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REFORM OF THE IMF AND WORLD BANK

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before the

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REFORM OF THE IMF AND WORLD BANK

Wednesday, March 6, 2002

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

The Committee met, pursuant to notice, at 10 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton and English; Senator Crapo.

Staff Present: Chris Frenze, Robert Keleher, Colleen J. Healy, Darryl Evans, Brian Higginbotham, Donald Marron, Patricia Ruggles, Diane Rogers, Nan Gibson, and James Barrett.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. I am pleased to welcome the panel of witnesses before us today. The members of the panel are all associated with the Meltzer Commission, and I would like to thank them specifically for their service and assure each of you that your Commission's influence on international economic policy has been very positive and far-reaching.

In recent years a number of issues have been identified related to proposals for reform of the International Monetary Fund (IMF). The evidence shows that the IMF was not financially transparent, it provided below-market subsidized interest rates and promoted moral hazard.

In addition, IMF's mission creep was reflected in its drift into lending for development and structural reform often involving longer loan maturities and rollovers of existing loans. Moreover, there was a lack of IMF accounting controls and lending safeguards that could result in misuse of taxpayer money. A number of other findings involved the IMF's heavy reliance on the G-10 for resources and a lack of meaningful financial support for the IMF by most of its members.

In the last few years the IMF has made some limited progress in the area of financial transparency. However, a former IMF research director has also noted, "the need to improve the financial structure of the Fund in terms of transparency, efficiency and equity."

The basic problem here is that the IMF is saddled with an archaic accounting framework rooted in an economic and institutional environment that no longer exists. For example, the IMF financial statements still present IMF loans as, "currency purchases" instead of loans. Furthermore, the workings of the SDR department remain as murky as ever. In addition the minutes of the Executive Board meetings are still classified for 20 years.

I would also like to note the President's Council on Economic Advisors (CEA) statements endorsing reform of the International Monetary Fund. According to the recent CEA report, IMF liquidity loan "programs, would appropriately involve short-term lending at penalty interest rates, to encourage and facilitate the borrower's quick return to private capital markets." This is very consistent with the findings of the Meltzer Commission as well as the Congressional mandates for IMF reform that are currently in law.

The administration's support for substantial grant financing of some World Bank activities is also very significant. This reform would offer the best approach to improving living standards and reducing poverty in the world's poorest nations. The traditional World Bank-IMF approach to saddling poorer countries with loans they cannot repay has failed. Moreover, the high failure rate of the World Bank projects reflects a waste of resources that could have been better used to alleviate poverty.

Unfortunately, the defenders of the World Bank status quo are resisting the administration's grants proposal. Ever since the idea of grants was first proposed, the World Bank's own evaluations of its performance have shown sudden improvement. However, we all realize that without truly independent review, performance can be misrepresented. An independent review of World Bank performance is urgently needed. Let me underscore that last thought. An independent review of World Bank performance is urgently needed.

The Bush administration has shown that it is serious about needed reform of the IMF and the World Bank. The work of the Meltzer Commission has been essential to this improvement of international economic policy. The recommendations of the Commission have led to U.S. Government proposals to limit moral hazards, curb international financial instability and reduce the waste of resources to the benefit of many millions of people around the world.

I would like to welcome all of you here this morning. Dr. Meltzer and Dr. Lerrick, Mr. Levinson, Dr. Bergsten, thank you for taking your time to come and share your thoughts with us this morning.

Dr. Meltzer, why don't we begin with you. And we are anxious to hear your interesting testimony, so why don't you go ahead and begin, and at the conclusions of all four statements, we will have some questions.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 34.]

OPENING STATEMENT OF ALLAN H. MELTZER, CHAIRMAN, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION (IFIAC); PROFESSOR, CARNEGIE MELLON UNIVERSITY

Dr. Meltzer. Thank you, Mr. Chairman. Thank you for holding this hearing. You, your colleagues and staff have played a major role in reforming and improving the operations of the International Monetary Fund and the development banks by insisting on greater transparency, increased accountability and improved performance.

You have rendered a great service to the American public and the people in the developing countries. Your efforts have not only saved taxpayers money, they have raised standards of accountability for performance. I am pleased to have been part of that effort, an effort that is continuing and has the support of the Bush administration, Treasury Secretary O'Neill and his principal staff.

Today we recognize the second anniversary of the Commission report. My colleague Adam Lerrick and I have divided the review of the past two years and prospects of the future into two parts. I will discuss the IMF, and he will discuss the development banks, particularly the World Bank.

The Commission proposed four kinds of changes at the IMF. First, it proposed improved transparency and information to permit outside observers to better understand what the IMF had done, what it recommended, and what resources it had available. Before this Committee took an interest, even a trained accountant would have difficulty interpreting the IMF's financial statement. The Commission developed a balance sheet that the IMF adopted.

Its accounting statements became less opaque. Reports of IMF surveillance of a majority of member countries, so-called Article 4 consultations, are now routinely posted on the IMF's website, along with a lesser but still substantial number of staff reports.

Improved quality and increased quantity of information helps markets to operate more efficiently and reduces risk. However, the IMF has not restructured accounting in the SDR department, and many countries have not improved the quality of their data. The IMF should do much more to get countries to improve data quality and to release it.

Second, the Commission found considerable overlap between the programs of the Fund and the development banks. It criticized the overlap and the large number of conditions that the IMF negotiated with borrowers, particularly borrowers in crisis. The IMF reduced the number of programs and the number of conditions attached to loans. It now limits conditions to matters directly related to the country's problem.

The Meltzer Commission proposed that troubled crisis countries should not look to the IMF to provide a reform program. Reform has a much better chance if the country adopts and implements its own choices of policy reforms. Management of the economy should remain in local hands. The IMF should confine its role to seeing that the promises are kept and that its loans are used effectively, not squandered on wasteful expenditures, paid to creditors or used to support the exchange rate.

The IMF has now moved in this direction. A senior IMF official recently said, quote, the main aim is to have a minimum amount of conditionality that enables countries to meet these goals. How can these goals be achieved? The IMF needs to be more flexible, not dictating to a country what policies are needed. The country should be allowed to present a program to the IMF. There has to be broad participation in the discussion of policies in the country, and the IMF needs to be selective, patiently waiting for the country to be ready. Already there are promising signs. The streamlining process is under way, and collaboration with the Bank, that is the World Bank, has been strengthened, end quote.

The IMF did not eliminate all duplication. The Poverty Reduction and Growth Facility continues. IMF management is sensitive to criticisms about the effect of disinflations on the poorest citizens of the disinflating countries. It does not want to give up poverty relief so that it can temper its macropolicies with policies to help the poor during a transition or recession. I believe it does not have enough confidence in the development banks to relinquish poverty fund programs to them where they belong.

Increased effectiveness of development banks would help to make the case for closing the IMF's poverty relief program and restricting the IMF to its principal functions, providing information; creating incentives that reduce the number, frequency, depth and virulence of financial crises; assisting governments to resolve crises; and preventing the spread of crises that occur.

Third, the Commission urged the IMF to phase in over five years an incentive system that induces countries to adopt prudent policies that reduce the risk of financial crises. We proposed a small list of observable prudent policies, preconditions, that if adopted and maintained would obligate the IMF to assist the country when it faced a financial crisis.

The great advantage for the country of adopting preconditions is that the IMF's commitment to assist in a crisis and its monitoring increased lenders' confidence that the country maintains prudent policies. Preconditions in place would act like a good conduct badge. The country would get more capital from the market at lower cost. This would foster development and reduce debt burdens.

IMF senior officials accepted this idea. They have proposed a contingent credit line to implement the proposal. Unfortunately no country has agreed to join. I believe there are two principal reasons. First, the IMF bureaucracy will not offer automatic assistance to countries that join. Second, until very recently all countries received assistance whether they adopted preconditions or not, so there was not much reason for private lenders to favor countries with more prudent policies over countries that were riskier.

The market does not lend to the poorest countries with little prospect of repaying its loans, but as Argentina, Ecuador, Russia and Indonesia have shown, the market has provided large loans to risky borrowers. Now that the IMF has not bailed out creditors of Argentina and others, I expect more discrimination by private lenders and more caution. Lenders who made moral hazard loans expecting to be rescued by the IMF and the G-7 will improve their monitoring and demand better policies by borrowing governments. If this proves to be correct, borrower incentives for prudent policies will be strengthened. More countries would willingly adopt more prudent policies and join an improved Contingent Credit Line (CCL).

A critical condition is that incentives work both ways. Countries with imprudent policies should not get IMF assistance in a crisis, once a five-year phase-in is completed.

Fourth, the Commission urged the IMF to improve crisis management by making different responses to prudent and imprudent lenders. The majority proposed that the IMF restrict its aid to two kinds of countries, those with prudent policies and those countries threatened by policies and practices of imprudent neighbors and trading partners.

As Argentina moved toward crisis, the IMF approved a standby loan to Brazil, a country currently with responsible monetary and fiscal policies, that seemed to be injured by Argentina's decline. After mistakes in December of 2000 and August of 2001, the IMF stopped lending to Argentina. Instead of offering Argentina a large loan with many conditions based on empty promises, the new IMF insisted on a coherent, consistent plan developed, adopted, and implemented by the Argentine Government. It has refused to finance Argentina's budget deficit or the bailout of international and domestic creditors. I should say it has so far refused to finance Argentina's budget deficit. It has not provided additional billions to support an overvalued exchange rate or to finance capital flight.

If the IMF withstands the pressure to throw in more money, moral hazard will be reduced. Lenders will expect to bear losses if they make risky loans. Countries that want to borrow to grow will have much greater incentive to adopt prudent policies, to rely more on foreign direct investment and less on short-term borrowing. They will invite foreign banks into the country and strengthen domestic financial institutions. The risk of crises will decline.

In the last decade the global economy experienced severe crises in 1994, 1995, 1997, 1998 and 2001. This alone suggests that the system was not working well. Tens of billions in emergency loans attempted to stem the crises. In many of the crisis countries, the banking and financial system collapsed, the exchange rate went into free fall, and unemployment rose as output fell.

Argentina, the latest crisis country, has one of the most severe crises. Unemployment rates will reach 30 percent of the labor force or more. That is worse than the worst year of the Great Depression in the United States. Mistaken policies have paralyzed economic transactions and bankrupted financial institutions.

The main problem with bailouts is that they cover over today's problem, but encourage a larger problem somewhere else. Twenty years of bailouts and conditional lending have failed. The crises have become larger. The promises to meet conditions are kept infrequently. This should not come as a surprise. The system of conditional bailouts and conditional lending relied on command and control. Countries had good reason to promise reforms, but few incentives to carry them through once the recovery was under way. Lenders came to expect that the IMF and other international financial institutions would not just bail them out, they would reward them with higher interest rates and fees for renegotiating and extending the maturity of their debt.

We have started to replace command and control with incentives for lenders and borrowers. If we continue on this path with patience and conviction in the face of pressures, we will achieve a better system. Lenders will have incentives to use the improved information that the IMF now provides, study the risks they have undertaken or are about to take.

Borrowers must have heightened incentives to adopt and maintain prudent policies. Rapid support for countries that meet preconditions provides the incentives. Some critics of the new policies assert that markets have failed, that openness, privatization and market incentives have been tried and have failed. This is a peculiar claim. It ignores such successes as Chile, China, Korea, Mexico, Poland, Taiwan and many others. It fails to mention that Argentina's problems are not novel. Their economy is barely open to trade. Their markets continue to suffer from the rigidities adopted by Juan Peron's governments.

There can be little budget discipline until there is a financial responsibility law that restricts provincial spending. Argentina's exchange rate was overvalued, its budget in deficit. The current government has no plan as yet to restore economic activity without inflation.

Argentine journalists ask me repeatedly, what does Argentina have to do to get IMF assistance? President Bush, Secretary O'Neill, Mr. Kohler, the Managing Director of the IMF, and many others have answered that question repeatedly. Argentina must come forward with a coherent, consistent plan that restores growth without inflation, increases productivity and settles its defaulted debt.

Policy toward Argentina is an abrupt change from past policies. Having embarked on a new and better course, the IMF and the G-7 must not go back to the old ways.

We are in the early phase of a transition to a safer, sounder international financial system based upon proposals for reform that this Committee and our Commission brought to public attention. Lenders now have reason to recognize the risks of lending to developing countries and, therefore, to be more prudent. Borrowers now have reason to recognize that excessive borrowing or imprudent behavior is costly to their country, because they may be dismissed from office suddenly. Recognition of the true risks and costs on both sides will do much more than so-called Basel standards to reduce moral hazard, promote more orderly development lending, save the taxpayers money and reduce the frequency of crises and tragedies in developing countries.

With your support and continued support of the new administration at the IMF and at the U.S. Treasury, we will achieve that safer, sounder system. Thank you, Mr. Chairman.

[The prepared statement of Dr. Meltzer appears in the Submissions for the Record on page 37.]

Representative Saxton. Thank you, Dr. Meltzer.

Dr. Lerrick.

OPENING STATEMENT OF ADAM LERRICK, SENIOR ADVISOR, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION; DIRECTOR, GAILLIOT CENTER FOR PUBLIC POLICY

Dr. Lerrick. It is a privilege to address the Joint Economic Committee. First, Mr. Chairman, I would like to thank you and Majority Leader Armey for the strong support you provided when violent attack came from almost all sides. Two years ago Minority Leader Gephardt greeted the publication of the Meltzer Commission report with the following appraisal, "an extreme neoisolationist attitude that will undermine development efforts in the world's poorest countries and the stability of the world financial system."

Then Secretary of the Treasury Summers made a rare personal appearance on the pages of the *Financial Times* to claim that one of the Commission's key proposals, a shift in the format of aid from loans to grants, would, "require an unworkable system for delivering assistance."

