. There is no smoking gun memo from within any of the banks which as yet has surfaced, one which states, in effect, that, based upon the Mexican experience, if the borrowers cannot repay, the banks can count on an IMF led bail out similar to what occurred with Mexico.

The Chairman states that, in 1997, the Thai finance Minister, knowing that he lacked sufficient funds to support the value of the currency, nevertheless, committed himself to do so; he must have expected, like the Mexicans, that Thailand would also be bailed out by the IMF. (Meltzer Tr. Feb 2, pp.135-139). But this is speculation; no evidence is cited in support of the Chairman's statement. If the banks in Thailand expected to be bailed out, why did they pull their loans as rapidly as they did when the crisis commenced? (Council on Foreign Relations Task Force (hereafter CFR), p. 9). It is not unprecedented for finance ministers to hope that the mere statement that they will not devalue their currency will be sufficient to stop a run on the currency. That is what the Mexican Finance Minister did in December 1994, knowing full well, like the Thai Minister, that his country was hemorrhaging reserves. The result was equally futile.

After first detailing the efforts of U.S. officials to pry open Asian capital markets for the benefit of American firms, Kristof and Sanger summarize the responsibility for the East Asia short-term banking fiasco:

> "Responsibility can be assigned all around: not only to Washington policymakers, but also to the officials and bankers in emerging market countries who created the mess; to Western bankers and investors who blindly handed them money; to Western officials who hailed free capital flows and neglected to make them safer; to Western scholars and journalists who wrote paeans to emerging markets and the Asian century." (Kristof with Sanger).

Stanley Fischer, Deputy Managing Director of the IMF, candidly noted: "I see very little sign that the capital flows to East Asia bore any relationship to what happened in Mexico....nobody, including me, believed that those [the East Asian] countries, which had been growing at 8 to 10 percent, were structurally weak." (Fischer, Tr. p. 218).

Unable to establish with any degree of certainty that the Mexican bailout led to the East Asian crisis, the Majority assert that in Mexico, Asia and Russia, the IMF "did little to end the use of the banking and financial systems to finance government favored projects, eliminate so-called "crony capitalism" and corruption , or promote safer and sounder banking and financial systems." But, until the 1997 crisis, South Korea had "graduated" from IMF and World Bank funding; the World Bank East Asia Miracle report had praised the Korean credit system; Korea had followed a development model based upon the Japanese experience of directed credit by the government to foster specific industries. "Crony capitalism" only made its appearance as an explanation of the Korean problems in the aftermath of the 1997 crisis.

It is true that the Russian and Mexican banking sectors represent two of the greatest asset steals of the century:

> " In his bid to increase capital inflows, [Mexican President Carlos] Salinas [de Gortari] has put state banks on the block at three times their book value and often more...But in exchange for high prices, Salinas offered their buyers sweet regulatory deals and long term promises of fabulous riches through Nafta, which would soon allow some of the new owners to sell their monopolies corporations at record profits...Through a policy of "directed" or selected liberalization, Salinas paved the way for the formation of more than a dozen monopolies that would control industries such as copper mining and telecommunications. (Oppenheimer, p. 91).

John Lloyd describes a privatization process in Russia similar to what occurred in Mexico (Lloyd, p. 35). To attribute to the IMF responsibility for the corruption and favoritism that characterized the banking scandals in Mexico and Russia is either naive or cynical. The distribution of banking assets to favored players was an integral part of the political power system in both countries. The IMF could no more stop that process than King Canute could part the waters. What it is fair to say is that uncritical praise for Mexico's reforms and Russia's progress in achieving a "market" economy provided a mantle of legitimacy for a thoroughly corrupt process in both countries of privatization of state assets, but the IMF was hardly alone in its failure to blow the whistle: virtually all of the industrialized country officials looked the other way. The geo-political stakes in both cases were simply too great. To blame the IMF alone in both Mexico and Russia for the outcome is wrong. It is a reflection of the schizophrenic approach of the Majority to the IMF: it is either too interventionist or did not intervene effectively enough.

3. The IMF: Too Easy?

Equally implausible is the Majority assumption that countries are tempted to resort to the IMF for financing because such resort has been made too attractive for them. This assertion is as plausible as asserting that someone goes to the dentist to have root canal work done on his mouth because he enjoys it. Countries, more often than not, resort to the IMF too late because they fear that IMF conditions will be too burdensome.

4. IMF Conditions

The Chairman set forth the central belief of the Majority that the conditions imposed by the IMF do not advance democratic governance:

" We believe that the interests of developing democratic government abroad, that the first step in that procedure must be to get the country to take responsibility for doing things that are in its own best interest. And that those can't be imposed from abroad and shouldn't be imposed by any international institution, even though we recognize that there's a useful role for advice." (Meltzer, Tr. Feb 2, pp. 200-1).

The Chairman is certainly right that if conditions are perceived in a country to have been imposed from without, they are unlikely to be effectively implemented. But the conditions that accompany IMF financing must be agreed with the country. It is the country that submits a letter of intent to the IMF, stating the country's proposed program. In practice, the content of the program incorporated in the letter of intent is negotiated with the IMF staff before it is formally submitted to the IMF. It is also true that countries, particularly small countries, desperate for assistance, may too easily agree with IMF staff suggestions. If that program departs too radically from what the political traffic in the country will bear, the program will certainly fail. The fact that a program is agreed with the IMF does not, by itself, undermine democratic government.

It is not unreasonable for the international financial community, in providing financing for a country with balance of payments difficulties, to want some assurance that the conditions that led to the need for such financing will be addressed. It is the content of the program that more often than not is the subject of dispute: is there an accurate diagnosis of the source of the problem? Is the burden of adjustment equitably shared within the society and between external creditors and the debtor country? These are contentious, but inevitable issues that accompany IMF assistance.

Mr Fischer was asked to speculate as to what would have happened had the IMF not intervened in 1997/8 in the East Asia:

" I believe that the crises would have been bigger, not smaller. That is, each country, at the moment the crisis broke out, would not have had the external financing available...would have had to stop external payments. I do not believe that could have been done in an orderly way.. And I think you'd have turned off financing for developing countries all over the world...In addition, I believe that without the international assistance effort, the policymaking solutions, responses, in those countries would have been much weaker...." (Fischer, Tr. p. 217).

There is plenty of room to differ as to whether the IMF analysis as to the source of the problem in the East Asian countries was mistaken (Fischer, LA; Sachs, American Prospect); and whether the burden of adjustment was equitably distributed among creditor banks, debtor countries, and within both debtor and creditor countries. Rather than confront these issues in the future, the Majority has opted for an impractical and implausible solution.

5. IMPLAUSIBLE AND IMPRACTICAL

(a) Who Certifies as to Pre-qualification?

The Majority does not identify who is to certify that a country has met the pre-qualification criteria. The Majority do not wish to entrust this responsibility to the IMF staff; there is no indication that the Bank for International Settlements (BIS) has the capability or the desire to assume this task. Nor is it likely that an international consulting firm could perform this function. Countries are unlikely to accept a foreign firm, with other international clients, having access to sensitive national financial data.

