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REFORM OF THE IMF AND WORLD BANK

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before the

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CONGRESS OF THE UNITED STATES

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Thursday, February 14, 2002

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

The Committee met, pursuant to notice, at 10:15 a.m., in Room 2318, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Ryan, English, and Putnam.

Staff Present: Chris Frenze, Robert Keleher, Colleen J. Healy, Darryl Evans, Brian Higginbotham, Matthew Salomon, Diane Rogers, and Frank Sammartino.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. It is a pleasure to welcome Under Secretary of Treasury John Taylor before the Joint Economic Committee (JEC) this morning. Let me just say there is a vote on, and I suspect there will be some members coming in as we proceed through the early parts of this hearing. So we will get started and as they come in, we will welcome them to our ranks.

Dr. Taylor enjoys a fine reputation as a distinguished academic economist from Stanford University and has previously served as a member of the Council on Economic Advisers and held a number of other government positions. In his current position, Dr. Taylor deals with some of the most challenging issues of international economic policy. A number of these issues relate to the proposals for reform of the International Monetary Fund (IMF), an issue I have been involved in since the debate over the 1998 IMF quota increase legislation.

In preparation for the 1998 debate, the JEC conducted an extensive research program on the IMF resulting in a series of studies and hearings. The outcome of this research concluded that the IMF was not financially transparent, that it provided below-market subsidized interest rates and promoted moral hazard. In addition, we found IMF mission creep was reflected in its drift into lending for development and structural reform often involving longer loan maturities and rollovers of existing loans.

Committee research also found that there was a lack of IMF accounting controls and lending safeguards that could result in misuse of taxpayer money. A number of other findings involve 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.

The research led to an introduction of the IMF Transparency and Efficiency act, a version of which later became law as a condition attached to the IMF appropriation. This reform mandated much more

IMF transparency and the use of risk adjusted interest rates in IMF bailouts. In the last few years, International Monetary Fund operations have become more transparent, although its financial statements still lack transparency. Although the IMF has made some limited progress in the area of financial transparency, 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."

I would also like to note the President's Council of Economic Advisers (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 rates of interest to encourage and facilitate the borrowers quick return to private capital markets." This is very consistent with the finding of the Meltzer Commission as well as the congressional mandates for IMF reform developed by this Committee in 1998. A version of these transparency and lending reforms became law in 1998 as conditions attached to the IMF quota increase legislation. Thus, congressional actions already taken strongly support the administration's position on needed reform of IMF lending programs.

The administration's support for significant 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 cannot repay has failed. Moreover the high failure rate of World Bank projects reflects a waste of resources that could have better been used to alleviate poverty.

Finally we now have an administration that is serious about needed reforms of the IMF and World Bank. Although change in these institutions will not occur overnight, consistent and steady advocacy of responsible reform will produce results that will limit moral hazard, curb international financial instability and reduce the waste of resources to the benefit of many millions of people around the world.

Mr. Secretary, thank you for being with us this morning. We have been joined by my good friend from Erie, Phil English. We thank the gentleman for being here in a timely fashion. Mr. Secretary, we are anxious to hear your testimony this morning and welcome you to the Committee. The floor is yours.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 18.]

OPENING STATEMENT OF DR. JOHN B. TAYLOR, UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Dr. Taylor. Thank you very much, Mr. Chairman and thank you and Mr. English for inviting me to this hearing to discuss reform of the international financial institutions. I know that reform has been a high priority for you and for this Committee for a long time, and I know that many of the ideas that have come forth in these hearings in the

Committee such as greater transparency, higher interest rates, longer maturities, have already had an impact on the International Monetary Fund, so they have been very constructive. Reform of these institutions is also a very high priority for President Bush's administration.

President Bush himself has given two speeches where he has drawn attention to some of the ways that the World Bank and the multilateral development banks could be improved, and Secretary O'Neill, on numerous occasions, has pointed out the need for reform in these institutions and the IMF. The goals of reform proposals that we have been thinking about are fundamentally to raise economic growth in the world and to try to create a greater degree of economic stability.

We hold those goals out all the time as guiding lights for our approach. We agree with you that there is still room for improvement, and therefore have made it a high priority. In this testimony, which I would like to put in the record, Mr. Chairman, I focus primarily on two reform initiatives which I think are very important for our overall reform effort. Those two reform efforts are more grants at the World Bank and the other multilateral development banks and the creation of a better sovereign debt restructuring mechanism, which would apply to emerging market debt and the activities of the International Monetary Fund. So I would like to focus on those two issues primarily in my oral remarks here, and of course I will be happy to answer any questions about what we are doing or what you are doing in this area.