World Bank President Wolfensohn deemed grants unrealistic.

One year ago my fellow witness Mr. Bergsten stated that the Joint Economic Committee hearing on the first anniversary of the report's publication was appropriate as a burial service because none of the Commission's recommendations had been or would be adopted. What a difference a year makes. Once branded ivory tower by some and radical by many, the Report was recently termed the blueprint for international reform efforts by *The Economist* magazine. Today we have a new administration that supports international reform, and a new International Monetary Fund with a disciplined approach to assistance. Many of the major recommendations of the Commission are on the way to becoming global public policy.

My remarks will focus on developments at the World Bank, particularly those current issues that would benefit from the intervention of the Congress.

A critical look at the Bank is doubly important as the institution assumes the leadership role in the United Nations campaign to double development aid flows to more than $100 billion each year. When leaders from both the industrialized and developing world meet in Monterrey, Mexico, on March 18th at the United Nations Conference for Financing for Development, two topics that originate in the Meltzer report will be high on the agenda: First, a change from loans to grants for the delivery of aid to the poorest countries; second, a move to rigorous measures to increase the effectiveness of development assistance.

President Bush launched these proposals at the Group of 7 meeting in Genoa last summer, and the Secretary of the Treasury continues to speak out forcefully in support of the administration's commitment to these policies. Grants were proposed by the Commission to address the shortcomings endemic to the tradition of open-handed lending by the multilateral institutions. The poorest countries had accumulated debt they were clearly unable to repay. Funds had been diverted to unproductive ends. Donor contributions ended in write-offs instead of real improvements in the standard of living of the impoverished.

This grant format is new because it is performance-based. Counter to the trend of lending blanket sums for indeterminate government plans, grants will be project-linked and executed under competitive bid by private sector contractors and nongovernmental organizations. For the easily quantified basic needs that improve the quality of life, and are the preconditions for economic growth, health, primary education, water and sanitation, the grants system would count by independent audit and pay for output. Numbers of babies vaccinated, children that can read, water and sewer services delivered to villages. No results, no funds expended, no funds diverted to offshore bank accounts, vanity projects or private jets.

Opposition to the use of grants has been orchestrated by the World Bank around the faulty argument that grants will deplete its resources together with its ability to help the poor unless they are partnered with an immense infusion of new funding, $800 million more each year from the U.S. alone. It is worth taking the time to explode this false argument.

It would seem logical that if money is given away instead of being lent, the stockpile of funds will eventually vanish. Not so. Grants will not cost more than loans. They deliver the same amount of aid without diminishing the funding pool and without asking for more taxpayer moneys from the industrialized world. The funding requirement is the same when the level of aid is the same. The arithmetic is straightforward. The International Development Association (IDA), the arm of the Bank dedicated to 72 of the globe's neediest nations, extends 40-year loans at virtually zero interest. The interest-free use of the money translates into a gift component equal to $73 out of every $100 loan. Although ultimately $100 will be repaid, the real cost to the recipient is $27. A simple way to verify the mathematics is that if the recipient were to take $27 out of the $100 received and invest it in the capital markets, the proceeds would be sufficient to repay the entire $100 loan at maturity, and he would get to keep the $73 out of the original $100 as a free gift. The loan is therefore identical to an outright grant that pays $73 out of $100 of program outlays, with the remaining $27 paid by the recipient. In both cases the cost to the country is $27.

Again, if the level of assistance is the same, grants cannot cost more than loans. The grant format can produce the same reflows into the IDA pool of financial resources as traditional loans at the same level of aid. For each $100 of donor funds, $73 would be disbursed as grants and $27 invested in the capital markets. The proceeds of the investment will match the $100 of loan reflows over the life of a traditional 40-year IDA loan.

The effectiveness of World Bank performance has been another highly contested but not unrelated debate. Although the Bank claims 75 to 80 percent success rates, when the Meltzer Commission reviewed the Bank's own data, it found that more than half of World Bank programs overall and more than two-thirds of projects in the poorest countries, failed to achieve both satisfactory and sustainable results.

Debate over the numbers is irrelevant, because the Bank's auditors are captive, because the judgments are made too early, at the time of final loan disbursements, but long before an operating history is established, because sustainability, the sine qua non of development, is given little consideration in the evaluation.

After the publication of the Meltzer Commission Report in 1999, World Bank sustainability ratings that had stagnated at 50 percent for years jumped to 72 percent in 2000. Was there such swift improvement, or was the bar simply lowered? Thinking has continued long after the official life of the Meltzer Commission. After 50 years and $500 billion of aid, we have no evaluation of World Bank performance except the one it chooses to promote. If the wrong people are applying the wrong criteria at the wrong time, how credible are the conclusions?

Why not establish a bona fide external audit by private sector firms on site to determine the lasting contribution of IDA projects after a credible operating history, and to provide a continuing benchmark for Bank efforts in the poorest countries. The World Bank is now seeking $13 billion in IDA replenishment funding. The U.S. share alone is $2.5 to $2.8 billion; five to seven million dollars, or just one-quarter of one percent of this commitment, would cover the cost of an audit. The condition of an external performance review of IDA programs, together with provision for its financing, should be written into the upcoming appropriation and to all funding going forward. Thank you, Mr. Chairman.

[The prepared statement of Dr. Lerrick appears in the Submissions for the Record on page 44.]

Representative Saxton. Mr. Levinson, we have a vote on, and so Mr. English and I are going to have to leave. Is your testimony five minutes, 10 minutes?

Mr. Levinson. It won't be more than 10 minutes.

Representative Saxton. It won't be more than 10? If we leave near the end of it, you will understand. Sorry.

Mr. Levinson. Well I have—

Representative Saxton. Mr. Crapo is going to take the chair when Mr. English and I go to vote. So go ahead, sir.

OPENING STATEMENT OF JEROME I. LEVINSON, DISTINGUISHED LAWYER IN RESIDENCE, WASHINGTON COLLEGE OF LAW, AMERICAN UNIVERSITY

Mr. Levinson. Well, in the year that has passed since this Committee met to discuss this subject matter, we have descended from the realm of theories to the flesh-and-blood world of the real economy in which theory has real consequences. The event that illustrates this truism is Argentina. The crisis was so long in developing that the financial markets have had time to absorb the Argentine financial default without significant consequences for other borrowing countries. In other words, financial contagion has been contained. We can then consider how to think about the lessons of Argentina in other than crisis conditions for the international financial system.

And yet Argentina remains, in my opinion, a watershed event. It conclusively demonstrates first the hollowness of the Meltzer Majority Report of the Commission on International Financial Institutions, hereafter the Commission, recommendations for reform of the IMF, the limitations of the IMF, World Bank and neoclassical economic paradigm, which Joe Stiglitz, the former chief economist of the World Bank, and Nobel Prize winner in economics, has referred to as market fundamentalism, slightly modified in recent years as the Washington consensus elite that has governed development thinking for the past 15 years; and it further illustrates the excessively short-term economic mindset of the Secretary and Under Secretary of the Treasury. The Treasury proposal for additional grant funding for the IDA, the World Bank soft loan affiliate for dealing with the poorest of poor countries, while superficially appealing as presently formulated by the Treasury, is ill-conceived, impractical and probably harmful to any sustainable financing for development in the poorest countries.

I would be glad to respond in more detail to questions on this subject, but in this testimony I will concentrate on the Argentine case as illustrative of the above three theses.

Argentina is the country that most enthusiastically embraced the neoclassical economic model promoted by the IMF and the U.S. Treasury, market liberalization, opening to foreign investment, particularly foreign direct investment, and a reduced role for the state in direct production of goods and services.

The original heart of the Meltzer proposal is to divest the IMF of discretionary authority with respect to conditions that attach to member country access to IMF financing. Such financing after a suitable transition period is made conditional on prequalification of the country. Only countries with financial banking systems previously determined to be sound are eligible to draw upon IMF funding.

The key to assessing the soundness of the system is its openness to foreign investment, which, according to the majority, is a guarantee against unsound crony capitalism in which financial decisions such as the allocation of credit are made on the basis of criteria other than arm's-length credit analysis.

Fred Bergsten, who came late to the Commission's deliberations, immediately identified the flaw in the proposal. A country with a sound banking system but unsound macroeconomic policies would automatically be eligible for IMF funding, but without any conditions that addressed the underlying conditions, the policies that necessitated recourse to the IMF. In recognition of the validity of the Bergsten critique, the final report of the majority contained a few sentences referring to the need for a sound macroeconomic framework as an additional precondition for IMF financing.

Argentina takes the issue out of the realm of theory and into the real world. Argentina not only opened its banking system to foreign capital, but it permitted the sale of virtually all of the previously Argentine-owned banks, primarily to American and Spanish financial institutions. There are no banks of any stature any longer majority-owned by Argentine nationals, nor are there any local cronies of any consequence to whom the banks can lend. Argentina has sold the previously stated-owned water, telecommunications and utilities to foreign capital, primarily state-owned Spanish and French companies, a process less privatization than de-Argentization. The previously state-owned petroleum company, YFPB, has been auctioned off to a combination of domestic private and foreign capital.

Argentina has divested to private capital the previously state-owned railroad system. The signature industry of Argentina, the meatpacking companies have been sold to the major international groups. Today there is no Argentine-owned meat packing company of any size or importance.

In light of this record, the statement by Secretary O'Neill that Argentina has not carried out significant economic reforms is simply incredible.

Argentina ran into difficulties because of a variety of problems, most notably, most commented upon in this country, the currency board arrangement, and finds itself in intense negotiations with the IMF in the midst of a profound economic depression.

A country cannot be frozen in time. Conditions change. Policy may not adapt. A crisis ensues requiring the countries to go to the IMF for assistance, precisely the circumstances envisioned for IMF intervention. The need for judgment as to the appropriate policies to address the situation cannot be evaded. Argentina thus put paid to the Meltzer majority theory that recourse to the IMF can be automatic in accord with pre-established criteria.

The issue remains, what are the criteria for IMF assistance? And that brings us to the issue which I think unfortunately the Commission did not address and on which there probably could have been a very large amount of agreement. The Chairman in his opening statement referred to mission creep. I couldn't agree with him more. I was in Argentina in 1996 on a speaking tour for the – sponsored by the AFL-CIO and the CGT, Argentina Confederation of Labor. This was at the time when the World Bank and the IMF were beginning their push for labor market flexibility, which is a euphemism for making it easier for firms to fire workers without severance payments, and for changes in the collective bargaining system which would be to the disadvantage of labor and would reinforce the position of capital.

It happens that my wife and I had dinner with the president of the Olmos local of the metallurgical workers, and they were commenting – his wife is an American – that the IMF and World Bank were pressing for the unions to be divested of the responsibility for administering, what in Argentina are known as Obras Sociales, health plans, and she said to me that they must think that we are really stupid because we are union people. But we know what they are about. They want to divest the unions of responsibility for the health care plans, because those plans reinforce worker loyalty to the unions.

Her husband, the head of the Olmos union, was pressing, along with a bunch of young Turks, for a general strike at the time, 1996. The president of the meatpackers union offered a barbecue for my wife and myself. You can imagine what that is like when they come around with the slabs of beef, pork, chicken and cut whatever cut you want. But when we walked into the union hall, the offices, it is a step back in time, because on the walls are these larger-than-life blown-up photos of the great moments, at least for the Peronistas, in Peronist political life; the march of the meatpackers union, down to get Peron released from jail. Evita on the balcony. Evita passing out food to the poor. And you realize when you step in there the role that history has as a limiting factor in connection with a society.

I was seated next to the president of the union, and I asked him what he thought about this IMF-World Bank initiative to divest unions of the responsibility for the health plans, and what he thought about the prospects for the general strike; he told me that he did not think it was possible because the unions were too divided. President Menem was too clever in terms of dividing the unions, and he did not, therefore, believe in a general strike.

The young Turks won out. The leadership of the CGT was changed, and a general strike was called at the end of September of 1996; it was hugely successful, but what was significant about it was that it wasn't only supported by the workers, it had broad support in the middle class, and this should have been a warning signal to the IMF, World Bank and indeed our own Treasury at the time that the social and political base for the economic policy was slipping away from the Menem government. No government embraced more enthusiastically the neoclassical economic model than the Menem government in Argentina.

In this country most commentary has focused on the currency board arrangement and the pegging of the peso to the dollar. There is one argument, for example, in the Washington Post that Argentina stuck with the currency board arrangement for too long, but that otherwise there is nothing wrong with the free market economic model which Argentina adopted.

I would like to suggest to you that the economic model is more fundamentally flawed than just the currency board arrangement. It could not solve the unemployment program, which even in the years of high growth in the mid-1990s never got below 13 to 14 present. It has resulted in the devastation of an education system which delivered 95 percent literacy, and of a health system which may have had quality problems, but achieved wide coverage of the Argentine population. It has led to an increasingly alienated and embittered working class and a regressive distribution of income that finally discredited altogether the economic model.

The breaking point came in December of last year when the IMF and U.S. Treasury demanded and the government accepted a policy of still more austerity and unemployment.

Argentine society, not just the unions, rose up and drove the de la Rua government from office. It should be noted that at that time, the IMF staff understood that the currency board was no longer sustainable; the conversations between the staff and Domingo Cavallo, the Minister of Economy, assumed a surrealistic character in which Cavallo insisted that there was nothing wrong with the currency board; they just needed IMF money to fortify confidence, and the IMF staff felt that he was divorced from reality. The meetings ended inconclusively, and that is when the Argentines went back home and de la Rua tried to implement this austerity program, which led to his fall.