(b) Opening to Foreign Banks

The Majority states that, among other criteria, a borrowing member country of the IMF would have to agree to open its banking system to foreign banks: "eligible member countries must permit freedom of entry and operation for foreign financial institutions in a phased manner over a period of years." Fernao Brasher, a former Brazilian central bank president who now heads a Sao Paulo bank with Austrian shareholders, though majority owned by Brazilians, urges the Brazilian government to limit the entry into Brazil of foreign financial institutions: " The richest countries of the world are wise enough to realize that national interests coincide with a strong, domestically led financial system...Why should Brazil, a developing country, be run rough-shod over?." Domestically owned Brazilian banks,

> " tend, in some instances, to support the stability of the financial system in times of crisis. For instance, in the tumult that followed the devaluation of the currency nearly a year ago, some foreign banks counseled their clients to avoid purchasing Brazilian government bonds and other securities, citing the risk of default." (Romero,a).

Despite Brazil having a strong domestic banking sector, if it were to impose limitations upon foreign ownership of domestic banks, under the Majority criteria, Brazil would be ineligible for future IMF funding. It is a technocratic approach. There is no room for national interests.

(c) Countries Most in Need Ineligible for IMF Assistance

If only countries that are pre-qualified are eligible for IMF funding, the Majority would cut off those countries that are probably most in need of such funding. Often, the crisis itself is what precipitates needed reform. Yet, the Majority would bar the IMF from conditioning its funding upon the implementation of a program designed to address the conditions that led to the crisis.

(d) Short Term Finance

The Majority assumes that a country which has resorted to IMF financing will quickly (weeks or months) regain voluntary access to the financial markets. (Majority, Ch. 2 p. 18). But what if it does not? What if the measures necessary to restore credibility in the market require legislative action, a time consuming and difficult process? The Majority assumes an almost automatic restoration of credit access in the private markets, but for countries for whom such access is, to begin with, already fragile, such an assumption might not be warranted.

Divested of any discretionary judgment, the IMF doesn't need a prestigious Managing Director, but a high level clerk, a couple of disbursing officers and a few lawyers to draw up the necessary legal documentation.

B. THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS

(1) The Financing Scheme in Detail (Chapter 3).

With respect to the World Bank, and the regional development banks, the Majority concludes that development financing displaces private market financing and, consequently, should be substantially curtailed. The World Bank would convert itself primarily into a non-financial development agency, with two tasks: (a) coordinating donor aid by individual countries and non-governmental agencies; (b) addressing issues not now being adequately addressed by any of the international agencies in the United Nations complex and without, finding innovative solutions for seemingly intractable problems.

The Majority recommends that poverty reduction programs and infrastructure projects be financed exclusively with grant funds. The grantee would not receive or administer the funds; the development banks would disburse directly to a vendor selected by the grantee. Loan funding would be confined to structural adjustment lending. In order to create an incentive for implementing agreed reforms, repayment of principal, under a structural adjustment loan, can be deferred for as much as ten years, provided that an independent third party certifies that the reforms have been implemented in a satisfactory manner, or, are still in place. If such a certification is not forthcoming, repayment of principal recommences.

The World Bank would cease operations (lending or grant) in its borrowing member countries in Latin America or Asia; that responsibility would be delegated to the IDB and ADB:

> "The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East."

However, the IDB and ADB would only be able to extend assistance (structural adjustment loans or grants) to countries without capital market access (as denoted by an investment grade international bond rating), or with a per capita income less than $4,000; starting at $2,500 levels, official assistance would be limited.

It proposes that, the "World Bank's role as lender would be significantly reduced." Repayments on the World Bank's existing IBRD portfolio will amount to $57 billion (49 % of loans outstanding) over the next 5 years and $102 billion (87 % of loans outstanding) over the next ten years." In vague terms, it proposes, "[s]ome of the callable capital should be reallocated to regional development banks, and some should be reduced in line with a declining loan portfolio." In other words, it should be returned to the shareholders; in the case of the U.S., it would be returned to the Treasury and would require Congressional appropriation for other uses.

Since the Majority recommends discontinuing World Bank lending in Latin America and Asia, the bulk of the repayments from borrowing member countries of the Bank in these regions will not be compensated by new loans from the World Bank; it is highly unlikely that the regional development banks will realize a commensurate increase in resources to be able to make-up for the loss of World Bank resources. There is likely to be a net loss of development resources for these countries. For five major borrowers of the World Bank--Argentina, Brazil, Mexico India and Indonesia--net repayments (that is amortization and interest less World Bank disbursements) over a five year period will be an estimated amount slightly in excess of $20 billion. (Salop/Levinson). Under such circumstances, repayment by borrowing member countries of the World Bank is almost certain to meet domestic political resistance. It is not in the interest of the United States to force a confrontation with major World Bank borrower countries in Asia and Latin America, many of whom have deep internal social unresolved problems.

<u>(1) Displacement of Private Financing</u>

The charge that the World Bank financing is concentrated in countries that have been market eligible and displaces private market financing is misleading. The Majority lumps all forms of foreign capital together, but Ernest Stern notes,

> " a very large part of private flows is directed to foreign investment, which is very important but serves a somewhat different function. A substantial portion of the rest is trade...and short term bank credits...You have a third element...which is portfolio equity investment and finally you have...long term debt financing...and it's only that part you can reasonably compare with the flows of the World Bank, because that's the same objective, sovereign Government borrowing on medium term." (Stern, Tr. pp. 111-112).

It is true that World Bank financing (and IDB lending) has been concentrated in the larger countries, many of which, at various times have been able to directly access the international financial markets. Those markets, however, have been highly volatile. Between 1983 and 1989, countries in the Western Hemisphere borrowing member countries of the World Bank experienced a cumulative net outflow of $ 116 billion. (Folkerts-Llandau and Ito, p. 2). Only after the March 1989 Brady debt reduction initiative, did capital in significant amounts return to Latin America. In the period 1990 to 1994, Western Hemisphere countries received a net inflow of $200 billion albeit in a form different than syndicated bank loans: On average since 1990, 41 percent of capital inflows to all developing countries has been in the form of portfolio investment in tradeable bonds and equity shares, and 37 percent has been FDI. (Folkerts-Landau and Ito, p. 2).

The portfolio investments have, during the decade of the 90's, been particularly unstable, reversing course at the first sign of trouble. Over $220 billion of public resources in the decade of the 90's has had to be mobilized to bailout imprudent investors and lenders. A significant part of those resources has come from the development banks. The Majority, as does the CFR, rightly questions the desirability of use of the resources of the development banks for bailout purposes. But, given the fact that those resources were mobilized for this purpose, it is not surprising that, for the past two decades, the lending portfolio of the World Bank and the IDB, in particular, have tended to concentrate in their larger borrowing member countries. (That concentration is also a consequence of the limited implementation capacity of the smaller countries).

The displacement argument also misconceives the nature of development finance. President James Wolfensohn of the World Bank testified from his own personal experience as to the difference between commercial or investment banking and development financing:

"I used to raise money for lots of countries...And I can tell you that I never had a discussion with them about their social policies or their economic policies...When we go in from the [World] Bank we go in on the basis of trying to look at what's happening to the country and what's happening to the people in the country and what's happening to social stability and what's happening on issues like governance, on openness of financial systems...Can you imagine the head of Goldman Sachs or Merrill competing for business, going in and talking to them about whether they should have a bigger education program?" (Wolfensohn, Tr. pp. 240-1).

In order for advice to be credible to the country authorities, it must be coupled with financing. (Wolfensohn Tr. p. 241; Stern, Tr. pp. 94/95). That dialogue between the Borrower and the development bank depends upon a relationship of trust and confidence, which is expected to continue over an extended period of time. The Majority proposed disbursement scheme, in which the borrower is divested of responsibility for administering the financing evidences a distrust of public sector officials that is not compatible with that relationship. It also largely defeats the purpose of development financing: that financing is not only concerned with achieving physical targets; equally, if not more importantly, it is concerned with policy and leaving the borrower institutionally stronger when the relationship ends. Not trusting the borrower with administration of the financing undermines this objective. (That distrust does not reflect my own experience, over a thirty year period, in dealing with high level officials throughout the Latin American region).