Last summer President Bush made an important speech at the World Bank where he called for increased assistance in the form of grants from the World Bank and the other multilateral development banks to the poorest countries in the world. He just reiterated this proposal last month in another speech and I will quote, "he is urging the World Bank to provide up to 50 percent of its assistance to the world's poorest nations in the form of grants rather than loans, grants for education, for health, for nutrition, for water supplies and for sanitation."

Why is this grants proposal so important as part of our efforts to encourage reform at the World Bank and the other multilateral development banks? There are a number of reasons. The first one I would mention is, as you referred to in your opening remarks, Mr. Chairman, is that it creates a greater degree of transparency. The loans that IDA (the International Development Association), the branch of the World Bank that provides loans to the poorest countries, makes are at highly favorable terms at this point. Their maturity is 40 years. The interest rate is 75 basis points, sometimes called a service charge, and there is a 10-year grace period.

So by any measure, these loans have an enormous degree of grant element anyway. We feel that since they have this element of grants in them already, it would be much more straightforward and transparent to basically make them grants in the first place rather than to call them loans. So transparency is the first advantage I would mention for converting at least some of the loans into grants.

A second advantage is that the loans are now being given to the poorest countries, many of which we are effectively writing down through the Highly Indebted Poor Country (HIPC) program. There are many people supporting this effective write down in the debt to enable these poor countries to get into a more sustainable situation. We feel that loans from IDA, or wherever, increase this debt again and go counter to the direction of reducing the debt.

So rather than put more loans on countries where the debt burden is high and therefore we are reducing the debt, we think it is important to try to stop the debt if you like, to try to give grants whenever possible instead to these very poor, highly indebted countries.

A third reason is that grants are really much more suited for many kinds of social spending, spending for disadvantaged people and sectors in particular, for raising the enrollment rate for girls, say, in Afghanistan, which is only 3 percent, or to try to help HIV/AIDS patients and fight communicable disease in general. Giving loans for these kinds of activities doesn't make a lot of sense. Grants are the more appropriate form of support because the returns on these are not economic, they are largely social.

The fourth reason which I have emphasized a lot, Mr. Chairman, is that the grants can be tied to measurable performance I think in a way which can make them even more effective than other forms of support. Measurable performance is a theme which the administration has stressed a lot in the international financial institutions. The hope here is that grants can be tied to actual results. So, for example, if the grant is used to provide assistance to education, then the performance would be measured in how much enrollment is increased or how much test scores are increased.

If the grant is to provide for health, for HIV/AIDS assistance, then it would be measured in terms of how much patients are actually being treated. And if the treatments are not up or the enrollment rates are not up, then the grants would be shifted to other providers. This provides accountability and enforcement of the purposes of the grants, which we think could make them much more effective as a development tool.

I would mention that there are two objections which countries have pointed to in this proposal, and then I would like to discuss where we are in terms of international negotiations. Some people have pointed out that by converting loans into grants, the reflows would diminish over time. Reflows refer to the fact that eventually the loans are paid off at least when they are not written down, and those reflows are again then used to make loans to poor countries. So if there were a transition from loans to grants, the reflows would diminish.

However those reflows are effectively payments by some poor countries to other countries. So by reducing those reflows as grants would do, of course, you are actually providing more assistance from the donor countries and less assistance from poor countries themselves. So the worry about reflows is simply a worry about poor countries financing other poor countries, and we think it is more appropriate to have the grants rather than the loans for that purpose.

A second objection that some people point out is a feeling that the grants are a proposal that really would mean less funding from the United States. The United States is pushing this proposal, and the suggestion or the worry, perhaps from some, is that means there is going to be less support for these kinds of activities. I would say that that is completely contrary to our intention, as evidenced most recently by President Bush's budget submitted last week where he has asked for and proposed an increase by a substantial amount to IDA under the condition that IDA's performance deliver results.

If that funding all goes through, it would amount to a 30 percent increase from last year to the third year of the IDA replenishment. So there is no intention here to reduce funding, the objective is to make the funding more effective. If I could just say for a minute something about the international negotiations, we have found a lot of support for this proposal from NGOs and from other countries, and there is a move now to have grants as part of IDA. There are differences of opinion about how much grants there should be, and so we still need to work out an agreement or a compromise amongst the U.S. and the other donor countries. But the good news is that there will be a move towards grants of some amount and the question is how much.