The best way, in my opinion, to understand the Duhalde government is in terms of the early months of the Roosevelt administration in 1933. Faced with a devastating depression and no good alternatives, FDR tried a bewildering variety of approaches. If asked to produce a coherent plan, as the IMF and Treasury have demanded of the Duhalde government, all of the creative experiments of the New Deal period would have been killed at their inception. Social Security would have been rejected in favor of private investment accounts, and the *Wagner Act* probably dismissed as an undesirable intervention in the labor market when the preferred objective of policy should be not to diminish the disparity of bargaining power between individual workers and firms, but to maximize that disparity in favor of capital.

Faced with this situation, what has Duhalde done? He has cobbled together the most broad-based government in the postmilitary era. He has an important part of the radical party, including the support of former President Alfonsin with whom he has been talking for some time, and who also hates the former economic model. He has also included Frepaso, the center left party. Both small and medium enterprises and the majority of the labor unions understand that Duhalde is their last chance. The alternative is a deepening of the "reforms," as demanded by the U.S. Treasury and the IMF, that they understand will be devastating for them.

No one, not the IMF, the Argentines or anyone else, had a good exit strategy for the currency board regime, but the Duhalde government finally did it, difficult as it has been. At first they experimented with a dual exchange rate. When that came under severe criticism, they backed off, and went to a floating rate. Duhalde attempted to allocate the burden of adjustment more equitably within Argentine society, placing the greatest cost upon the foreign-owned banks and utilities who had sweetheart deals from the Menem government and made big profits in the last years; he has concluded a difficult negotiation with the provinces in connection with revenues and expenditure cuts. And the papers report this morning that the Argentine Senate has passed the first reading of the budget. He probably has the best chance of any recent government to carry out a reasonable economic policy with a broad base of political and social support. But Duhalde confronts increasing outrage, at growing income inequality, declassing of the middle class and the reversal of social gains for the working class.

We can expect a period similar to the early New Deal era of trial and error, what works and what doesn't, what is socially and politically feasible and what is not. Understood in these terms, what the Duhalde government seeks to accomplish is not dissimilar to FDR's objective: to assure society that within the framework of representative political democracy and a market economy, there is room for a policy alternative that has as its objective not just economic efficiency, but a more just society. And that may be his problem, for that objective brings him into conflict with the IMF and our own Treasury that seems determined to force upon the Duhalde government the same policies and prescriptions that brought down the de la Rua government, a Herbert Hoover-type economic policy, deep cuts in fiscal expenditures in the midst of a crushing economic depression, and unemployment, which as Professor Meltzer says now may reach 30 percent, and labor market flexibility measures that only can drive a wedge between the government and the unions.

We have the Deputy Managing Director of the IMF warning about hyperinflation, hyperinflation with 30 percent unemployment in a four year recession-depression, with massive unused capacity in the consumer goods industry because of lack of demand. It may be that if they monetize the deficit without adding to capacity, in a year or so when they absorb existing capacity, they will have an inflation problem, but all she did was reinforce the difficulties facing the Duhalde government.

For years the IMF has been trying to convince critics that it does not have a cookie-cutter, one-size-fits-all approach. Yet we are now told that it is bringing in a new lead negotiator for the Argentine negotiations, an individual with no background in the country or the region, who does not speak the language, is ignorant of the history, culture and all of complex bargains, formal and informal, that make up a country's social compact.

Increasingly, the IMF resembles the Mad Hatter's tea party in Lewis Carroll's *Alice in Wonderland* fable. White is black. Black is white. Night is day. Day is night. Knowledge is vice. Ignorance is virtue. There is then a growing gap between the social and political reality of Argentina and the policy priorities of the U.S. Treasury, the Bretton Woods institutions and an important part of the American academic, and journalistic establishment for whom growing income inequality is irrelevant, the middle and working classes in Argentina pampered and undeserving of any special concern.

The significance of Argentina is, however, larger than Argentina. It is symptomatic of a disconnect between an increasingly conservative Washington establishment and a growing disenchantment in Latin America with the social consequences of the neoclassical economic model that for the past 15 years has been the preferred, and indeed the only, acceptable economic policy in Washington.

The leading candidate of the Cardoso government in Brazil – Brazil is going to face Presidential elections this year – the slogan he has adopted is revealing. (Speaking in Spanish.) That is to say, nothing against stability, but everything against inequality. I think that is indicative of the degree to which the equity and inequality issue is coming to the fore in Latin America.

So for me reform of the international financial institutions must start with a reconsideration of the economic model, its income distribution effects, and social and political consequence. In other words, for me the name of the game is political economy, not an economic technocracy run amok, which is what we now have at the IMF and, sad to say, with our own Treasury. Thank you.

[The prepared statement of Mr. Levinson appears in the Submissions for the Record on page 49.]

Senator Crapo. [Presiding.] Thank you very much, Mr. Levinson.

Dr. Bergsten.

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

Dr. Bergsten. Thank you very much, Senator.

Let me try to do three things, if I might, in my opening remarks: first, address this question of Argentina, which, as Professor Levinson said, does raise in very stark terms the IMF and reform issues we have talked about; second, segue a bit, because Argentina, I think, has revealed several important implications about the functioning of the monetary system as a whole; and then finally, comment on changes, reforms, and improvements that have been made in the monetary system, and what that implies about the Meltzer recommendations and other proposals two years later.

First on Argentina. As I step back a bit from the immediate situation that Professor Levinson addressed, my conclusion is that the IMF is in great danger of whipsawing itself over Argentina. The fact is that for a long time, including quite recently, the IMF was not too tough on Argentina – it was too soft on Argentina. All of the time that Argentina was running very successful economic growth and price stability policies in the 1990s, it was letting its fiscal position deteriorate sharply.

The share of national debt to GDP has more than doubled from 1993 to now – from about 23 percent to 50 percent. It was during the good period, which lasted through 1998 or so, the boom period, when fiscal rectitude should have been pursued and the budget not permitted to get out of hand.

But the IMF said nothing about it despite continued close involvement with Argentina. Then, as the crisis came into clear appearance – and I think all of us on this panel plus many others were saying as long as two years ago that the fiscal situation, the currency board, and other circumstances were simply unsustainable and could not continue – the IMF poured not one, but two huge financial rescue packages into Argentina. It did not insist on change in those fundamental problems. It, therefore, encouraged those policies to continue and the crisis to come on.

So the problem in stage 1 was not the problem typically stated – that the IMF is too tough on poor countries – but rather it was too soft. It did not insist on necessary changes. Indeed, it financed unsustainable policies, made the situation worse, delayed the evil day, and therefore made it even more severe, as Professor Levinson has now so graphically developed.

Indeed, when the IMF made its second big loan to Argentina last summer, it seemed that the IMF was gambling for redemption, as we sometimes say about companies headed for bankruptcy. You seem to be in trouble, you make a huge last bet on some speculative outcome, and you bring yourself down in a heap, for example, Enron. That is what the IMF in a big sense did in Argentina.

Now that Argentina faces these desperate straits, as graphically described by Professor Levinson, the problem is that the IMF will go to the other extreme and be too tough, because in the circumstances he described, including the desire we all have to maintain a democratic political system in Argentina, we cannot be so insistent on all of the necessary reforms at the same time that we drive the country into total anarchy or a return of authoritarian government or worse.

Yet the IMF, if it sits back and does not offer a helping hand, does, in fact, I am afraid, risk that outcome. If it did it, it would be as bad as the commercial banks that we attack for seesaw behavior. The private banks throw huge amounts of money into countries when they are doing well, pull money out when the countries start to do poorly and make the situation worse – the famous seesaw, the famous gyrations from one extreme to another, which always make situations worse by overdoing the booms and then overdoing the downturns as well. And that is the risk for the IMF now if it does not find a way, pretty soon, to work constructively with the Argentine Government to come out of this difficulty.

I am afraid that our own administration has performed even worse. They have already whipsawed themselves. They came into office vowing not to support continued big bailouts of unsustainable situations, including clearly unsustainable exchange rates, but they did. They supported the big new rescue for Argentina. They supported one for Turkey as well, where we don't know the outcome yet. But clearly in Argentina they whipsawed themselves; they said they wouldn't support big bailouts, but did anyway. Their credibility is much in doubt. Professor Meltzer puts a positive spin on that and I hope he is right that a new day is coming. But I suggest that it could then go too far in that other direction as well, and therefore run the risk that the Argentine crisis would become even worse.

I am afraid that the situation in that sense is not better than it was a year or two ago when the Commission reported, but indeed worse, and the performance of both the IMF and the U.S. Government in the interim has made it worse.

Now, having painted a pretty bleak picture on that front, let me say there is some very good news. The good news is that the Argentine situation has had virtually no spillover effect on the rest of the region or the rest of the world. In other words, there has been virtually no contagion. Indeed, there has been some positive contagion. The Mexicans and others report that, in the wake of the Argentine meltdown, they have gotten increased capital inflow. Money moved from Argentina into Mexico. One reason the Mexican peso is the only currency in the world that has been stronger than the U.S. dollar for the last couple of years is because money has moved from other emerging markets, including Argentina, into Mexico.

Why is it that there has been so little contagion from Argentina to the rest of the world? I suggest it is largely because of improvements in the functioning of the international monetary system. Obviously this crisis was anticipated for a long time. Some people believe that is why there is no contagion. That was a factor. But Thailand had been anticipated for a long time by many people. Mexico in 1994 was anticipated by a lot of people. So that is not the sole explanation.

I think there are really three factors. First, the markets are learning to differentiate between different countries rather than to generalize about regions as they did in Asia in 1997 and 1998, and that increased differentiation has been helped substantially by the better data, the greater transparency, the data standards that the IMF has put out and begun to enforce. All of that has improved the functioning of the markets and, therefore, the lack of contagion in the system.

Second, all of the emerging-market economies, particularly those in Latin America, have strengthened their domestic banking systems. There is still a lot of reform to be done, but there has been substantial improvement, and that has reduced the risk of contagion.

We know that the common factor in all crisis countries in the 1990s was weak, vulnerable domestic financial systems that permitted the contagion to occur. Now those systems are being strengthened, in response to the Basel core principles adopted by the IMF and others in 1997, and to other international reform efforts, the standards developed by the Financial Stability Forum, and the like. That is improvement that reduces contagion and that is positive reform.

Third, and I think probably most important, has been the nearly universal adoption of floating exchange rates. Argentina was one of the last holdouts and it has paid the price. But all of its neighbors, fortunately, have adopted floating exchange rates – managed floats, not pure floats. Indeed, one of the crucial systemic issues now is how best to manage floats. Argentina's neighbors have gotten away from fixed pegs, they have gotten away from currency boards, et cetera, and that enables them to buffer shocks of the type coming from Argentina and reduce the risk of crisis.

So these three important reforms have lessened the impact of Argentina on the rest of the system and have indicated the virtues of the improvements in the international monetary system that have taken place.

Let me conclude by simply adding that a number of other developments are occurring, which I believe also promise improved functioning of the international monetary system. I agree with Professor Meltzer's comment today in his testimony, that we are in the early phase of a transition to a safer, sounder international financial system. But I don't think it is primarily, or even importantly, because of proposals that came from the Meltzer Commission.

I have already mentioned the improvements that are occurring: much greater data dissemination and openness, improvement in national banking and financial systems, and moves to floating exchange rates. All of those are very important.

In addition, there are several other things. The U.S. Government has proposed, as you, Mr. Chairman, and Professor Meltzer pointed out, shifting from loans to grants in the development banks. Here I differ with Professor Levinson. I think that is a good reform and it should be supported. One needs to make sure that it does not reduce the level of aid over time, and Adam Lerrick addressed how to do that. But if that is taken care of, it is clearly a good change because it avoids the risk of a new debt buildup, a new need for debt relief programs and the like.

In addition, the beleaguered IMF itself has now made some fairly far-reaching proposals for new procedures to handle debt work-out cases. This is another implication of Argentina, and also of many other countries in the last few years. We needed a more orderly work-out mechanism. Deputy Managing Director Anne Krueger has made a proposal that will do that in a sweeping way. We are holding a big conference on that at my institute on April 1-2 to try to look at its details. I think it is a very promising idea. I hope our own government gets behind it. They have not yet indicated that they will. I hope that they will. I think that would be a very constructive forward step.

Moreover, we are about to publish a study on debt relief, which makes a couple of proposals. One is to deal with the problem – where I agree with Meltzer and Lerrick – on the need to focus tasks separately on the Fund and the Bank. I oppose the idea of eliminating the Poverty Reduction and Growth Facility but strongly support moving it from the IMF to the World Bank where it belongs. That is another recommendation that we will be presenting in our new study.

In addition we are suggesting a doubling or more of the amount of debt relief to the poorest countries, financed in large part by mobilizing the rest of the sterile gold stock sitting in the vaults of the IMF and serving no purpose. You may recall that the stock was tapped to a modest extent a couple of years ago to help finance the first round of debt relief for the Highly Indebted Poor Countries (HIPC) Initiative. We are suggesting going the rest of the way, using the rest of that sterile gold supply to finance more HIPC debt relief and indeed finance debt relief for some of the other low-income countries that have not been included in the HIPC Initiative so far.

Finally, I think you might note that George Soros and some others have proposed that you in the Congress take up something that has lain fallow here for five years – the proposed fourth amendment to the IMF, which would not only create a new issue of Special Drawing Rights to provide more liquidity to countries that need it, but also to provide more assistance to the poorest countries in the world. Soros proposes a whole new delivery mechanism of such assistance, which is akin to the Meltzer-Lerrick proposal that was in the Meltzer Commission report – a market-based system for both the supply and demand sides of the foreign assistance market. Soros has put out a very interesting proposal on that that I commend to you.

The financing side would require action by the Congress. You may be aware, Mr. Chairman, that 72 percent of the IMF membership has approved the fourth amendment, this new creation of Special Drawing Rights, on a different basis than in the past. It is therefore awaiting U.S. action, because our 15 percent would put the number over the top. Without our 15 percent, it can't happen, because it requires 85 percent of the total membership.