The private markets are not a dependable source of development finance. The development banks, in contrast, provide such a source of long-term finance for high value human capital investments. However, it is also true that for many of the more advanced middle income countries, it is time for the World Bank (and regional development banks) to begin, with them, to plan for reduced access to development bank resources, but that planning must be coordinated with market access experience over the next decade and take into account the financial consequences for both countries and institutions.

(2) Structural Adjustment financing

With respect to structural adjustment financing, the Majority rightly observes that reform is most effective when the country has made the political decision to undertake such reforms; it cannot be bribed from outside, or forced by "conditionality", to do it. And yet, the Majority proposes to do just that with a financing scheme that is both impractical and unwise. It is proposed that the borrower be given an "incentive" to carry out its obligations under an agreed structural adjustment program: deferral of repayment of principal for as much as ten years, provided that an independent third party, on an annual basis, certifies that the reform program is being implemented, or is still in place.

If reform lags, or backslides, then, repayment resumes. Again, discretion is vested in an "independent" third party that would have the responsibility to determine whether the government is complying with its reform obligations, and enjoy the financial advantages of deferral of repayments, or must resume such payments. As with the IMF, the World Bank and the regional development banks, are divested of discretionary judgment for determining compliance.

Who are the 'independent" third parties that are vested with such extraordinary powers? Foreign accounting, consulting firms, academics? What borrowing member country of the World Bank is going to cede such discretionary power to foreign consultants or academics? The proposal is justified on the basis of creating an" incentive" for the country to comply with its reform commitments. It is conditionality by another name, but it is not even necessary. The incentive for the borrower complying with its commitments, as the Majority originally wisely said, is its decision that the reform is in its own interest, and the prospect of future funding from the IFIs.

(3) A World Development Association?

The World Bank changes its name to the World Development Association, a symbol of the diminished role of development financing. It may be true that not enough is being done in areas of public goods identified by the Majority, but it is hard to see why the new Association, largely divested of its financing function, should be any more effective as a coordinator of aid than the UN Development Agency. Or, why, for example, it should be more effective in addressing tropical disease research than the World Health Organization

(4) Relationship to Regional Development Banks

The Majority is preoccupied with duplication between the functions of the World Bank and the regional development banks. Undoubtedly, there is some overlap, but each of the development banks arose out of a specific history, often, as was the case with the IDB, in reaction to the priorities of the World Bank. That conflict has largely dissipated, but it is undesirable, as the IDB itself recognizes, to return to a situation where only one institution is the basis for assured long term development financing. Such monopoly breeds arrogance. The institutions do a pretty good job of working out priorities among themselves. The Majority's preoccupation with duplication is exaggerated. (Stern, Tr. pp. 102-3).

(5) Repayments and Grant Financing

The World Bank (and the IDB) are now, in their ordinary operations, on a self sustaining basis, that is present levels of lending for the foreseeable future, can be financed out of earnings and loan repayments by their borrowers. The proposal to return World Bank loan repayments to the shareholders, and to substitute grant financing for this self sustaining revolving loan fund, is a reckless gamble. The majority members of the Commission are not naive. President Wolfensohn testified as to the historic difficulty in obtaining Congressional appropriations for IDA financing (Wolfensohn, Tr. p. 234). The Clinton Administration abandoned any attempt to obtain from the Congress modest amounts of funds for the IDB soft loan fund. To return World Bank loan repayments to the shareholders and expect some substantial part of those repayments to reemerge from the domestic legislative processes as grant financing for the development banks is not credible. Whether intended or not, the return of capital to the shareholders can have only one result: undermine, discredit and ultimately terminate the World Bank, the IDB and the ADB. The Congress should reject the Majority proposal.

C. AN ALTERNATIVE

1 THE IMF-A MORE LIMITED ROLE

And yet, the Majority has a point. Like an archeological dig, layer upon layer of often competing and conflicting policy mandates have been imposed upon the Bretton Woods institutions: from limited and well defined functions in the first three decades of their existence, they have been: (i) entrusted with overseeing the debt workout of the 80s; (ii), the arbiters of internal structural reform within their borrowing member countries; (iii) the front line agencies of the international financial community in combating world poverty; (iv) entrusted with the responsibility for guiding into market economies the former Soviet Union and Eastern European countries ; (v), the lead agencies, particularly the IMF, in the decade of the 90s, in dousing the successive financial crises that appeared to threaten the stability of the international financial system.

They are, to a very great extent, the victims of their own success for, they are perceived by their major shareholders to be the only international institutions competent enough to be entrusted with these tasks. It makes sense to reconsider these multiple, and too often, conflicting mandates.

The first issue with respect to the IMF is should it continue to be a financial crisis manager, or should future crises be resolved by the market? Eichengreen and Portes are candid as to the risks involved in a market strategy:

> " Clearly life would go on in the absence of the IMF (or with a greatly reduced role for IMF lending). Lenders would still lend; borrowers would still borrow. But to say debt problems would be resolved by the consenting adults involved without additional costs being imposed on the principals and innocent bystanders is a leap of faith...without other institutional innovations that reduce the pain..." (Eichengreen and Portes pp. 15-16).

Eichengreen and Portes are equally candid in their paper as to the difficulties involved in accomplishing the institutional innovations to which they refer. A continued crisis managing role for the Fund is the most likely outcome, but that role has to change.

Secretary Summers states, " The basic principle is clear: programs must be focused on the necessary and sufficient conditions for restoring stability and growth. Intrusion in areas that are not related to that goal carries costs that exceed the benefits." (Summers, 1999). The CFR notes that the IMF "is still needed to see that balance of payments problems, be they under fixed or flexible exchange rates, are resolved in ways that do not rely on excessive deflation, competitive devaluations, and imposition of trade restrictions, and to respond to liquidity crises when neither private capital markets nor national governments can handle those problems well on their own." (CFR p. 115). And it is still more specific as to the limits of IMF conditionality: " The IMF should limit the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies." (CFR p. 116).

This more limited mission is contrary to the expansive terms in which the IMF has conceived its mission. In addition to the traditional concern with fiscal, monetary and exchange rate policy, the IMF also reviews,

> "the growth and welfare implications of a country's macroeconomic and structural policies have increasingly been taken into account, since they may strongly affect the credibility and sustain-ability of a country's overall macroeconomic policy. In addition, social, industrial, labor market, and environmental issues have increasingly been taken into account if these have significant implications for macroeconomic policies and performance."(IMF Survey, 1995).

It is difficult to see what element of domestic policy would not be a proper subject of IMF conditionality. The difference between the more limited role outlined by the Secretary and the CFR and the expansive mandate conceived by the IMF is the difference between night and day. It is reasonable to require of the IMF that as it assesses a country's proposed program, it make a judgment as to whether the program allocates the burden of economic adjustment equitably, and, if not, to negotiate for changes in the program. In more recent years, that is what the IMF has been doing. But it is unreasonable to expect the IMF, on a continuous basis, to be actively engaged in poverty reduction programs. It is not consistent with the more limited role envisioned for the institution by the Secretary. The IMF should continue to defer to the World Bank and the regional development banks with respect to poverty reduction programs.