The U.S. has shown flexibility. For example, we have said that the 50 percent grant assistance could go to countries whose per capita income is less than $1 a day. That seems like a reasonable definition of poor countries, but some of our other donor partners would like a more exclusive definition of what it means to be poor. So we are going to work these out. It's not settled yet, but think we are moving in the right direction.

Let me switch now to the other major reform issue, and that is looking for a better sovereign debt restructuring process for emerging markets. We have been working in the administration to develop an overall strategy for emerging markets and for the IMF. A sovereign debt restructuring mechanism would be part of that strategy. The overall strategy is already focused on crisis prevention, which is described in my written testimony; on narrowing the focus of the IMF, as this Committee has argued in the past, narrowing the focus in terms of the conditions and its work; to try to limit official sector support, especially in situations where debt becomes unsustainable in countries; and finally, trying to find ways to keep the contagion low, the contagion that occurs in crises.

And even if we are successful, and I think we have been in these four areas, there is still something missing in the sovereign debt market, and that is a more predictable approach to resolving situations when debt does become unsustainable. We see the need for some more predictable sovereign restructuring mechanism or a workout strategy, if you like, for countries that reach an unsustainable debt position. Ideally such a mechanism would never have to be used, but simply having it in place would create a great degree of certainty and predictability.

There are several alternatives that have been suggested, and the United States is in consultations with other governments, with the IMF, with the private sector, legal experts, financial experts, traders, investors, academics, to look for and ultimately propose a constructive approach that could be put through in a consensus basis in the international community.

At this point, one of the most practical and promising proposals on the table is a decentralized approach to this problem. It would encourage borrowers and lenders to put certain clauses in their debt so that when a country needs to restructure, there is a more orderly process. Many existing bonds do not have such clauses at this point in time, and we feel if there were more clauses, the workout process could be more predictable.

We feel it is important to provide additional incentives to countries to use these kinds of bonds. One approach is to say that a country that is in an IMF program, or is about to begin one, would be required that any newly-issued bonds have these kinds of clauses. So we think it is a promising approach and we will be working with our colleagues in other countries to discuss more details about this. There are other approaches that have been put forward.

One proposal that has been suggested by the IMF would have the IMF step in situations where they view debt as unsustainable and impose a stay on legal actions when they feel it is appropriate. We feel the decentralized approach has advantages and want to give it emphasis, but even with this decentralized market-oriented approach, there will be a role for the IMF in assessing sustainability and deciding how sustainable a new IMF program would be, at least for countries that are beginning IMF programs.

So let me stop with that, Mr. Chairman, and again, welcome questions on those two issues or anything else on reform.

[The prepared statement of Dr. Taylor appears in the Submission for the Record on page 21.]

Representative Saxton. Dr. Taylor, thank you very much. That was great testimony, and obviously very informative. With regard to the World Bank, the reasons for changing from loans to grants involve transparency, the fact that they write down the debt anyway, the fact that grants are more suitable for disadvantaged spending, and finally, fourth, that grants would be tied to measurable performance. These are all, I think, very logical reasons to pursue such a grant program.

In addition to that, there has been some discussion about providing grants directly to private contractors to carry out programs rather than to provide grants through government entities, and it seems to me that that approach would provide for a more specific target and a more trackable record. It would involve a specific target, an entity that would be responsible, and which would have the responsibility of justifying a program, and it seems to me that that might provide for more transparency than to funnel the money, if you will, through a government entity.

Would you talk about that a little bit?

Dr. Taylor. I agree very much with the notion of tying the grant to actual performance, and I think that is true no matter who the provider is. If the -- as you know, the World Bank now works its assistance through governments, but the provision of services can frequently be assigned by the government to other providers, and in that case, it is important that those providers, whether it is a public enterprise or a private enterprise, do exactly what you are saying. I think it is useful to look for ways in which individual providers or the private sector in general could be getting more encouragement and assistance through the World Bank and the other multilateral development banks.

I really applaud your suggestions. More generally, one of the things which I think would be important is to try to find ways to do the kind of things that the European Bank for Reconstruction and Development does, and that is to provide support for small businesses in the private sector, and that is a very successful operation. We are also looking for ways that that could be extended to some of the other multilateral development banks. I know it is not exactly what you are referring to, but it is related, Mr. Chairman.

Representative Saxton. Thank you. Let me turn to the IMF for just a moment and ask a couple of questions with regard to how – in a general sense –the reforms that we made in the late 1990s as a result of some requirements that were attached to the $18 billion appropriation that we passed in the Congress are performing. Can you respond in a general or even specific way about how those reforms are working and how you see that process moving forward as a result of that legislation?