So this is an area where the Congress, I think, could act very positively to support a strengthening, a further reform of the monetary system, but also do it in a way that would help promote the development objectives that I think all of us who are involved with the Meltzer Commission agree with.

So my bottom line is that Argentina has indeed raised a lot of further questions about the functioning of the IMF but I am worried that if we are too tough now, it is going to make it worse. The Argentine case does, however, have the very positive implication that contagion has been sharply reduced, I believe, because of fundamental systemic reform, only tangentially related to the Meltzer Commission proposals.

I think those reforms will continue. Other reforms are in train, and I believe it is true that, as Professor Meltzer said, we are in the early phase of a transition to a safer, sounder international financial system. Thank you.

Representative Saxton. [Presiding.] Thank you very much.

Let me begin with a question to Dr. Meltzer. Dr. Meltzer, throughout your testimony in various ways you have advocated for a higher level of involvement in the planning stages of economic assistance that may be offered to various countries, and you apparently believe that it is quite important that plans be developed not from the outside, but with strong inside participation. Perhaps the strongest indication is in the paragraph where you are talking about President Bush and Secretary O'Neill and others believing that Argentina must come forward with a consistent coherent plan that restores growth without inflation, increases productivity, and settles its default payment. The key to that sentence seems to be that Argentina must come forward. Tell us why you think that is important.

Dr. Meltzer. I think that is crucial, and the reason it is crucial is we have a long history of the IMF presenting countries with long lists or short lists of recommendations and requirements for the loan. We have a very, very short list of the – having those conditions adopted. Let's take the case of Korea, where the IMF presumably did a great deal to stem the crisis of Korea. Korea as a result of that agreed to privatization of many of its industries. Very little of that has happened. Why has it not happened? Once Korea began to improve, once the economy of Korea began to improve, most of the reform just couldn't be passed. The Korean Government would not agree to it, did not feel the necessity to agree to it, because the economy was on the mend.

In Argentina, people keep saying what is it the United States or the IMF want us to do? And the answer that Dr. Lerrick and I gave them when we were there is: This is your country. You have to want the reforms. The reforms will only work if you want them to work. You can promise lots of things to the IMF to get the money, but the important thing is that you adopt reforms that you will be willing to live with, that will improve the operation of your country and will bring more foreign capital at lower cost.

The long record – to be brief about it – the long record is one in which countries agree to make the reforms when they are in crisis. They will agree to almost anything. Once the crisis ends, they find it impossible either to get the reforms passed through their legislature or to implement them fully or even partially once they have passed them.

What we want – what we believe is essential is that they have – they see that these reforms are good for them, that they adopt reforms that are good for them, recognizing fully, as I am sure you recognize, that politically it is often very difficult to do things that would improve the body politic as a whole, because it tramples on the particular province of some very active, very vocal interest group. That is the problem in Argentina.

But reform won't come in Argentina or anywhere else until the people in that country are willing to adopt those reforms. That is the idea. Secretary O'Neill has said it, I think, extremely well by saying, the only way that countries grow is by increasing their productivity. We can't increase their productivity, they can increase their productivity.

Representative Saxton. Thank you.

Let me turn to Dr. Lerrick for a minute. In this morning's *Wall Street Journal* there appears an editorial that is critical of the leadership of the World Bank for suggesting that before reforms take place there should be a significant increase in the assets and the resources available to the World Bank for their activities around the world.

In your testimony, on the other hand, you talked about two concepts: one, moving from loans to grants; and second, I found very interesting that the World Bank apparently at this point has chosen not to accept the idea, but that measurable goals be put in place so that countries who fund the World Bank, can see whether or not progress is actually being made.

In your testimony you talk about easily quantified basic needs that improve the quality of life, and other preconditions to economic growth, health, primary education, water and sanitation, et cetera.

Can you talk about this subject a little bit for us so that we can have the benefit of your thinking?

Dr. Lerrick. Would it be helpful, Mr. Chairman, if I explained how the grant mechanism would actually work with a concrete example?

Representative Saxton. Sure.

Dr. Lerrick. If a country wished to vaccinate its children against measles, which is one of the greatest sources of fatality in Africa, the way it would be structured today is the country would apply to IDA, the concessional arm of the World Bank, for a loan to the Ministry of Health to provide health services to its people. The money would be guaranteed by the government, so the debt would be incurred by the government itself. The World Bank would disburse the funds, and there would be relatively little control over what the actual physical results were, whether children actually were vaccinated.

Under the grant proposal that has been put forward, the World Bank would set the mechanism up in a different manner. It would say to the country that it is an excellent idea to vaccinate your children against measles. Go out and ask for competitive bids from private sector contractors, from the Red Cross, from the Anglican Church, for the cost of vaccinating children in the rural areas for measles. If it was a very poor country, the Bank would pay 90 percent of the cost. So if the best bid from a qualifying contractor came back at five dollars per child vaccinated, the World Bank would say, fine, for every child you vaccinate, we will pay you directly $4.50, and the country will pay you 50 cents. However, we are only going to pay you upon audited, independent, truly independent, verification of delivery of service.

So at the end of the first month, if the contractor came back and said we vaccinated 10,000 children, there is an auditor that is independent of the Bank, independent of the country, independent of the contractor who would go out and verify how many children were vaccinated. If that was confirmed, the World Bank would write a check for $45,000 directly to the contractor. The country would write a check for $5,000. If the next month no children were vaccinated, no funds would be expended. So without results, there can be no funds expended whatsoever.

This same mechanism would be used for wastewater treatment. It would be paid per cubic meter of water treated. It is irrelevant whether the wastewater treatment plant is built. The only thing we care about is how many cubic meters of water are treated. Same with schools and children. We don't care whether the school is built on time and under budget, we care how many children have learned to read.

And that is the difference in the delivery mechanism, and by doing this, you reduce dramatically the possibility of the funds being diverted to unproductive uses, and you eliminate the possibility of an accumulation of unsustainable debt by the poor countries.

Representative Saxton. Okay.

Dr. Lerrick. And you increase the incentives for delivery of results.

Representative Saxton. Let me ask you a related question regarding the World Bank. Mr. Easterly made a number of observations about the failure of the IMF and the World Bank's development aid. According to him, he says, and I quote, "Consider the facts, and it soon becomes evident that the $1 trillion spent in aid since the 1960s, with the efforts of advisers, foreign aid givers, the International Monetary Fund, and the World Bank, have all failed to attain the desired results. With notable exceptions, government mismanagement usually continued in these countries. The growth rate of the income per person of a typical member of this group during the past two decades was zero."

Now, what you are suggesting is a different approach to try to get the growth rate somewhere above zero, I assume.

Dr. Lerrick. I certainly hope so. Yes, Mr. Chairman.

Representative Saxton. Would you – I know the answer to the question, but let me ask you it anyway so you can get it on the record. Is this an acceptable outcome for public policy?

Dr. Lerrick. Absolutely not. I don't think there is any outcome that is acceptable for public policy where vast amounts of taxpayer funds are used and no results are achieved.

One of the problems with past aid, and, in fact, one of the senior members of the World Bank staff, Michael Klein, described the bankruptcy of traditional aid results, is that because it is based on the wrong incentives. The goal is to create incentives to deliver results, not to cover up the problems with a blanket of money that can be used for whatever purposes, without any accountability either by the government or by the World Bank as to how funds were actually used and what results were achieved.

Representative Saxton. I had an experience with regard to failure regarding the IMF in the case of Russia. Some of us went to talk to the Russians about what went wrong with the IMF-Russian transaction, and while we were there members of the Russian Parliament, the Duma, actually spent an afternoon trying to convince us that the moneys were stolen by U.S. banks. Can you give us a better notion of perhaps what really happened in Russia?

Dr. Lerrick. Well, I did not follow the Russian situation closely enough to give you a precise opinion. I would say one of the problems in terms of the assistance that was provided to Russia was that the IMF's view was that its job was very simply to provide funds to the Central Bank of Russia in return for agreements to enact certain policies, or at least to propose those policies to Parliament.

One of the problems in Russia is the conditions did not even insist on enactment of the policies, they only insisted on proposal to the Parliament of the policies.

The IMF felt that once it delivered the funds to the Central Bank, its responsibilities were over. It was up to the Central Bank of Russia to police how the funds were used and where they went. And there are many who believe that this is a mistake in IMF policy. But that was their attitude, and that is how the funds went to wherever they wound up going.

Representative Saxton. Let me return to Mr. Easterly for just a moment. Apparently he has been under some kind of investigation by the World Bank. It almost seems as if perhaps he is being punished by the World Bank for having told what he believed to be the truth about World Bank problems. Do you have any feelings?

Dr. Lerrick. I am not close enough to that situation to comment. In fact, as I understand it, Mr. Easterly now works for Mr. Bergsten at the Institute for International Economics.

Dr. Bergsten. Yes. Dr. Easterly does now work for me, a joint appointment as a senior fellow at my Institute for International Economics and the new Center for Global Development that we have helped create to deal with the range of development issues.

You quote Easterly's conclusions exactly right, but you have to go the next step and ask why. His conclusion, which is based on very detailed, in-depth, and credible research, is that aid has gone to the wrong countries. Aid has been given to countries with lousy policies and, if countries have lousy policies, there is no reason to expect that aid or private capital or anything else is going to work.

We have given aid to the wrong countries because our goal has not been development, it has been to buy allies in the Cold War. It has been to provide political favors. It has been for numerous commercial purposes. But the aid that we are now flogging for not having achieved development was really never given to achieve development, and so in that sense it is an unfair knock.

The implication for the future, of course, is that you should only give aid to countries where you have some confidence that their policies are going to provide a fruitful environment where the aid can work. Lots of studies, including by Easterly, show that in those circumstances aid provides a substantial additional boost to economic growth, per capita income growth, and the like, though further improvements can forever be made.

On the World Bank point, it was a confused situation. Easterly was in the research department, which had published and was selling in its own book store at the World Bank a book by him that made all of these points and made all of these criticisms. So you might say the World Bank was being pretty open because one of their own people wrote a book that makes these same conclusions, which they were selling in their own book store and still do so today.

What Easterly did was write an op-ed in *The Financial Times* which put the point rather starkly, which had not gone through the clearance procedure within the World Bank. Like in most institutions, you are supposed to get clearance. They almost always say go ahead and do it. But he hadn't done that. Other people hadn't done it either so there was some debate about whether the criticism was on the substance or not. Our invitation to him had come before any of this brouhaha blew up, so he may have left anyway and I frankly think that is a less important part of the whole picture.

Representative Saxton. Wouldn't it be more productive for the management of the World Bank to be more concerned about the ineffectiveness of their programs than pursuing a point relative to someone who wrote an op-ed that they may have disagreed with?

Dr. Bergsten. Indeed.

Mr. Levinson. Mr. Chairman, might I take off from where Adam left off in describing how the system would work on grants, because I think it would be—

Representative Saxton. If you promise to do it in 2½ minutes or less.

Mr. Levinson. I will do it in 2½ minutes. Let's take his example whereby you are going to finance measles elimination by putting it out to bid, and that the contractor only gets paid after you show how many kids have been inoculated by an independent auditor, and he says the independent auditor is independent of the government and of the contractor. So who is the independent auditor? Is it going to be Arthur Andersen or Deloitte-Touche or one of the accounting firms? Are they going to go around in northeast Brazil and determine how many kids have been inoculated?

Under this scheme that they propose, the contractor goes out and borrows the money because he is not going to be paid until this independent auditor certifies that the thing has been done, so he is exposed in terms of having borrowed the money, and he is dependent upon the finding by this independent auditor.

What is the role of the government? Supposing you get the kids inoculated. Supposing you get the schools built or whatever project you have. Who assumes the responsibility for the recurring costs, having to be put it in place? The government? The government then turns around and says, wait a minute, we didn't have anything to do with this. This was put out to independent bids. If the cement is watered, we didn't do the inspection, someone – the independent auditors – did the inspection. We are not going to take the responsibility of maintaining potentially defective schools. So who takes the responsibility for the recurring costs of administration, salaries, maintenance in this scheme?

Everybody should be in favor of more grants, but the problem is that there is a basic contradiction because Adam also points out that the World Bank has a high degree of subsidy with these 40-year loans. They are very near grants, but at least it provides a self-renewing source of financing.

This business of loading the countries with debt – let me just conclude with this point that Fred made. You are extrapolating from a situation of the Cold War where we gave Mobutu $5 billion, which he stole. The Congo has nothing to show for it, or Zaire or whatever they are calling it these days. Other countries in Africa, the same thing. It is the Cold War debt that we are talking about writing off.

And to finally conclude within my 2½ minutes, part of the problem was that in the 1980s the World Bank and the development banks went over to what was called policy-based structural adjustment lending. Fancy term. The money went into the central bank, the front door, and the money went out the back door in return for policies with respect to promises. The country has debt and very little to show for it in terms of facilities which are going to add to the productivity of the country. So don't confuse that debt with debt incurred for productive purposes.

And as I say, I don't see how it functions in terms of a country is going to pay up on the basis of audits by people like Arthur Andersen. Who are they going to get to do this? I really doubt it.

Representative Saxton. Thank you.

Dr. Lerrick. Mr. Chairman, if I may just comment very quickly. The key to the grants proposal is that the ongoing maintenance, the operations expenses, all of these costs are assumed by the contractor. He is not being paid to build the school or build a hospital. He is being paid to teach children to read, to vaccinate children. Therefore, in the case of a poor country, the contractor is paid 90 percent by the World Bank, not by the government. The government is only paying 10 percent. As the Under Secretary of Treasury stated in his recent testimony, we are shifting the performance risk to the private sector. In other words, if the contractor comes and doesn't teach children to read, he doesn't get paid either by the Bank or the country.

And so we believe it is perfectly workable. And the country is going to choose the program. The Bank doesn't choose the program. It is the country that chooses the program chooses the contractor.