2. THE WORLD BANK (AND THE REGIONAL DEVELOPMENT BANKS)

With respect to the World Bank, the CFR recommends: "The Bank should concentrate on the longer-term structural and social aspects of economic development. It should expand its work on social safety nets. But it should not be involved in crisis management, in emergency lending, or in macro-economic policy advice." (CFR p. 116). These are sensible general principles, but it is unlikely they can withstand the heat of actual crises such as the successive ones that occurred in the decade of the 90's. Absent an identified alternative source of public financing, which does not now seem to be on the horizon, the temptation will remain to do what every U.S. Treasury Secretary (and his counterparts in the other industrialized nations) has done since the 1982 Mexican default: resort to the Bretton Woods institutions as sources of funds and as crisis managers.

The issue, then, is how can these institutions carry out this function in a more equitable way than has been the case to date? In 1998, the IDB, as part of the Brazil bailout package, loaned Brazil $4.5 billion, one half of the IDB $9 billion annual lending program. The IDB coupled its financing with a commitment from the Brazilian government to maintain an agreed level of funding for human capital development in education and health. The linking of the IDB financing with the Brazilian Government's financial commitment for these two sectors was a way for the international financial community to say that the economic adjustment program that it supported should not sacrifice investment in the human capital of the country.

3. DISTORTED PRIORITIES: ONE-SIDED LABOR MARKET INTERVENTION

(a) The Successive Financial Crises

Like the movie Ground-Hog Day, the essential elements of the successive crises of the past twenty five years repeat themselves so that we seem to be reliving the same experience again and again. The syndicated bank lending of the decade of the 70's, the tesobono and East Asian financing fiascos, all have common characteristics: in each instance, banks and investors, awash with liquidity, seek a higher financial return than they can obtain in their home bases; without "due diligence", they invest (tesobonos), or loan (East Asia, 1970's, syndicated bank loans) to governments or banks and corporations in the developing countries; much of the resources are not used for productive investments; a combination of external and internal shocks leads to an international financial crisis, which is perceived to put at risk the international financial system.

The IMF and the World Bank are charged with overseeing the workout; the financial institutions, who were equally responsible for the crisis by their imprudent lending or investing, are bailed-out and rewarded: they are enabled to buy into local banks and financial institutions at bargain basement prices (Mexico and East Asia); the debtor countries are counseled to export their way out of the crisis, which, in practice, means flooding the U.S. market with goods and services because that is the only market that is effectively open to them; and, in order to make their goods more internationally competitive, the IMF and World Bank require governments in the debtor countries to adopt labor market flexibility measures--making it easier for companies to fire workers without significant severance payments, weakening the capacity of unions to negotiate on behalf of their members, all for the purpose of driving down labor costs and benefits.

Workers in both the industrialized and developing countries, particularly in the unionized part of the labor market, bear a disproportionate part of the burden of adjustment. (U.S. workers may, as consumers, have benefitted from lower prices as a consequence of lower cost imports, but that benefit is likely to be ephemeral; the increasing U.S. trade deficit, as both former Secretary of the Treasury, Rubin and Secretary Summers have repeatedly said, is not, economically, or politically, sustainable; manufacturing jobs lost to imports or FDI, are not likely to return).

Professor Joseph Stiglitz, former Chief Economist at the World Bank, observes:

> "[e] ven when labor market problems are not the core of the problem facing the country, all too often workers are asked to bear the brunt of the costs of adjustment. In East Asia, it was reckless lending by international banks and other financial institutions combined with reckless borrowing by domestic financial institutions--combined with fickle investor expectations--which may have precipitated the crisis; but the costs in terms of soaring unemployment and plummeting wages were borne by workers." (Stiglitz).

Professor Stiglitz's comment is an apt summary of not only the East Asia crisis but of each of the successive financial crises of the past twenty five years.

It should be a requirement in the future that before public funds are disbursed, the financial institutions involved in such crises must make a substantial commitment to the resolution of the crisis. Bondholders are not accustomed to such a requirement and, in contrast to the syndicated bank lending of the decade of the 70's, there are legal and practical problems in obtaining such a commitment. (Bucheit, Tr. pp. 460-74). But it is also true that a stated policy by the Bretton Woods institutions would put such bondholders on notice that in the future they cannot assume that they will be bailed out by the official financial community. The fear that such a requirement will retard market access for developing countries is exaggerated. The story of the past twenty five years is that, in the financial markets, greed trumps all other considerations. Indeed, the Latin American debtor countries only regained substantial voluntary access to the financial markets after the markets perceived a greater credit worthiness on their part after the Brady debt reduction initiative of March 1989.

(b) Labor Market Intervention

Joanne Salop, Vice President, Operations Policy and Strategy, World Bank, explains that, "with respect to freedom of association and the right to collective bargaining, the Bank is in the process of analyzing the economic effects in order to form an informed opinion." (Salop/Levinson). Robert Holzmann, Director, Social Protection, the World Bank, in a seminar jointly sponsored by the IMF and the AFL-CIO, elaborates on the Bank's reservations with respect to core worker rights, particularly the right of freedom of association:

> " And on both accounts we have a problem with some of the core labor standards, in particular, one which deals with freedom of association which concerns an important human right which has economic dimensions, but most importantly , also has a political dimension. This political dimension, which prevents us from simply using it as an instrument during our programs and to impose it on countries, because this would be considered as a breach of our rules."(Holzmann).

The "political" argument invoked by Mr Holzmann is a bogus argument: it is based on the idea that World Bank intervention for the purpose of addressing abuses of the right of freedom of association contravenes the provision of the Articles of Agreement that prohibits taking into account "political considerations" in the Bank's decisions". (Article IV, Section 10 of the IBRD Articles of Agreement).

To claim that result is required by Article IV, Section 10 of the Articles of Agreement, is a blatant distortion of the intent of the authors of the Charter, John Maynard (Lord) Keynes and Harry Dexter White. (Levinson). The Bank feels no such inhibition with respect to intervention in a country's labor market to condition its financing upon a member country taking measures--labor market flexibility-- that make it easier for firms to fire workers, weaken the capacity of unions to negotiate on behalf of their members and drive down urban unionized wages. Nothing is more politically charged than such a one-sided labor market intervention that so blatantly favors the interests of employers.

Holzmann continues:

> "The second one has to do with the economics of core labor standards, in particular again, the freedom of association, because while there are studies out--and we agree with them that trade union movements may have a strong and good role in economic development--there are studies out that also show that this depends. So the freedom by itself does not guarantee that the positive effects are achieved." (Holzmann).

The Bank appears to be reopening in the year 2000, the debate, which we thought had been settled in the 1930s, about the desirability of allowing workers the right to form unions of their own choosing as a means of equalizing bargaining power between the individual worker and the enterprise.

Professor Stiglitz summarizes his experience with the labor issue in the World Bank:

> "I am just completing serving three years as Chief Economist of the World Bank. During that time, labor market issues did arise, but all too frequently, mainly from a narrow economics focus, and even then, looked at even more narrowly through the lens of neo-classical economics; a standard message was to increase labor market flexibility–the not so subtle sub-text was to lower wages and lay off unneeded workers." (Stiglitz).

We would not accept as a basis for domestic labor policy in our own society, at least the great majority of Democrats would not, the "narrow neo-classic economic lens" to which Professor Stiglitz refers. We should not accept it within the World Bank. The U.S. Executive Director (USED) should have read a clear and forceful statement in the Board of Executive Directors of that institution stating that the United States considers settled the right of workers to freedom of association and collective bargaining. (In the protocol of these institutions, reading a written statement signals that it carries the imprimatur of the Treasury, not just the USEd).