Representative Saxton. Mr. Crapo.

Senator Crapo. Thank you very much, Mr. Chairman. I have a lot of questions, but very little time, so I will only ask one of my questions, and that is relating to performance audits.

As members of the panel may know, a couple of years ago, well, about a year and a half ago, I introduced with Senator Enzi from Wyoming a concurrent resolution calling for basically an independent performance audit of the World Bank. One of the concerns that I have had, as I have tried to evaluate the issues surrounding the World Bank and the International Monetary Fund, is there seems to be a tremendous amount of difference of opinion based on alleged factual information about the effectiveness of the performance of either of the two institutions.

And that is not unusual in the political world we live in up here. We are debating ANWR over in the Senate today, or in the next little while, the exploration for oil in Alaska, and the data we are getting on what that is or is not going to do to the environment, or will or will not do in the terms of the production of oil is about as far apart as one could conceivably see it getting in terms of the information that we have upon which to make these policy decisions.

So I introduced the resolution to try to get some type of an independent performance evaluation of the World Bank.

Dr. Meltzer, maybe I could start with you and just ask you if you would comment on whether that is even possible. I mean, I know it is possible, but my point is, under what parameters – well, I guess the question is should we do it, and if so, under what parameters should it be done? How do we – do we define performance so it can then be audited, or do we let the auditors look at what is there and tell us what performance is? Or how do we accomplish the objective of getting a truly independent performance evaluation of the World Bank?

Dr. Meltzer. I share your view that an audit – the purpose of your bill, and I commend you for offering that piece of legislation. I think that is an important step forward.

As Dr. Lerrick pointed out in his testimony, we don't have very much information about what the World Bank accomplishes. What we have mostly is the observation that after having spent enormous amounts of money, if we look at the countries, we don't find any major progress either in the development of sanitary sewers or water in the villages or inoculations of children. There are just an enormous number of things where we have not systematic evidence, but we have very good casual evidence that the growth rates are negative and not very much is happening. So we know that nothing – that these programs are not working.

It is true that it will be difficult to audit every one of the programs. There will be some things where time will have to pass. It may take longer, there are lots of reasons, but there are going to be a very large subset where we should be able to get a measure of success or failure. And we certainly can do better than just deciding that the program is successful because when we gave the last amount of loan, the program was onstream.

Let me give you just one example, and then I will stop. We didn't learn this by visiting the country, we learned it at the World Bank. They gave us examples of schools that were built, but there were no books and no roads, so people didn't get to them. Now, when they made the last payment, the building was going up, so they count that as a success. I don't think any reasonable person would say that is what we mean by a success in development. We would count as a success in development that there are now 100 or 200 or 300 children who can now read, compute, add, subtract. That is what we would like to find out.

Those things should not be hard to do. Just as we can do audits on the performance of education here, which the Congress has now approved, we can do audits on the performance of education in Africa or in Latin America or in other places where the World Bank gives money.

One final example. When I visited people in Honduras, including a very imposing man named Cardinal Rodriguez, he told me that they came to Honduras, the World Bank came to Honduras. They were going to develop the wood industry. They spent a couple of million dollars. Most of the money went to consultants. There is no wood industry. That is what we want to get at. We ought to be able to find those things out. Like all things in life, it won't be perfect.

Senator Crapo. It looks like everybody on the panel wants to comment, so why don't we go right down the line.

Dr. Lerrick. Senator, I don't think it is that difficult. There are two bases for evaluation. First, every single loan or project that the World Bank group approves sets out its goals it said it was going to achieve. That certainly is one benchmark that you want to measure against. Were the goals achieved? Were they surpassed? Were they not achieved?

Second, if the goal says we are going to build five schools for $1 million in five different villages, just because they built the buildings on time and under budget, if there are no children in the schools, even though the Bank would qualify that as a success, I don't think any of us would. So it is not that difficult.

Now, to come up with the estimate of the cost of this audit, I asked two private sector firms that do this on a continuous basis, sometimes for the multilateral agencies, sometimes for private industry. The comment of one was quite interesting. His estimate of the cost was much lower than the $5 to $7 million. He said the reason is that, based on our experience, 30 to 40 percent of the projects we are going to find nothing, nothing whatsoever, and that will be a very quick audit. Only on 60 to 70 percent are we going to have to actually look at anything, because on 30 to 40 percent, when we arrive, there will be no building, there will be no road, there will be nothing there, and there will be no record of anything ever being there. I increased his estimate of the cost just in case he does find something.

But I think the way it can be structured is that you have contractors – inspectors – not necessarily accountants, but other firms that specialize in the applicable industry. NGOs could also perform audits that would go out and report back, and then you would publish the results project by project. You don't need to do every project. A representative third of the projects is more than enough. That is only 125 projects for three years of IDA lending. And then the auditors would report to the executive and legislative branches of the G-7 governments, and the GAO and its counterparts would review the methodologies, review how the audits were done, and report to their legislatures.

Senator Crapo. Thank you.

Mr. Levinson. Very briefly. The world they describe bears no resemblance to the world I knew as general counsel of the Inter-American Development Bank. In education, nobody builds schools without providing for teachers, without providing for teaching curricula. The argument usually is over the teaching standards, the content of the curriculum, whether or not there is sufficient teacher training, who is going to finance the recurring costs, et cetera. So this idea that the World Bank or the IDB or any of the development banks just go out and authorize money for things that aren't built is ridiculous. It doesn't happen, or if it does, it is an extraordinarily exceptional case. Even when I was at the IDB throughout the 1980s and the early 1990s, we were long past the idea that you build water without discussing tariff rates, water facilities without discussing tariff rates and agreeing on a tariff policy for the government so it is self-renewing. You don't build schools without determining how recurring costs are going to be financed, who is going to finance teachers.

So this world they are describing is just completely divorced from the reality that I knew as general counsel of the Inter-American Development Bank, which may prove your point that it is Kafka-like in terms of seeing the same reality. I didn't see that reality. I think it is ridiculous, frankly.

Dr. Lerrick. Mr. Crapo, may I interject? The example I gave of the schools was not my example, it was the example of World Bank President Wolfensohn in testimony when he described a project that they would rate satisfactory, and where the long-term benefits would be nonexistent because they built a series of schools where there were no roads, no teachers and no books.

Dr. Meltzer. In fact, Mr. Wolfensohn, in testifying before the Commission, said, you know, I don't know, when I came to the Bank, that is what I asked: Why do we evaluate the project only at the level when we give the money? Why don't we evaluate it after three to five years? I have been trying for years to try to get that changed.

Senator Crapo. Dr. Bergsten.

Dr. Bergsten. I am totally with you in spirit about the audits and the evaluations, but I think you have to make a critical distinction. One would be simply an audit of whether a school has been built or vaccines have been provided, and somebody could go and count buildings and I suppose count vaccinations given at hospitals and see if that has happened. So that should be done if it is not being done.

I thought you were calling for something more profound, and maybe the Chairman was, too, which was an audit of the results of the program in terms of whether it helped generate economic growth or improvement in life expectancy or various standards. If that is what you meant, then it is much, much more difficult for two reasons.

You have to ask what analysts call the counterfactual question: What would have happened in the absence of that particular aid or private investment or whatever program? And then you get into a realm of high uncertainty as to what the results were.

To be specific, there is the question of additionality. Suppose the World Bank waved a wand overnight and did everything that Mr. Lerrick just proposed. Let's assume that happened in Brazil and the Brazilian Government, instead of spending $10 billion that it would otherwise have spent on education, now lets the foreign funding, the 90 percent, go into place. The Brazilians take money that they would have otherwise spent on education and put it into buying more jet fighters for their military. So there is no net increase in the devotion of resources to education in the country.

This is the problem that has perplexed assistance programs from time immemorial, and how you come to grips with that requires you, the foreign lender, to then become more and more intrusive into the overall programs. You try to do some of the things that Mr. Levinson just indicated. You say, well, we are not just going to get water supply, we are going to figure out what your tariff is. And that in turn gets into your overall policy.

But then you can play off between sectors, so now you have to look at the overall budget. But that can be offset by monetary policy. So now you figure how to run the central bank. By that time you are running the country. And we all agreed at the start you can't do that.

I am not saying one shouldn't try this, I am only saying it is very, very difficult, because even if you did the Lerrick-Meltzer reforms overnight and put it in place perfectly – I have a lot of sympathy for some of the objectives of that – it would not get you to a very confident position in terms of the net bottom line outcome that you want, that I want, and the Chairman focused on, when he said economic growth has been zero as a result of development aid.

I am afraid that is not auditable in the sense we think of bringing one of the auditing firms into the act. That is a job of analysis, it is conjectural under the best of circumstances, and as one who made policy and has worked on these problems for more decades than I care to admit, it is a perpetual problem, and I am afraid there is no easy answer.

Dr. Lerrick. Senator Crapo, a quick comment.

Senator Crapo. I am going to have to leave quickly. You can have the last word.

Dr. Lerrick. First of all, Mr. Bergsten is absolutely right to raise the issue of what we call "fungibility." How are you sure that the money you gave for health care was not used for fighter jets?

First, that problem is greatly reduced since what we are focusing on here are the IDA countries, the very poorest countries that have very little access to foreign capital and where it is much easier to ensure additionality.

Aside from that, we are focusing on a much simpler analysis. We are not looking at the question of whether life expectancy has increased. That is certainly the long-term goal of aid. But what we are looking at is a very simple thing. It is an absolutely necessary condition to increase life expectancy that children be vaccinated. That in and of itself won't be sufficient, but what we are just trying to ensure is that on the immediate projects we are examining, we know there are immediate results.

What the long-term impact, which requires more analysis and assumptions as to how the country will grow or not grow or what policies it will follow, that requires a much more detailed analysis. But it is a necessary condition of aid to know that when a program is financed, the immediate results are achieved, and that is easily auditable for these types of.

Senator Crapo. Well, thank you. I am going to have to leave, and I would like to get into this in much more detail. I am sure that we will on other occasions. But I want to thank the Chairman for holding this hearing.

Representative Saxton. Let me turn to a very basic question on a very basic subject. Let's just assume for a minute that some or many of the reforms that you have talked about this morning, in terms of the subsidized interest rates and the necessity of planning, broad planning as you put it, including a major part of the planning effort by the recipient countries, that perhaps measurable programs be put into place and so on and so on.

As Members of Congress, those of us who are here this morning have always been concerned, particularly Mr. English and Senator Crapo, have always been concerned, because we are responsible for appropriating funds and ensuring that they are used effectively. However, if an agency that we fund is not transparent, it hampers our ability to exercise any kind of reasonable oversight. This has been a significant issue with respect to the archaic and confusing organization of the IMF financial statements, for example.

In fact, several years ago in questioning a member – actually it wasn't before this Committee, it was before the banking Committee, but I was invited to be a guest at the Banking Committee for this IMF hearing – one of the members of the IMF executive board it turned out actually was the U.S. Executive Director didn't understand the IMF's financial statements, and I felt bad for that person that day because it had to be fairly embarrassing.

In recent years now the IMF has made some improvements in transparency, providing for a good deal of information about its financial activities with borrowers on its official website. That is good. It has also attempted to clarify aspects of its financial operations. For example, it now publicly releases its operational budget. However, despite the improvement, the IMF reporting of its financial operation is still not transparent in many respects.

We feel we have pried their door open a little bit, but we have a long way to go. For example, standard IMF loans are not classified as loans. Further, the delay for transcripts of Executive Board meetings are not made public for 20 years, and I have a hard time understanding that. The operations of the SDR department are equally murky.

Would you agree that there is room for improvement in IMF financial transparency, and shouldn't the minutes of the executive board meetings be released before a period of two decades goes by?

Dr. Meltzer. Yes to both questions.

Let me just reinforce what you correctly pointed out. The transcripts of the executive board contain information about what they think is happening in the countries. That is valuable information to the markets. There is no reason that I can think of why that information has to be secret for 20 years.

I believe firmly that we need to insist upon two things. One is that they have a right to conduct their business by themselves in whatever way they find convenient to reach conclusions. Organizations need a certain amount of secrecy or lack of transparency in order to reach agreements. It makes it much harder to reach agreements if we have to do everything in the sunshine. But then the agreements should be there. We should know what it is that they have decided to do and hold them accountable for what they have agreed to do and see that it is enforced.

So I put great weight on the idea of allowing organizations, whether it is the U.S. Congress or the administration or the IMF, to be able to conduct their business in any way that they find useful so that they have the opportunity to reach an agreement. We should know what the agreements are, and we should be able to monitor them and see whether they accomplish what they set out to accomplish.

Dr. Lerrick. Mr. Chairman, I certainly agree with both of your statements. I will just raise one example: Stanley Fischer, the former first Deputy Managing Director of the IMF, said that he hoped that he would be able to finish his term at the IMF without ever having to understand how the SDR department works.

Certainly there is a great – I think a tremendous amount that needs to be done to render the Fund's financial operations transparent and even comprehensible to the outside world.

Representative Saxton. Well, you know, I think it was 1998, somewhere about that time, the IMF required additional money. And we appropriated $18 billion.

And I go back home and my constituents and the constituents of, I assume, all 435 of us in the House and all hundred in the Senate go back home and they say, how do they use that money? And when you stop and realize that the United States taxpayers provide somewhere around 25 percent of the usable resource that the IMF has at its disposal, it seems to me that we have a special responsibility to the people who provide those dollars in the form of tax revenues to be able to identify the programs that they are used for, and the effectiveness of these programs, and to be able to tell the taxpayers that their moneys are being well spent or maybe not well spent.

Certainly, as you correctly point out, the IMF has its own responsibility to make decisions in a way that it sees fit, but we need to see the results of those decisions and the deals that are put forward and be able to measure their effectiveness. And without transparency, without being able to see inside the organization to be able to evaluate those programs, we cannot meet our responsibility, and that has always bothered me.

Mr. Levinson.

Mr. Levinson. In one minute. What you say, I think, is unexceptionable up to a point. The argument is that if you make available the transcripts, after I think 20 years, you are absolutely right, is too long. That is foolish. But it inhibits candid discussion within the board.

So a sufficient time – it is not unreasonable, I think, for a sufficient time. Twenty years, I couldn't agree with you more, is far too long to hold the deliberations secret.

But I think in fairness, one has to say that the IMF has made a lot more information available. You get now the letters of intent of countries on the website, not while they are in negotiation, but—

Representative Saxton. If you could permit me to say, I agree. In fact, I said that here a few minutes ago, and I understand that.

Mr. Levinson. So all I am saying is that we shouldn't underestimate how far they have come under pressure from you and under pressure from the Congress. There is no doubt that the pressure from the Congress has been a big factor in terms of moving them to greater disclosure.

The only question I have is the discussions in the board can turn pretty candid and pretty contentious, and you don't want to inhibit that. But 20 years is ridiculous.

Representative Saxton. Actually, some of the things that have been done were a direct result of the reforms that we put in place with the $18 billion in 1998, and we are pleased that we have been partially successful, but, as Congress sets some kind of an example for openness, I hope that other institutions that do this important work will follow suit as well. In fact, given the opportunity, we are going to insist on it once again.

In the meantime, Dr. Meltzer has one final comment that he would like to make.

Dr. Meltzer. I just wanted to give you two brief pieces of evidence on the question of transparency. When the Commission was meeting, we asked for and got permission to read some of the Article 4 consultations, and I put one of the staff assigned to read the ones that were written before the Congress had required some release, and then to read the ones that were written after the Congress had required some release, and I audited what she did. To neither her naked eye nor mine could you see any difference in what people were saying or doing about the countries. That is one.

Second, for most of its history, the Federal Reserve records were private and not made available to anyone. They now are made available. I am reading most of them, and I have read them before and after they were permitted to be released. That is when people didn't believe they were talking for public consumption and after they knew that they were talking with a lag for public consumption. Again, I cannot detect any major difference in what they say or how they behaved in the two circumstances.

So I don't believe that people will be terribly hampered by the fact that they are doing this. Information of all kinds leaks out anyway, and we learn about these things formally or informally.

Representative Saxton. I would like to thank each of you for being here today to share your point of view with us. We appreciate it very much. I think this is an extremely important set of subjects that we talk about in this Committee at great length from time to time. However, it is important to have these public discussions so that members of the public and taxpayers and others can benefit from each of your backgrounds and knowledge about these issues.

Thank you very much for being here with us. We look forward to working with you in the future.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome the panel of witnesses before us today. The members of the panel were all associated with the Meltzer Commission, and I would like to thank you for your service, and assure you that the commission's influence on international economic policy has been positive and profound.

In recent years a number of issues have been identified related to proposals for reform of the International Monetary Fund (IMF). The evidence shows that the IMF was not financially transparent, it provided below-market subsidized interest rates, and promoted moral hazard.

In addition, IMF mission creep was reflected in its drift into lending for development and structural reform, often involving longer loan maturities or rollovers of existing loans. Moreover, there was a lack of IMF accounting controls and lending safeguards that could result in misuse of taxpayer money. A number of other findings involved the IMF's heavy reliance on the G10 for resources, and the lack of meaningful financial support for the IMF by most of its members.

In the last few years, the IMF has made some limited progress in the area of financial transparency. However, a former IMF research director has also recently noted "the need to improve the financial structure of the Fund in terms of transparency, efficiency and equity." The basic problem here is that the IMF is saddled with an archaic accounting framework rooted in an economic and institutional environment that no longer exists. For example, the official IMF financial statements still present IMF loans as "currency purchases," instead of loans. Furthermore, the workings of the SDR department remain as murky as ever. In addition, the minutes of Executive Board meetings are still classified for 20 years.

I would also like to note the President's Council of Economic Advisers' (CEA) statements endorsing reform of the International Monetary Fund (IMF). According to the recent CEA report, IMF liquidity loan "programs would appropriately involve short-term lending at penalty interest rates, to encourage and facilitate the borrower's quick return to private capital markets." This is very consistent with the findings of the Meltzer Commission as well as the Congressional mandates for IMF reform that are currently in law.

The Administration's support for substantial grant financing of some World Bank activities is also very significant. This reform would offer the best approach to improving living standards and reducing poverty in the world's poorest nations. The traditional World Bank/IMF approach of saddling poor countries with loans they often cannot repay has failed. Moreover, the high failure rate of World Bank projects reflects a waste of resources that could have been better used to alleviate poverty.

Unfortunately, the defenders of the World Bank status quo are resisting the Administration's grants proposal. Ever since the idea of grants was first proposed, the World Bank's own evaluations of its performance have shown sudden improvement. However, we all realize that without truly independent review, performance can be misrepresented. An independent review of World Bank performance is urgently needed.

The Bush Administration has shown that it is serious about needed reforms of the IMF and World Bank. The work of the Meltzer Commission has been essential to this improvement in international economic policy. The recommendations of the Commission have led to U.S. government proposals to limit moral hazard, curb international financial instability, and reduce the waste of resources to the benefit of many millions of people around the world.

PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Thank you, Chairman Saxton, for calling this hearing on reform of the IMF and World Bank. I'd also like to thank our witnesses for taking the time to testify before us today. All four of you worked on the Congressional Commission on International Financial Institutions, making you uniquely well qualified to discuss this topic. Revisiting the issue for today's hearing with you is especially valuable given the international events that have occurred since your reports were published in 2000.

The IMF and World Bank were created as a response to World War II and the recognition that supporting global economic stability and prosperity would be an effective means of ensuring global peace. Today the economies of the world are even more interconnected. In the wake of September 11th and our ongoing war on terrorism, we are reminded that these institutions continue to serve a crucial role in our national, as well as economic, security.

Unfortunately, the recent economic crisis in Argentina suggests that the effectiveness of these organizations is sometimes insufficient. Economists and policymakers continue to debate over whether that is due to fundamental problems in the missions of these organizations, misguided policies, or simply mismanagement of well-intended policies.

Today's hearing should shed some light on what the Argentine experience teaches us about how well the IMF and World Bank are serving their missions, and what can be done to make these institutions stronger players in our efforts to support global economic and national security.

The International Monetary Fund Two Years After the IFIAC (Meltzer) Commission

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Testimony prepared for the Joint Economic Committee hearing on:

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The International Monetary Fund Two Years After the IFIAC (Meltzer) Commission

by Allan H. Meltzer

Mr. Chairman you, your colleagues and staff have played a major role in reforming and improving the operations of the International Monetary Fund (IMF) and the development banks. By insisting on greater transparency, increased accountability and improved performance, you have rendered a great service to the American public and the people in the developing countries. Your efforts have not only saved taxpayers money, they have raised standards of accountability for performance. I am pleased to have been part of that effort, an effort that is continuing and has the support of the Bush administration, Treasury Secretary O'Neill and his principal staff.

Today, we recognize the second anniversary of the commission report. My colleague Adam Lerrick and I have divided the review of the past two years and prospects for the future into two parts. I will discuss the IMF, and he will discuss the development banks, particularly the World Bank.

What Was and Was Not Done

The Commission proposed four kinds of changes at the IMF. First, it proposed improved transparency and information to permit outside observers to better understand what the IMF had done, what it recommended and what resources it had available. Before this Committee took an interest, even a trained accountant would have difficulty interpreting the IMF's financial statements. The Commission developed a balance sheet that the IMF adopted. Its accounting statements became less opaque. Reports of IMF surveillance of a majority of member countries, so called Article IV consultations, are now routinely posted on the IMF's website along with a lesser, but still substantial, number of staff reports. Improved quality and increased quantity of information helps markets to operate more efficiently and reduces risk. However, the IMF has not restructured accounting in the SDR department, and many countries have not improved the quality of their data. The IMF should do much more to get countries to improve data quality and to release it.

Second, the Commission found considerable overlap between the programs of the Fund and the development banks. It criticized the overlap and the large number of conditions that the IMF negotiated with borrowers, particularly borrowers in crisis. The IMF reduced the number of programs and the number of conditions attached to loans. It now limits conditions to matters directly related to the country's problem.

The Meltzer Commission proposed that troubled crisis countries should not look to the IMF to provide a reform program. Reform has a much better chance if the country adopts and implements its own choices of policy reforms. Management of the economy should remain in local hands. The IMF should confine its role to seeing that the promises are kept and that its loans are used effectively, not squandered on wasteful expenditures, paid to creditors, or used to support the exchange rate.

The IMF has now moved in this direction. A senior IMF official recently said:

> "The main aim is to have a minimum amount of conditionality that enables countries to meet these goals. ...
>
> How can these goals be achieved? ... The IMF needs to be more flexible, not dictating to a country what policies are needed. The country should be allowed to present a program to the IMF. There has to be broad participation in the discussion of policies in the country. And the IMF needs to be selective, patiently waiting for the country to be ready. Already, there are promising signs. The streamlining process is under way, and collaboration with the Bank has been strengthened."[1]

The IMF did not eliminate all duplication. The poverty reduction and growth fund, PRGF, continues. IMF management is sensitive to criticisms about the effect of disinflations on the poorest citizens of countries in adjustment. It does not want to give up poverty relief so that it can temper its macro policies with policies to help the poor during the transition or recession. I believe it does not have enough confidence in the development banks to relinquish PRGF programs to them, where they belong. Increased effectiveness of the development banks would help to make the case for closing the IMF's PRGF program and restricting the IMF to its principal functions: providing information, creating incentives that reduce the number, frequency, depth and virulence of financial crises, assisting governments to resolve crises, and preventing the spread of crises that occur.

[1] "IMF Conditionality: How Much is Enough? IMF Survey, 31 (January 14, 2002), p. 14.

Third, the Commission urged the IMF to phase in over five years an incentive system that induced countries to adopt prudent policies that reduced the risk of financial crises. We proposed a small list of observable, prudent policies (pre-conditions) that, if adopted and maintained, would obligate the IMF to assist the country when it faced a financial crisis.

The great advantage for the country of adopting pre-conditions is that, the IMF's commitment to assist in a crisis, and its monitoring, increase lenders' confidence that the country maintains prudent policies. Pre-conditions in place would act like a good conduct badge. The country would get more capital from the market at lower cost. This would foster development and reduce debt burdens.

IMF senior officials accept this idea. They have proposed a contingent credit line (CCL) to implement the proposal. Unfortunately, no country has agreed to join. I believe there are two principal reasons. First, the IMF bureaucracy will not offer automatic assistance to countries that join. Second, until very recently, all countries received assistance, so there was not much reason for lenders to favor countries with more prudent policies over countries that were riskier. The market does not lend to the poorest countries, with little prospect of repaying loans. But, as Argentina, Ecuador, Russia, and Indonesia have shown, the market has provided large loans to risky borrowers. Now that the IMF has not bailed out creditors of Argentina and others, I expect more discrimination by private lenders and more caution. Lenders who made "moral hazard" loans, expecting to be rescued by the IMF and the G-7, will improve their monitoring and demand better policies by borrowing governments.

If this proves to be correct, borrowers' incentives for prudent policies will be strengthened. More countries may willingly adopt more prudent policies and join an improved CCL. A critical condition is that incentives work both ways. Countries with imprudent policies should not get IMF assistance in a crisis once a five-year phase-in is completed.

Fourth, the Commission urged the IMF to improve crisis management by making different responses to prudent and imprudent lenders. The majority proposed that the IMF restrict its aid to two kinds of countries: those with prudent policies and those countries threatened by the policies and practices of imprudent neighbors and trading partners.

As Argentina moved toward crisis, the IMF approved a stand-by loan to Brazil, a country currently with responsible monetary and fiscal policies, that seemed to be injured by Argentina's decline. After mistakes in December 2000 and August 2001, the IMF stopped lending to

Argentina. Instead of offering Argentina a large loan with many conditions based on empty promises, the new IMF insisted on a coherent, consistent plan developed, adopted and implemented by the Argentine government. It has refused to finance Argentina's budget deficit or the bailout of international and domestic creditors. It has not provided additional billions to support an overvalued exchange rate or to finance capital flight.

If the IMF withstands the pressure to throw in more money, moral hazard will be reduced. Lenders will expect to bear losses, if they make risky loans. Countries that want to borrow to grow will have much greater incentive to adopt prudent policies, to rely more on foreign direct investment and less on short-term borrowing. They will invite foreign banks into their country and strengthen domestic financial institutions. The risk of crises will decline.

What Remains to be Done?

In the last decade, the global economy experienced severe crises in 1994-95, 1997-98, and 2001. This alone tells us that the system was not working well. Tens of billions in emergency loans attempted to stem the crises. In many of the crisis countries, the banking and financial systems collapsed, the exchange rate went into free fall, unemployment rose as output fell.

Argentina, the latest crisis country, has one of the most severe crises. Unemployment rates will reach 30% of the labor force or more. That is worse than the worst year of the Great Depression in the United States. Mistaken policies have paralyzed economic transactions and bankrupted financial institutions.

The main problem with bailouts is that they cover over today's problem but encourage a larger problem somewhere else. Twenty years of bailouts and conditional lending have failed. The crises have become larger. The promises to meet conditions are kept infrequently.

This should not come as a surprise. The system of conditional bailouts and conditional lending relied on command and control. Countries had good reason to promise reforms, but few incentives to carry them through once recovery was underway. Lenders came to expect that the IMF and the other international financial institutions would not just bail them out. They would reward them with higher interest rates and fees for renegotiating and extending the maturity of their debt.