Mr Fischer denies that the IMF is one-sided in its labor market intervention. In Indonesia, in 1998, after the fall of the Suharto Government, Fischer observes, the IMF intervened with the new government to press for adoption of core worker rights, including the right of freedom of association and collective bargaining; Nazi Germany would not, he notes, on political grounds be eligible for IMF assistance. (Fischer, Tr. p 189). (The IMF Charter does not have a "political" clause, but the IMF has previously invoked, by means of a legal opinion, the same inhibitions as are asserted for the World Bank).

Mr Fischer's assertion of IMF intervention to assure freedom of association in Indonesia, and candid acknowledgment that there are limits to political tolerance, is a welcome departure from the continued invocation of the political section of its charter by the World Bank as a basis for failing to address labor market abuses; but there was also a disturbing aspect of Mr Fischer's testimony: he was relieved that the De La Rua government, elected in Argentina in 1999, has submitted its own labor flexibility measure legislation and therefore, a potential conflict with the IMF had been avoided.

The IMF intervention with respect to the Argentine labor market is, according to the IMF, a consequence of the Argentine currency regime that prevents the Country from using the exchange rate as a means of adjusting relative international prices. (IMF Submission, p. 21). The IMF--- and successive Argentine Governments--- seek to make Argentine goods more competitive in international markets by lowering labor costs. Achieving that objective, requires diminishing the social and economic gains of workers, and that requires weakening the unions that won those gains for their members.

The labor relations system in a country like Argentina is more than a question of optimum economic efficiency considerations: the union movement in that country is a result of a long history of social conflict; it is an essential component of the social compact of Argentine society. Any change in that compact ought to be negotiated within Argentine society free of pressure by the IMF or the World Bank. It should be no part of the "conditionality" of either institution in Argentina, or anywhere else in the world. It is not in the national interest of the United States to be associated with a policy that involves such a one-sided labor market intervention on behalf of employers. It is creating an increasingly alienated and embittered urban working class in both Argentina and other countries.

C. Does Growing Income Inequality Matter?

Income inequality in Latin America, already the worst in the world, increased in the past two decades, the period in which the Latin American countries embraced the market liberalization strategy. (Birdsall). A number of members of the Commission believe that growing income inequality is not important.

Commissioner Calomiris:

"What I care about is poverty and, as Mr Huber mentioned, exiting from poverty, and I don't care very much about inequality. I don't think it's part of our objective as a Commission to be talking much about inequality" (Calomiris, Tr. Jan. 4, 2000, p. 78).

But the issue will not disappear:

"In Latin America today, all countries except President Fidel Castro's Cuba are free of military rule, but polls show that only two nations, Uruguay and Costa Rica, indicate a rate of satisfaction with democracy of over 50 percent. Although massive government corruption has prompted much disillusionment, analysts say it also stems from the fact that the benefits of the new free market have gone disproportionately into the hands of the rich." (Faiola).

Reporting on the prolonged strike at the National University in Mexico City, Julia Preston observes:

" But the student strikers were also a product of globalization...The government has stimulated growth by restraining inflation, mainly by depressing workers' wages. Official figures show that the minimum wage today buys 48 percent of what it did in 1982. So, while export enclaves have thrived, workers have been drawn into a spiral of downward mobility...[I] n today's increasingly impoverished urban working class, even small tuition costs can break a family."

Ms Preston concludes with a caution: "The damage to education and the division among Mexicans could serve as a cautionary tale to anyone who thinks the changes that globalization brings will only reinforce democratic institutions." (Preston). A far sighted leadership in the World Bank and IMF would have realized that market liberalization and privatization of state owned assets, required strong institutional counterweights. A strong labor movement, at its best, has been in the forefront of the fight for social justice; it might have provided such an institutional balance. (Stiglitz). But that is not the view that has prevailed in the Bretton Woods institutions.

4. The HIPC Initiative

The Majority observes that the debt of heavily indebted poor countries (HIPC) "cannot be repaid under any foreseeable future developments." (Majority, Ch. 2). Yet, they condition forgiving such debt on "debtor countries "implementing institutional reforms and an effective development strategy". The HIPC's are then the only ones, under the Majority proposal, that are subject to IMF conditionality. It makes more sense to accept the implications of the Majority observation that the debt cannot be repaid; unconditionally forgive the HIPC debt, and let the debtor countries start over with a clean slate. Future resources can be determined on the basis of an assessment of whether they have used well the opportunity gained by unconditional debt relief. II. THE WTO

A. CORE WORKER RIGHTS

The Commission heard extensive testimony, including that of John Sweeney, President of the AFL-CIO, with respect to whether core worker rights should be incorporated into the main body of the WTO agreement and the role of labor flexibility in the Bretton Woods institutions. Yet, there is no discussion of the testimony or the issues in the Majority Report. (Majority, Ch. 5). The Commission colloquy with the witnesses is both provocative and illuminating. It is too important an issue to be ignored.

1. THE NORTH AMERICAN AGREEMENT ON LABOR COOPERATION AS PRECURSOR TO CORE WORKER RIGHTS AND THE WTO

The demand that core worker rights be integrated into the WTO agreement must be understood in light of the experience with the North American Agreement on Labor Cooperation (NAALC), the labor side agreement to the Nafta. The Nafta, like the WTO, is misnamed; both agreements are trade and investment agreements. Chapter 11 of the Nafta, designated the INVESTMENT chapter, prevents a party to the Nafta, read Mexico, from imposing restrictions on FDI. Both the Nafta and the WTO contain provisions dealing with intellectual property protection. The WTO, additionally, includes trade related investment measures (TRIMs) and a separate protocol in which countries agree to open their financial services market to foreign capital. Dispute settlement provisions in both agreements are detailed and allow for either trade sanctions or monetary penalties for violations of provisions assuring corporate property rights.

First, we ought to be clear about what we mean by core worker rights. Ms Thea Lee of the AFL-CIO, in her testimony of December 14, 1999, emphasized the qualitative nature of these rights: " The prohibitions, the three prohibitions on child labor, forced labor and discrimination and then the two affirmative standards that affirm the right to collective bargaining and the right to freedom of association. These standards do not in any way place quantitative restrictions on countries. They do not require that countries set minimum wages or hours limitations or anything of that nature." (Lee, pp.7-8).

Mexico has based its development strategy on attracting FDI. (Lustig). The Salinas de Gortari administration (1988-1994) evidenced its determination that it would brook no interference by Mexican workers in creating a climate conducive to attracting that investment. When a labor leader, a member of the governing political party, in Matamoros, in Mexico, which is across the border from Brownsville, Texas, tried to negotiate aggressively with largely U.S. owned maquiladora plants, he was arrested by Federal Police, bundled on a plane to Mexico City where he was held incommunicado for weeks. The companies then imposed their own contracts upon the leaderless workers. (Cody). In order to prepare the ground for privatization of the Cananea copper mining and smelting company, historically viewed in Mexico as the birthplace of Mexican trade-unionism, the government crushed the union by declaring the enterprise bankrupt, abrogating the collective bargaining contract with the union, and sending in the army to subdue worker protests. (Foreign Labor Trends, 1989-90).

In 1992, Volkswagen (VW), anticipating the enactment of the Nafta, determined that in order to be competitive it needed to lower wages and revise work rules, which it proceeded to unilaterally impose. The VW union, affiliated with the Confederation of Mexican Workers (CTM), closely allied with the governing party, approved without any consultation with the membership, the company's actions. The workers reacted with work stoppages and demands for the creation of a union not affiliated with the CTM:

"After weeks of a bitter strike, Salinas gave VW permission to rip up the union contract. The company promptly fired 14,000 workers and rehired all of them, minus some 300 dissidents, under a new contract. Within days, VW revamped its entire Mexico operations–the German car maker's first such experiment anywhere." (Business Week, a)..