We have started to replace command and control with incentives for lenders and borrowers. If we continue on this path, with patience and conviction in the face of pressures, we will achieve a better system. Lenders must have incentives to use the improved information that the IMF now provides to study the risks they have taken or are about to take. Borrowers must have heightened incentives to adopt and maintain prudent policies. Rapid support for countries that meet pre-conditions provides the incentives.

Some critics of the new policies assert that markets have failed, that openness, privatization and market incentives have been tried and have failed. This is a peculiar claim. It ignores such successes as Chile, China, Korea, Mexico, Poland, Taiwan and many others. It fails to mention that Argentina's problems are not novel. Their economy is barely open to trade. Their markets continue to suffer from the rigidities adopted by Juan Peron's governments. There can be little budget discipline until there is a financial responsibility law that restricts provincial spending. Argentina's exchange rate was overvalued, its budget in deficit. The current government has no plan as yet to restore economic activity without inflation.

Argentina journalists ask me repeatedly, what does Argentina have to do to get IMF assistance. President Bush, Secretary O'Neill, Mr. Koehler, Managing Director of the IMF, and many others have answered that question repeatedly. Argentina must come forward with a consistent, coherent plan that restores growth without inflation, increases productivity, and settles its defaulted debt.

Policy toward Argentina is an abrupt change from past policies. Having embarked on a new and better course, the IMF and the G-7 must not go back to the old ways.

We are in the early phase of a transition to a safer, sounder international financial system based on proposals for reform that this Committee and our Commission brought to public attention. Lenders now have reason to recognize the risks in lending to developing countries and therefore to be more prudent. Borrowers now have reason to recognize that excessive borrowing or imprudent behavior is costly to their country and, because they may be dismissed from office suddenly, to them personally. Recognition of the true risks and costs on both sides will do much more than so-called Basle standards to reduce moral hazard, promote more orderly development lending, save the taxpayers money, and reduce the frequency of crises and tragedies in developing countries.

With your support and the continued support of the new administrations at the IMF and the U.S. Treasury, we will achieve that safer, sounder system.

World Bank Reform

Statement Presented to the Joint Economic Committee

of the Congress of the United States

by

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It is a privilege to address the Joint Economic Committee. First, Mr. Chairman, I would like to thank you and Majority Leader Armey for the strong support you provided when violent attack came from almost all sides.

Two years ago, Minority Leader Gephardt greeted the publication of the Meltzer Commission report with the following appraisal: "...an extreme neo-isolationist attitude...(that) will undermine development efforts in the world's poorest countries ...(and) the stability of the world financial system." Then-Secretary of the Treasury Summers made a rare personal appearance on the pages of the Financial Times to claim that one of its key proposals, a shift from loans to grants, would "require an unworkable system for delivering assistance". World Bank President Wolfensohn deemed grants "unrealistic". One year ago, my fellow witness Mr. Bergsten stated that the Joint Economic Committee hearing on the first anniversary of the report's publication was appropriate as a burial service because none of the Commission's recommendations had been or would be adopted.

What a difference a year makes. Once branded "ivory tower" by some and "radical" by many, the report was recently termed the "blueprint" for international reform efforts by The Economist magazine. Today, we have a new Administration that supports international reform and a new International Monetary Fund with a disciplined approach to assistance. Many of the major recommendations of the Commission are on the way to becoming global public policy.

My remarks will focus on developments at the World Bank, particularly those current issues that would benefit from the intervention of the Congress. A critical look at the Bank is doubly important as the Bank assumes the leadership role in the United Nations campaign to double development aid flows to more than $100 billion each year.

When leaders from both the industrialized and developing world meet in Monterrey, Mexico on March 18 at the United Nations Conference on Financing for Development, two topics that originated in the Meltzer report will be high on the agenda. First, a change from loans to grants for the delivery of aid to the poorest countries. Second, a move to rigorous measures to increase the effectiveness of development assistance. President Bush launched these proposals at the Group of Seven meeting in Genoa last summer and the Secretary of the Treasury continues to speak out forcefully in support of the Administration's commitment to these policies.

Grants were proposed by the Commission to address the shortcomings endemic to the tradition of open-handed lending by the multilateral institutions. The poorest countries had accumulated debt they were clearly unable to repay. Funds had been diverted to unproductive ends. Donor contributions ended in write-offs instead of real improvements in the standard of living of the impoverished.

This grant format is new because it is performance-based. Counter to the trend of lending blanket sums for indeterminate government plans, grants will be project-linked and executed under competitive bid by private sector contractors and non-governmental organizations. For the easily quantified basic needs that improve the quality of life and are the preconditions for economic growth---health, primary education, water and sanitation--the grant system would count by independent audit and pay for output: numbers of babies vaccinated, children that can read and water and sewer services delivered to villages. No results: no funds expended. No funds diverted to off-shore bank accounts, vanity projects or private jets.

Opposition to the use of grants has been orchestrated by the World Bank around the faulty argument that grants will deplete its resources, together with its ability to help the poor, unless they are partnered with an immense infusion of new funding--$800 million more each year from the U.S. alone. It is worth taking the time to explode this false argument.

It would seem logical that if money is given away, instead of being lent, the stockpile of funds will eventually vanish. Not so. Grants will not cost more than loans. They deliver the same amount of aid without diminishing the funding pool and without asking for more taxpayer monies from the industrialized world.

The funding requirement is the same when the level of aid is the same. The arithmetic is straightforward.

The International Development Association (IDA), the arm of the Bank dedicated to 72 of the globe's neediest nations, extends 40-year loans at virtually zero interest. The interest free use of the money translates into a gift component equal to $73 out of every $100 loan. Although, ultimately $100 will be repaid, the real cost to the recipient is $27.

This is identical to an outright grant that pays $73 out of $100 of program outlays with the remaining $27 paid by the recipient. In both cases, the cost to the country is $27. Again, if the level of assistance is the same, grants cannot cost more than loans.

The grant format can produce the same reflows into the IDA pool of financial resources as traditional loans at the same level of aid. For each $100 of donor funds, $73 would be disbursed as grants and $27 invested in the capital markets. The proceeds of the investment will match the $100 of loan reflows over the life of a traditional 40-year IDA loan.

The effectiveness of World Bank performance has been another highly contested but not unrelated debate. Although the Bank claims 75-80% success rates, when the Meltzer Commission reviewed the Bank's own data, it found that more than half of World Bank programs overall and more than two thirds of projects in the poorest countries failed to achieve both satisfactory and sustainable results. Debate over the numbers is irrelevant because the Bank's auditors are captive, because the judgments are made too early--at the time of final loan disbursement but long before an operating history is established--and because sustainability, the sine qua non of development, is given little consideration in the evaluation.

After the publication of the Meltzer Commission report in 1999, World Bank sustainability ratings that had stagnated at 50% for years jumped to 72% in 2000. Was there such swift improvement or was the bar simply lowered?

Thinking has continued long after the official life of the Meltzer Commission. After 50 years and $500 billion of aid, we have no evaluation of World Bank performance except the one it chooses to promote. If the wrong people are applying the wrong criteria at the wrong time, how credible are the conclusions?

Why not establish a bona fide external audit by private sector firms, on site, to determine the lasting contribution of IDA projects after a credible operating history and to provide a continuing benchmark for Bank efforts in the poorest countries.

The World Bank is now seeking $13 billion in IDA replenishment funding. The U.S. share alone is $2.5-2.8 billion. $5-7 million dollars, or just ¼% of this commitment, would cover the cost of an audit. The condition of an external performance review of IDA programs, together with provision for its financing, should be written into the upcoming appropriation and into all funding going forward.[1]

[1] Senator Crapo of Idaho and Senator Enzi of Wyoming focused on the issue of an external performance audit of World Bank programs in the 106th Congress. See S. Con. Res. 136 in the 2nd session.

REFORM OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

PROFESSOR JEROME I. LEVINSON

Before

The JOINT ECONOMIC COMMITTEE

March 6, 2002

In the year that has passed since this Committee met to discuss this subject matter, we have descended from the realm of theory to the flesh and blood world of political economy in which theory has real consequences. The event that illustrates this truism is Argentina.

Because the crisis was so long in developing, the financial markets have had time to absorb the Argentine financial default without significant consequences for other borrowing countries. In other words, financial contagion has been contained. We can then consider how to think about the lessons of Argentina in other than crisis conditions for the international financial system.

And yet Argentina remains in my opinion a watershed event. It conclusively demonstrates (i) the hollowness of the Meltzer Majority report of the Congressional Commission on International Financial Institutions (the Commission) recommendations for reform of the IMF; (ii) the limitations of the IMF/World bank neo-classical economic paradigm, what Joe Stiglitz, the former Chief Economist of the World Bank, and a recent Nobel prize-winner in economics, has referred to as market-fundamentalism, slightly modified in recent years as the Washington Consensus Lite, that has governed development thinking for the past fifteen years; (iii) and the excessively economic mind-set of both the Secretary and Under-Secretary of the Treasury, Messrs Paul O'Neill and John Taylor.

The Treasury proposal for additional grant funding for the IDA, the World Bank soft loan affiliate for dealing with the poorest of poor countries, while superficially appealing, as presently formulated by the Treasury, is ill conceived, impractical and probably harmful to any sustainable financing for development in the poorest countries. I would be glad to respond in more detail to questions on this subject, but in this testimony I will concentrate on the Argentine case as illustrative of the above three theses.

THE MELTZER MAJORITY RECOMMENDATIONS FOR THE IMF

The heart of the original Meltzer Majority proposal is to divest the IMF of discretionary authority with respect to conditions that attach to member country access to IMF financing. Such financing, after a suitable transition period, is made conditional on pre-qualification of countries:

only countries with financial banking systems that have previously determined to be "sound" are eligible to draw upon IMF funding; key to assessing the soundness of the system is the openness to foreign investment, which, according to the Majority, is a guarantee against unsound crony capitalism in which financial decisions as to the allocation of credit are made on the basis of criteria other than arms length credit analysis. According to the Meltzer Majority, it was that crony capitalism which was the principal cause of the East Asian financial crisis of 1997-8.

Fred Bergsten, who came late to the Commission's deliberations, immediately identified the flaw in the proposal: a country with a sound banking system but unsound macro-economic policies would automatically be eligible for IMF funding but without any conditions that addressed the underlying policies that necessitated recourse to the IMF. In recognition of the validity of the Bergsten critique, the final report of the Majority contained a few sentences referring to the need for a sound macro-economic framework as an additional pre-condition for IMF financing.

Argentina takes the issue out of the realm of theory and into the real world of policy-making in imperfect circumstances. Argentina not only opened its banking system to foreign capital; it permitted the complete sale of the previously Argentine owned banks to primarily American and Spanish financial institutions. There are no banks of any stature any longer majority owned by Argentine nationals.

Nor are there any local cronies of any consequence to whom the banks can lend. Argentina has sold the previously state owned water, telecommunications and utilities to foreign capital, primarily state owned Spanish and French companies, a process less privatization than de-Argentization; the previously state owned petroleum company, YPFB, has been auctioned off to a combination of domestic private and foreign capital; similarly, Argentina has divested to private capital the previously state owned railroad system. The signature industry of Argentina–the meat- packing companies–have been sold to the major international groups in the industry: today there is no Argentine national owned meat-packing company of any size or importance. In light of this record, the statement by Secretary O'Neil that Argentina has not carried out significant economic reforms is simply incredible.

Argentina, which for most of the decade of the 1990's, had been acclaimed as a star of the international financial system, the country in Latin America, even more than Chile, which had most enthusiastically embraced the neo-classical economic paradigm promoted by the IMF/World bank and U.S. Treasury–privatization, openness to foreign direct investment, reduction of the role of the state in the economy--finds itself in intense negotiations with the IMF in the midst of a profound economic depression.

A country cannot be frozen in time. Conditions change. Policy may not adapt. A crisis ensues, requiring the country to recur to the IMF for assistance, precisely the circumstances envisioned for IMF intervention. The need for judgement as to the appropriate policies to address the situation cannot be evaded. Argentina puts paid to the Meltzer Majority theory that recourse to the IMF can be automatic in accord with pre-established criteria, IMF judgements and conditions no longer relevant. The issue remains: what are the criteria for IMF assistance?

THE IMF AND ARGENTINA: POLITICAL ECONOMY VERSUS ECONOMIC TECHNOCRACY

Because the Meltzer Majority went off on the tangent of pre-qualification as a condition for automatic access to IMF resources, the Commission lost a great opportunity to illuminate and provide guidance for the Congress on this central issue of IMF operations: conditionality. For, if there was one issue on which all members of the Commission concurred, it was that IMF conditionality had become too intrusive and had expanded into areas in which the IMF staff had little or no comparative advantage.

That view was not limited to the Commission. A Council on Foreign Relations Task Force on which Commissioner Bergsten served came to the same conclusion. And the new Managing Director of the IMF, Mr Horst Kohler, gave every indication that he recognized the validity of this concern and wanted to return the IMF to a more traditional strategy of dealing with macroeconomic policies which is its area of expertise.

At the same time, there were profound differences within the Commission over the degree, if any, to which additional issues such as core worker rights, and, more generally, human rights, as well as income inequality, should be an integral part of the policy framework which is the necessary pre-condition for financial assistance from the Bretton Woods Institutions. The degree to which this is feasible or desirable is, in my view, the central issue in any discussion of the future of these institutions, and U.S. policy with respect to them. Despite extensive, and I would say illuminating in depth testimony on such issues as core worker rights and the importance or lack thereof of income inequality, you will find no discussion at all in the Majority report of these issues.

Again, Argentina brings the discussion down from the level of the merely theoretical to the often excruciatingly difficult decisions involved in policy-making in the real world of political economy. The history of the currency board arrangement in Argentina in which the peso was linked to the dollar in a one to one relationship has been too much commented upon to require any extensive recapitulation here. Suffice it to note (i) the arrangement was not imposed upon Argentina but decided upon by the government of Carlos Saul Menem and his Minister of Economy, Domingo Cavallo in the early 1990's for the purpose of bringing a raging hyperinflation to a halt; (ii) it largely achieved the objective and therefore initially had broad support in Argentine society; (iii) it also divested policymakers of any discretionary decision making authority with respect to the level of economic activity in the country which was determined by the amount of dollars available to the government from export earnings and international borrowing to back each peso in circulation; (iv) the currency board arrangement therefore was market-fundamentalism carried to its logical conclusion: the level of economic activity was vested in the financial markets, creating a powerful incentive for international borrowing; (vi) with the peso linked to the dollar in such a direct way, a strong dollar constituted a disincentive for Argentine exports which became uncompetitive, especially after the Brazilian devaluation of the real, the major trading partner for Argentina; (vii) the result was that the debt to export ratio became increasingly unsustainable and the international financial markets closed to Argentina.

Whatever the original purpose served of the convertibility plan, as it is known in Argentina, and in Argentina it did initially have a purpose, once in, there is no good way out. Not the Argentines, nor the IMF, nor anyone else for that matter, had an exit strategy. Indeed, the discussions in late 2001 between Minister Cavallo, who had been recalled as Economy Minister by President Fernando De la Rua , the successor government to Menem, and the IMF assumed a surrealistic character: the IMF staff realized that the convertibility plan was no longer feasible, but Cavallo, the author of the plan, denied that there was any problem with the arrangement, only market ignorance which could be overcome by IMF financing, which was not forthcoming.

Determined to maintain the convertibility plan at any cost, the De la Rua government proposed still further austerity measures in face of a four year recession/depression and 22 percent unemployment. Argentine society rose up in revolt and drove the De la Rua Government from office. Most comment in the U.S. has focused on the convertibility plan as the main culprit in the Argentine drama. The Washington Post, for example, held that the Argentine government stuck with the convertibility plan too long but that there was nothing inherently wrong with the market liberalization strategy.

I disagree. The market liberalization strategy which Argentine followed since the early 1990's, strongly supported by the IMF/World Bank and U.S. Treasury was fatally flawed in two other respects: the basic theory of the IMF/World bank neo-classical economic strategy is that as the public sector is diminished in economic importance, a dynamic, export oriented industrial sector provides the motor for growth and employment but this did not happen in Argentina . Without a strong productive public sector to complement it, the private sector could not perform the role envisioned for it. Even in the years of relatively high economic growth in the mid-90s, unemployment never fell below 13-14 percent. Rather, throughout the decade of the 90's, the public sector was denigrated by both the Argentine governing authorities and the Bretton Woods institutions.

Since, under the convertibility plan, relative international prices could not be adjusted through the exchange rate, pressure mounted on the part of the IMF/World Bank for a more direct attack upon the cost structure of Argentine industry, particularly labor costs. The Menem government embraced the strategy. Strongly supported, indeed egged on by the Bretton Woods institutions, the Menem government tried to shift the balance of power between labor and capital in collective bargaining arrangements decisively in favor of capital.

The social gains for Argentine workers of the past fifty years were at risk. The basic compact in Argentine society through which the formerly despised working class, the descamisados, the shirtless ones, were integrated into Argentine society, in the age of globalization, was now declared too expensive. The unions reacted with fury, leading to general strikes of varying degrees of effectiveness and an increasingly embittered and disaffected working class.

Not strong enough by themselves to bring down the government, in December 2002 they were joined by an important part of an increasingly impoverished middle class, seeing no way out except more austerity, unemployment and loss of status. In both that middle and working class the economic model of the past decade was perceived to have disproportionately benefitted a small elite linked to international capital and business, widening income inequalities in a country which had not previously been notable for the exaggerated income disparities that permeate other societies in Latin America.

It is not too much to say then, that what is at stake in Argentina today are not merely economic policy choices, important as they are, but confidence that such choices can be made within the framework of representative political institutions. That is the situation which the government of Eduardo Duhalde faced when it came to power after the December 2001 political upheaval that dislodged from power both the De la Rua government and its immediate successor.

The best way, in my opinion, to understand the Duhalde government is to see it as the contemporary counterpart of FDR in 1933. FDR campaigned in 1932 on a platform of a balanced budget, but changed direction when convinced that such a policy followed by his predecessor, Herbert Hoover, would only deepen the depression and unemployment; he embraced the Keynesian prescription of using government spending to prime the pump and restart economic growth. This policy reversal was only one of a series of often bewildering stops and starts in economic policy-making as the Roosevelt Administration by trial and error experiments, determined what would work and what would not, what the political system could bear and what were the limits of social tolerance.

It had the great advantage, however, of not having an IMF and O'Neil Treasury looking over its shoulder. If asked to produce a coherent policy from its inception, it would have dismally failed; all of the creative energy which gave us the New Deal would have been strangled at birth. Indeed, it would have been told that social security was unacceptable and only private investment accounts could gain IMF/World Bank approval. The Wagner Act would probably have been rejected as an undesirable intervention in the labor market where the preferred objective of labor market policy should be not to diminish the disparity of bargaining power between individual workers and firms, but to maximize that disparity in favor of capital.

Duhalde faced with a similar crisis of confidence in the governance system itself has responded, like Roosevelt, with a trial and error approach. Confronted with the immediate issue of how to exit from the convertibility plan, the Dhualde government initially proposed a dual exchange rate plan, but then withdrew from it when faced with international and domestic criticism of its feasibility.

The Duhalde government has tried to allocate the burden of adjustment in Argentine society more equitably, placing the highest costs upon the foreign owned banks and utilities, who bought them on highly favorable terms: captive, monopoly market; repatriation of profits without limits; fixing tariffs in dollars, with an index linked to the U.S. inflation rate and virtually non-existent state regulation or controls. Consequently, the majority of concession holders in recent years obtained high profits, in comparison with other Argentine companies and similar industries in other parts of the world. Duhalde is obviously gambling that the French and Spanish investors have too much at stake not only in Argentina, but also more generally in Latin America to walk away from their Argentine investments.

In political terms, although not popularly elected but selected by the Congress in accordance with the law and constitution, he has crafted a broad based government; supported by former President Raul Alfonsin, who was the first elected post-military President, and represents the more nationalist small and medium industry and public sector employees, he has recruited an important part of the Radical Civic Union Party to complement his own Justicialista (Peronista) party; additionally, he has incorporated members of the Frepaso center-left coalition that tried to offer an alternative to the two great traditional powers, the Radicals and Peronistas.

Duhalde, if not enthusiastically supported by the majority of the unions affiliated with the CGT, the Argentine confederation of Labor, can count on their tolerance because they know that the alternative of deeper market reforms will devastate them still further than has already occurred; similarly, the small and medium entrepreneurs know, like the unions, that the Duhalde/Alfonsin combination is their only salvation.

And Duhalde has departed from the top down Argentine style of governing: in a weekly radio address, in which he also answers call-in questions, he has not minimized the hard choices for Argentina. Not quite the fire-side chats of FDR, in Argentine terms they are a major innovation in participatory democracy.

The respected senior Justicialista politician, Antonio Cafiero, observed that the Duhalde administration was not only burying the convertibility plan, but the economic model of the past decade. That statement set off alarm bells in Washington and the Duhalde team has backed off from Cafiero's defiant observation, but it represents an accurate expression of the anger at and desire for an alternative to the neo-classical economic model attempted to be implemented in the past decade

The Duhalde government has finally forged an agreement with the provinces on revenue sharing and provincial expenditures, but has not yet obtained Congressional approval of a budget. We can expect hard bargaining in the Congress and probably considerable back and forth in economic policy making direction. What Duhalde is trying to do is create an economic policy which responds to the demand of a broad swath of Argentine society for a policy that more explicitly takes into account the income distribution effect of policy, minimizes rather than exaggerates income disparities, and preserves as much as possible of the social gains of working class Argentina so as to avoid creating a permanently disaffected urban working class.

Understood in these terms what he seeks to accomplish is not dissimilar to the task that confronted FDR: to assure Argentine society that within the framework of representative political democracy and a market economy there is room for a policy alternative that explicitly seeks a more just society and not just economic efficiency at the sacrifice of equity.

What then has been the response of the IMF and the U.S. Treasury? They demand of the Duhalde government that it adopt Herbert Hoover economics: in the midst of a devastating economic depression with unemployment approaching 25 percent, they seek budget cuts, labor market flexibility reforms to weaken still further urban trade union bargaining power, and a "coherent" economic plan, which apparently means assurances that it will not depart substantially from the prior neo-classical economic model followed by the predecessor Menem and De la Rua governments.

They are impatient with the messy and time consuming give and take of negotiation between the center and the provinces over revenue distribution and expenditures, that is to say with representative democracy in a context of agonizing choices. They are indifferent to the income distribution effect of the policies they advocate. There is no indication that they understand that the collective bargaining regime in a country grows out of the history of labor relations, often beset, as in Argentina, by past sharp class conflict.

The Deputy Managing Director of the IMF, Anne O. Krueger, in the midst of an economic depression, unemployment in the 25 percent range and unused spare capacity in the industrial sector, warns of hyperinflation. Surely, if the Duhalde government were to monetize the deficit without adding to capacity, as demand increases there would be a risk of inflation further down the line in perhaps a year. But hyperinflation in the midst of economic depression, massive unemployment and a consumer goods industrial plant with substantial underutilized capacity?

In a country with a history of inflation like that of Argentina, the caution of the Duhalde government is understandable, but I confess to being baffled as to why the Argentines have not requested and obtained a $1 billion credit from the IDB for small and medium enterprises. Unlike Salvador Allende in Chile in 1972/3 and Alan Garcia in Peru in the 1980's, the Duhalde government has the confidence of that sector; he can demand of them that as profits increase with employment and demand restored, they invest in additional capacity rather than send the money out of the country as occurred in similar circumstances with Allende and Garcia. But what I think is less important than that the Duhalde government formulate a policy in which they–and Argentine society-can have confidence and which reflects the Argentine social and political reality.

For years, the IMF staff from the top on down has been trying to convince critics that it does not have a cookie-cutter approach in which one size fits all. Yet, we are now told that it is bringing in a new lead negotiator for the Argentine negotiations from the Asia region, an individual--and team-- with no background in the region, unable to speak the language, ignorant of the history, culture, and all of the complex bargains, formal and informal, that make up a country's social compact.

Apparently the IMF feels the need to be tough because of past failures of Argentine governments to fulfill commitments, but those failures are also a reflection of an unreality among the IMF staff as to what the political and social traffic would bear in Argentina. They were so infatuated with the Menem government commitment to the neo-classical model they were promoting they lost sight of the fact that the Menem government had lost its political and social base, a situation replicated with the De la Rua government.

Increasingly, the IMF is coming to resemble the mad-hatter's tea party in Lewis Carroll's Alice in Wonderland: night is day, day is night, white is black, black is white, knowledge is vice, ignorance is virtue.

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Nor is this excessively technocratic mind-set mitigated at the political level by a U.S. Treasury leadership that understands that we do not start from ground zero, that there is a history here, an often tragic one at that, and that decision-making in political economy is different from pristine economic theory in controlled laboratory conditions. Instead of a largeness of vision to complement the so far impressive social and political sophistication of the Duhalde government, both the Treasury and the IMF top leadership evidence a small bore mind-set unworthy of the stakes that are at issue in Argentina.

President Ricardo Lagos of Chile contends, it is possible "to fight the region's gravest problem--gross income disparities between the wealthy and vast under classes--without violence and within the confines of the free markets and parliamentary democracies established over the past two decades."

I know that the Lagos formulation of the issue is not generally accepted here in Washington, or in important parts of American academic thinking where income inequality and equity issues are dismissed as irrelevant. We saw that view exhibited in the deliberations of the Commission: Professor Charles Calomiris, a Republican appointee, expressed the majority sentiment : "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." (Calomiris, Transcript, January 4, 2000, p. 78). Or , with respect to core worker rights: " There simply is no basis aside from gross violations of human rights for a country to be told that they 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, Transcript , December 14, 1999, p. 135). Of course in a capitalist economy, collective bargaining is a critical element in determining the distribution of income in society.

The issue is not confined to Argentina. The research department of the IDB, the oldest and largest regional development bank, in a report last year notes that based upon extensive public opinion polling, despite economic growth, albeit modest in the past decade, 86 percent of the people in the region believe the distribution of income is unjust. The report notes that " income inequality has swept away many of the benefits of recent economic growth for large sectors of society. A prime example of this phenomenom is Mexico. Between 1996 and 1998, GDP per capita increased by 9.7 percent in real terms, which is a spectacular gain... However, poverty barely declined. The huge increase in median income was due entirely to income gains among the richest 30 percent–particularly the richest 10 percent–of the population. " It further notes that, " [n]o country in Latin America for which data on income distribution are available can boast a decline in inequality".

Last week, I participated in a workshop on Argentina in Bonn, Germany. At breakfast, a Brazilian participant told me how impressed he was with the comments of a senior former high official of the Argentine government. That individual stated that Argentine had become an "indecent" country in which poverty was now endemic and the gap between the rich and poor had become a chasm. My Brazilian friend observed that the Argentine commentator really seemed to care about such things. In Brazil, he said, poverty has been endemic and income distribution has been among the worst in the world for centuries and no one in the Brazilian elites really cares.

Perhaps these are random unrepresentative comments, but in my opinion they reflect an increasing disconnect between a Washington and American academic elite indifferent to equity and income distribution issues and a social and political reality in much of Latin America in which these issues are increasingly coming to the fore as central political questions.

So, for me, when we talk about reform of the IMF and the World Bank, organizational gimmicks and questions of process take a decidedly secondary importance to rethinking the economic paradigm they are inflicting upon their borrowing member countries.