By sending in the army to intimidate the workers at Cananea, symbolically so important in Mexico's union history, intimidating the too aggressive union leader in Matamoros, and allowing VW to unilaterally recast its operations, the message to Mexican workers was clear: don't get in the way of the government's determination to attract FDI, or you will be crushed.

Candidate Bill Clinton in 1992 understood that if these abusive practices continued at the same time that the Nafta dismantled the barriers to FDI, the temptation for American companies to relocate production to Mexico could be irresistible:

" For a high wage country like ours, the blessings of more trade can be offset at least in part by the loss of income and jobs as more and more multi-national corporations take advantage of their ability to move money, management, and production away from a high wage country to a low wage country. We can also lose incomes because those companies who stay at home can use the threat of moving to depress wages, as many do today." (Clinton).

Candidate Clinton conditioned his approval of the Nafta upon complementary agreements that would assure that each party to the Nafta would effectively enforce its own labor and environmental laws. The NAALC contained no enforcement provisions for a violation of the core worker rights of free association and collective bargaining. Nor is there any legal bridge between the NAALC and the Nafta, so that violation of the NAALC brings no trade sanction or financial penalty under the dispute settlement provisions of the Nafta..(The WTO contains a provision on prison labor, but no other provision relating to core worker rights).

In summing up the results of the first proceeding alleging denial by the government of Mexico of the right of free association, the U.S. National Administrative Office (USNAO), which administers the NAALC on behalf of the U.S., observed:

:"...Despite pursuing every legal means of redress, the attempts to register an independent union failed......interested workers who signed the original petition were subsequently dismissed from their employment and remain unemployed to date...It appears that such dismissals were intended as punishment and a warning to other Sony workers... (USNAO, 1995).

Three years later, in another maquiladora case (Han Young), involving the right of freedom of association, the USNAO concluded:

"[t] he placement by the Tijuana CAB [a form of labor court in Mexico] of obstacles to the ability of workers to exercise the right of free association... is not consistent with Mexico's obligation to effectively enforce its labor laws on freedom of association in accordance with Article 3 of the NAALC...not one independent union had been registered or had obtained collective bargaining rights in Tijuana and only one other exists in the entire maquiladora sector." (USNAO, 1998).

The risk that candidate Clinton foresaw has materialized: American manufacturers increasingly seek to take advantage of the low wage business climate enforced by the Mexican government:

"Mexico is now home to more than 3,000 export-processing plants, or maquiladoras, which produce everything from cars to pharmaceuticals to electronics. And new ones are sprouting up each day....Foreign direct investment, which averaged $5 billion a year under former President Salinas, has jumped to more than $10 billion a year under Zedillo." (Business Week, b, pp. 61-2).

Tens of thousands of auto parts manufacturing jobs have gone to Mexico. (Bradsher).

The General Electric Company has undertaken a new "super aggressive round of cost cutting"; in order to meet the stiff goals, "several of GE's business units–including aircraft engines, power systems, and industrial systems–have been prodding suppliers to move to Mexico...Migrate or be out of business; not a matter of if, just when. This is not a seminar just to provide information. We expect you to move and move quickly. " (Business Week, b, p. 74).

The NAALC and the Nafta were submitted to the Congress as a single package; the demand that core worker rights be included as a part of the WTO does no more than build on the experience of the NAALC. Based upon what we have learned in the NAALC, instead of ineffectual side agreements, those core worker rights must now be incorporated into the main body of any trade agreement.

2. OBJECTIONS

(a) Imposition from without

Chairman Meltzer observes that he is only opposed to imposing such rights from without (Meltzer Tr. Dec 14, p. 36). It is difficult to see why incorporating such worker rights into the WTO is any different than any other requirement that countries must adhere to as the price of admission to the WTO. Countries must accept national treatment of imported goods and services and an agreed intellectual property standard. Witnesses Daniel Tarullo and Professor Jagdish Bhagwati, strong supporters of globalization, both candidly admit that there is no basis for distinguishing core worker rights from an intellectual property standard in the WTO. (Tarullo, Tr. p. 188; Bhagwati, Tr. p. 26).

(b) The ILO Alternative

The Chairman and Commissioner Johnson both refer to a "strengthened" ILO as a substitute for including core worker rights in the WTO. (Meltzer Tr. Dec. 14, p. 65; Johnson, Tr. Dec 14, p. 87); but the ILO has no enforcement power. Neither the Chairman nor Commissioner Johnson make a concrete proposal as to how the ILO should be strengthened.

(c) Union Self Interest

Throughout the Commission Hearing on worker rights there is a suggestion by some members of the Commission that the advocacy by American labor leaders on behalf of workers is tainted by self interest. (Meltzer-Sweeney Tr. Oct 20 p. 29; Sachs Tr. Dec. 14, p. 116). That self interest, however, may also be a powerful force in initiating change which benefits the disadvantaged worker. A worker in Mexico, Salvador, Indonesia, or wherever, who can exercise the right of freedom of association and collective bargaining as a consequence of advocacy of these rights by American and European unions, is not less advantaged because these unions acted, in part, out of self interest. There are very few saints in the world. The fact that there is a coincidence of interests between American unions and workers abroad, denied their core worker rights, does not invalidate the efforts to assure such rights to all workers.

In the words of Gibson Sibanda, president of the Zimbabwe Congress of Trade Unions, "They tell us that African trade unions will be used by the trade unions of the industrialized countries to undermine the comparative advantages of African workers. It is vital that we insist that this is a question of fundamental human rights, and has nothing to do with protectionism." (ICFTU, November 1999).

(d) Protectionism: The "Bloody Shirt"

When the issue of core worker rights is raised by its proponents, the almost invariable response is that it is merely a disguised form of protectionism. The cry of protectionism has become the "bloody shirt" of trade politics. In the decades immediately after the conclusion of the Civil War in the United States, rather than debate pressing social questions arising out of the post-civil war industrialization, Republican politicians would resurrect against their Democratic opponents, who had been divided on the war, Civil War issues: was the opponent for or against the Union? This tactic was known as waving the "bloody shirt". In contemporary trade politics, rather than discuss a distorted international trade, finance and investment regime, and its social consequences, the defenders of the status quo wave the contemporary "bloody shirt" of protectionism.

In 1998, in Geneva, Switzerland, the ILO adopted a Declaration on Fundamental Principles and Rights at Work. The Declaration was initially opposed by the employer group in the ILO and most of the same nations that oppose incorporating core worker rights in the WTO. They contended that the Declaration would be used for protectionist purposes. Replying on behalf of both workers in the developing and industrial countries, the vice-chairperson of the Workers' delegation stated:

> "The Workers' group is quite clear that to ask to belong to a trade union and for it to bargain on your behalf is not protectionism; to seek an end to child labor is not protectionism; to wish to eradicate discrimination in the workplace is not protectionism; to call for an end to slavery or forced labor is not protectionism; but to deny those rights to workers in the name of comparative advantage–that is truly protectionism." (United Nations Association p. 57).

<u>(e) Death in Africa and Responsibility for Poverty</u>

In an exchange with Ms. Lee, Commissioner Sachs states,

> " I ...agree with you that international trade costs jobs in textiles and apparels. ...and that is what should happen in the kind of economy the U.S. has...I also see it as a huge benefit for the rest of the world to be able to produce textiles and apparel and sell them to the U.S. market...I will use the word nothing less than immoral how the textile lobby fought liberalization of apparel from Africa. Because their people are dying for lack of access to the markets." (Sachs, Tr. Dec 14, p. 105).

Commissioner Calomiris framed the issue in blunt terms:

> " ... [i]s it true that core worker standards would help very poor people? Just to remind you, we're not dealing with the overfed teamsters here..I think that is a big problem and I really don't care very much , to be honest, compared to that problem whether employees in the United States have wages that go up or down by five or ten percent or whether anyone in the United States has wages or incomes that go up or down by five percent compared to that problem." (Calomiris, Tr. Dec. 14, p. 131).

For both Commissioners Sachs and Calomiris, the villains in the piece are the American workers, who stubbornly refuse to immolate themselves in the cause of poverty alleviation in the poorer countries, but this charge is a vast oversimplification. The Commission heard extensive testimony from Professor Ayyiteh on the endemic corruption and mismanagement in African countries.(Ayyiteh, Tr,. Sept. 28, 1999). (Commissioner Sachs did not identify specific African countries but painted with a broad bush.). Africa is afflicted with an AIDs problem of epic proportions. Until very recently, commodity prices for major exports from the African countries have been severely depressed. Many African countries had preferential access to the European market through the Lome Convention with the European Community, but that access did not result in a vigorous textile trade. To place the onus for "people dying" in Africa on the American textile worker is disproportionate to the facts.

Commissioner Calomiris elaborates:

> There simply is no basis aside from gross violations of human rights for a country to be told that it cannot participate as a trading partner with the rest of the world... denial of freedom of association and collective bargaining are not such gross violations: they don't come close". (Calomiris, Tr. Dec 14, p. 135).

According to the International Confederation of Trade Unions, 123 workers who tried to exercise these rights were murdered in 1998, 1,650 were attacked or injured, and 3, 660 were arrested. (ICFTU, January, 2000). Governments may not have been directly responsible for all of these abuses, but too many have been indifferent, amounting to complicity, in such abuses. We ought not to be equally indifferent, for we too then become accomplices.

(f) Jobs Lost: A Wash For the Economy as a Whole

In his dialogue with President Sweeney, the Chairman noted that if 500,000 jobs, as alleged by Mr Sweeney, had been lost in manufacturing, they had been more than made up for in other parts of the economy; Mr Sweeney was seeking to defend unionized jobs, but from the point of view of the economy as a whole, it was a wash. (Meltzer-Sweeney. Tr. Oct. 20, 1999, pp. 26-27; Majority, Ch. 5). But not all jobs are equal: " You keep referring to our members. I'm not talking about our members. I'm talking about the difference between good jobs and bad jobs. I'm talking about the high road versus the low road, and 500,000 manufactured jobs, organized, unorganized, whatever they are, are the issue here." (Sweeney Tr. Oct 20, 1999, p. 29).

The Majority state that the Department of Commerce estimates that jobs supported by exports pay 13 to 16 percent more than the national average of non-supervisory, production jobs. (Ch. 5, p.5). Other studies note that, "[i]n reality, imports are doing more damage to wages than exports are doing to raise them. At the economy's margins, where current rather than past trade is having its largest impact, imports have been destroying better- than-average jobs". (Economic Policy Institute, p.2). Even if one assumes, as does the Majority, that employment levels are controlled by macroeconomic factors (such as the intervention of the Federal Reserve), the effect of large chronic trade deficits "will present itself in the shifting composition of jobs (i.e, a shift from manufacturing to service sector jobs) and in deteriorating job quality (i.e falling wages for large segments of the workforce)" (Id at p. 5).

(h) Technology

The conventional wisdom is that technology accounts for whatever changes have taken place in the workplace that disadvantage workers. But there have always been technology innovations and there is no reason to think that contemporary technological change is any more disruptive than in the past: " Technology historians remain skeptical that the Internet age can match the period from about the 1880s to 1910 in terms of its impact on peoples lives. Inventions and new products from that period of technological dynamism included Bessemer steel making, refrigeration, the light bulb, the phonograph, the telephone, the radio, the automobile and the airplane." (Lohr).

(I) Not a Panacea

International worker rights is not a panacea. Where land tenure arrangements are as distorted as in Brazil, or, where, as in Mexico, the government encourages large land holdings for efficiency reasons, migration from rural areas to the great urban metropolitan centers will continue to put downward pressure on urban unionized wages. But such rights would eliminate, or, at least mitigate, the most egregious abuse in the international economic system: the deliberate use of the coercive power of the state to deny workers the most basic worker rights in order to gain a competitive advantage in attracting FDI.

B. THE ENVIRONMENT

There are two relevant provisions relating to (a) " measures necessary to protect human, animal or plant life or health" and (b) "to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption" Both provisions are contained in Article XX, (b) and (g), the General Exceptions clause of the WTO. Both provisions are carried over from the GATT, drafted over fifty years ago.

Under the dispute settlement provisions of the WTO , panels are established whose members are drawn from a WTO roster of trade experts. A permanent Appeals Body is also established to oversee the panels. The United States has invoked Article XX (b) and (g) as a defense for measures it has taken to protect exhaustible natural resources-- Dolphins, Sea Turtles and clean air. In all three cases, the invocation of the exceptions provisions under Article XX have been rejected. In each of the three cases the U.S. position was weakened because it could not demonstrate to the satisfaction of either the panels or the Appellate Body that it had made a serious attempt to reach an agreement with the other parties. It can, hence, be argued that to the extent the decisions encourage negotiation before resorting to the exception provisions of Article XX, they are not unreasonable.

A close reading of the cases, however, leads to the conclusion that it will be virtually impossible for any party invoking Articles (b) and (g) to ever prevail. Article XX has been given a narrow reading:

> "The Panel observed that Article XX provides for an exception to obligations under the General Agreement. The long-standing practice of panels has accordingly been to interpret this provision narrowly, in a manner that preserves the basic objectives and principles of the General Agreement. " (Tuna/Dolphin, June 16, 1994, p. 59).

More recently, the Appellate Body has confirmed this restrictive interpretation: "..[.t]he negotiating history of Article XX set forth limited and conditional exceptions from the obligations of the substantive provisions of the GATT." (Shrimp/Sea Turtle, p. 61).

Under these restrictive interpretations the environmental considerations are considered subordinate to the trade objectives. Yet, the Appellate Body in the Shrimp/Sea Turtle case notes:

> " While Article XX was not modified in the Uruguay round, the preamble attached to the WTO Agreement shows that the signatories to that Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy. The preamble of the WTO Agreement--which informs not only the GATT 1994, but also the other covered agreements--explicitly acknowledges "the objective of sustainable development". (Shrimp/Sea Turtle p. 48).

In the Decision of Ministers at Marrakesh to establish a permanent Committee on Trade and Environment, the Ministers expressed their view that,

> "there should not be, nor need be, any policy contradiction between upholding and safeguarding an open, non-discriminatory and equitable multilateral trading system on the one hand, and acting for the protection of the environment, and the promotion of sustainable development on the other..." (Shrimp-Sea Turtle, p. 58).

There is an evident tension between these expressions of the need for a balanced approach between trade, environment and sustainable development considerations and the continued highly restrictive interpretation given to the exceptions provisions of Article XX. That tension should be resolved by amending the WTO Agreement to transfer Articles XX (b) and (g) from the exceptions clause to a new chapter in the main body of the Agreement.

Without a change in the expertise of the roster from which panel members are selected however, neither a core worker rights or environmental amendment to the WTO can be effective. The roster from which experts are drawn for dispute settlement panels should be expanded to include individuals expert in environmental and labor matters.

This statement has not attempted to address the more profound issues of national sovereignty involved in decisions of the WTO. I would only note that any international agreement involves some limitation on national sovereignty. But the WTO does not have the legal authority to require a country to change its laws; as the frontier between more traditional cross border trade violations and policies previously considered internal to a country becomes increasingly blurred, this issue will certainly become more acute. I interpret the Majority's cautions in Chapter 5 of the Majority report to be a recognition of this fact.

III CONCLUDING REMARKS

If the IMF and World Bank are to play the essential role in the international economy that I believe is desirable they are going to have to accept that the high water mark of their role in overseeing structural transformation in their borrowing member countries has now passed. Professor Stiglitz reminds us that they approach issues from an "excessively economic" view, and, within an even more narrow neo-classical economic lens. That approach is singularly unsuited to the complexity of the kinds of transformations now in train in the East Asian countries as well as in Latin America. Each one of these countries is going to have to work out a new social compact within society. How they balance out economic efficiency considerations with social and political stability is for them to decide, just as it is for Argentina to determine how to revise its labor markets, an essential component of Argentina's social compact.

And a new social compact is going to have to be negotiated internationally that balances minimum standards of equity with economic efficiency criteria and national sovereignty. It is no good any longer waving the contemporary "bloody shirt" of alleged protectionism to avoid having to come to terms with the need for such a negotiation. The immediate battleground is in the IFIs. We are forced to try and persuade, or to coerce, existing institutions–the WTO, the World Bank and the IMF–to adopt minimum standards of equity for which they have little or no sympathy.

Is there any reasonable prospect that we can achieve such standards within these institutions? We cannot know the answer to this question so long as the United States sounds an uncertain trumpet. The President in Seattle, admirably, did not dissemble as to the United States objective with respect to the WTO: inclusion in the main body of the agreement of a core worker rights clause. His Trade Representative undermined this position, assuring other governments that the U. S. objective is limited to the establishment of a working group. (Dugger).

In the Bretton Woods institutions, despite the Congressional mandate included in the legislation establishing this Commission, to use the voice and vote of the United States in support of core worker rights, the USEDs' in these institutions have never voted against a financing for a government which is a notorious and egregious abuser of such rights. Countries opposed to core worker rights and environmental protection might well be excused for thinking that the U.S. commitment to these values is suspect.

It may be that the resistance in these institutions to such minimum standards is so great that no policy, no matter how consistent, will make a difference. In that case, the trade, investment and finance system, as now constituted, does not deserve further support. That is not blanket opposition to trade, development finance, or even globalization. It is opposition to a system that is now so profoundly inequitable that it is a travesty of what it ought to be.

A brief note on process

The Chairman refused to appoint, as is the custom in a bi-partisan commission, a deputy chairman from among the minority appointees. I believe this was a mistake. The Chairman was receptive to suggestions for witnesses and, even where it was evident that he did not agree, to subject matter. The Chairman briefed individual members of Congress; he was accompanied by staff, but there were no memoranda of conversation circulated to other members of the Commission. Nor was there any verbal briefing. As is evident from my own, and other, separate statements, there are strong disagreements, not necessarily along partisan lines, on substance among the members of the Commission. I would not have wanted my views represented to others by the Chairman. A Vice-Chairman would, I believe, have forced a more baloanced consultation and communication process. For future reference, I would suggest that the Congress, in authorizing such Commissions, specify that a vice-chairman be appointed from among the minority appointees.

Unfortunately, neither the Majority, nor my own statement can do justice to the testimony of all of the witnesses who testified before the Commission; for those who wish to take the time to peruse the record, it is rich, if often contentious, as it should have been, in substantive discussion. I believe it initiated the beginnings of a constructive debate as to the future shape of the architecture of an international finance, trade and investment regime that can assure self sustaining growth with a greater degree of equity in distribution of the fruits of that growth than is now the case.

I would like to thank Gerald O'Driscoll, staff Director, and his assistant, Ferdinand Von Stade, for their invariable courtesy and helpfulness.

ADDITIONAL VIEWS OF RICHARD HUBER

I have signed both the majority report and the dissenting statement with Messrs. Bergsten, Levinson and Torres.

I agree with the basic thrust of the report that there is a need to recast the relative roles of the IMF and the World Bank. At the same time, I agree with the dissenters that the report is too negative in its appraisal of those institutions and that some of its recommendations might not work to benefit either the world economy or the national interest of the United States.

While I fully support the core recommendations of the report, I feel compelled to point to several areas where I am less than totally comfortable. To begin, I agree with the dissenters that the tone of the report should be more evenhanded in describing the half-century history of the IMF and the World Bank. It is easy to point to their failures and shortcomings, but there also have been many successes and achievements. I believe that the world is a better place that it would have been had the two institutions not existed.

I have consistently expressed my discomfort with the debt forgiveness recommendation for HIPCs. I would have much preferred a mechanism like Chile's Chapter -- 18/19 debt-for-equity scheme of the late 1980s and early 1990s. Such mechanism would help kickstart the privatization process with the aim of prying the means of production in the HIPCs from the often larcenous hands of corrupt governments and putting them in the hands of entrepreneurs, domestic or foreign, who could operate them effectively and invest in them to create growth.

As to our proposed reforms for the IMF, I heartily endorse the narrowing of focus and the other steps in the report. Whole I also agree with the desire to make it more rules-driven, I am still concerned about making it totally mechanistic. In other words, since none of us can foresee the future, I continue to believe in giving considerable latitude to the executive board of the institution to react to future crises. I recognize that the final draft of the report remedies this in part, but I would have gone further.

I fully support leaving developmental, lending and poverty reduction grants to the World Bank (Perhaps under a new name) and the regional development banks. I also agree that these institutions should not be involved in balance-of-payment lending or financial crisis assistance. However, I do not think that the Commission had adequate time to study the various entities, especially the regional banks, well enough to support the recommendation that for Latin America and Asia the IADB and the ADB should be the sole institutions, respectively, with the World Bank keeping this responsibility for the rest of the developing world. While I certainly agree that the overlaps that exist today are wasteful and often counterproductive, I am not completely convinced that the sweeping division of the world in the report is the only or best way to achieve the goals of greater effectiveness and accountability.

When the Commission met on March 2, I mentioned my concern that any suggestion of "returning the capital" of the developmental institutions to their shareholders might not only appear unseemly, but really have a negative impact on the whole effort of poverty alleviation. It is easy to say that such withdrawals would be replaced by new monetary allocations to grant funds; in the political reality of the legislative bodies of donor countries, however, this could be very difficult to achieve.

Finally, I share the dissenters' concern about our treatment of the WTO. I think that all (or almost all) of us agree that scrutiny of it did not fit into our mandate to review the IFIs, I concur in our single meaningful recommendation about it (that penalties and fines are much better enforcement tools than retaliation), but I am afraid that anything we say may be "used against us" or, what is worse, be used against the WTO in the politically charged debate that will take place soon. I would prefer simply to leave out the part on the WTO with a comment as to how it did not really fall within the scope of our study and should be left for future consideration.

In closing, I want to echo the words of many of my fellow Commissioners who have complimented Allan Meltzer on his leadership and even temper throughout the long process of doing work that all of us hope will have some impact. I am proud to have been a member of the Commission.