Dr. Taylor. I think the request that there be more transparency is working well. As I see it, there is more release of information about programs, there are more requirements that countries provide data. I actually think that greater transparency has had important impacts on the markets themselves. One of the reasons I think that contagion seems to have diminished, or at least be more based on fundamentals, is that there are more facts out there, more transparency about what countries are doing. So I think that is effective. I think we could do more. I think the institutions could do a lot more.

One of the things that I note probably because of my background and education, is that there is still a lot of confusion if you like, complexity is a better word, to the way the information is presented, especially with respect to the IMF and the way that the loan activity is described as purchasing or exchanges of currency. It is confusing to all but the experts, and I think we could do a better job trying to explain that and that would create transparency itself.

Another example of reforms that have come out of this Committee's discussions and others are that there would be higher interest rates on loans which were provided for short-term liquidity purposes, and that has occurred in two ways at least. The supplemental reserve facility (SRF) has a higher interest rate and a shorter maturity, and that has been used. There is also a contingent credit line, CCL, with tougher up-front eligibility criteria, short maturities, and interest rates below the SFR but above the IMF's normal lending rate. That has not been adopted yet, but it is there for countries that want to meet the necessary prequalifications. I think this is also important to have happen, but I think it is still very small relative to the total in practice.

So these new instruments are there, but they are not used very much at this point in time, and I think that means they need to be reconsidered, or we need to understand why they are not being used the way they are. I think it comes back to the incentives that face the countries and to the official sector.

Representative Saxton. Let me ask about two things, and I will do it in one question. The notion that the IMF producing a situation in which bad economic practices are encouraged known as moral hazard persisted, and I suspect, to a large degree, continues to persist, and that, of course, is enhanced by – let me refer to the second subject of the question, and that is enhanced by subsidized interest rates that the IMF has used as a standard practice. In other words, on a smaller scale, if I were an investor and I had a rich uncle who said to me, Jimmy, you go out and make your investments, and you know you can make some riskier investments than maybe you otherwise would because I am going to be there to bail you out with a low interest rate if you fail.

Are moral hazard and low subsidized interest rates still problems with the IMF, or have there been some progress made?

Dr. Taylor. I think we are trying to make some progress on both of those by limiting official support or endeavoring to limit it to situations, which are more like liquidity problems rather than sustainability problems. That is very difficult to do in practice. I noted that the Council of Economic Advisers report paid a great deal of attention to that distinction. So, if we are able to do that, it will reduce the moral hazard. Of course the interest rate is related to limiting official support because if there were higher interest rates on these loans, then they would be much less attractive to the government.

Now the interest rates on the IMF loans are, of course, much lower than what the country has to pay in the markets, and if it were higher, they would use it less; but, of course, then it would be something that would be less desirable for the countries to use and they may not use it.

So I think what we have tried to do is give reasons why it is not good to provide support in those situations, to limit it more to liquidity situations. In the process of making decisions, many factors come into play, so it's difficult to make that judgment, but I think that is what we are trying to do and that will ultimately limit the moral hazard problem that you raised.

Representative Saxton. Thank you. I think that is an extremely important objective. Mr. English.

Representative English. Thank you, Mr. Chairman and Dr. Taylor. It is great having an appointment of your academic eminence in a position like this, and I am not setting you up for anything. I do have a couple of questions, though, and as someone who in a previous life wore a green eyeshade, I am particularly curious to know what is the status of internal controls in the IMF and what kinds of corruption safeguards are currently in place?

Dr. Taylor. I think there have been some improvements in that area, too. At this point in time, there is a requirement that borrowing countries publish audits of central bank financial statements, and that is meant to be a safeguard of IMF resources.

Representative English. On that point, and I am curious, what is typically the scope of those audits, and are they available outside of the IMF management?

Dr. Taylor. Well, the scope of the required audits is the central bank's financial statement and the central bank is to provide the information that is necessary. In terms of the availability, I don't know, and I will have to find out how available those audits are or in what form or what detail, but I will be very happy to get back to you on that. There is a requirement that the audits be published.

Representative English. Very good. Proceed. And then what else have you done to implement, what else has the IMF done to implement corruption safeguards in recent years?

Dr. Taylor. In addition to the publication of audited central banks financial statements, all countries must undergo an assessment of their central banks' control, accounting, reporting, and auditing systems to ensure they are adequate to protect central bank resources, including IMF disbursements. Any critical vulnerabilities identified must be remedied before additional Fund resources are disbursed. At some point, of course, money is fungible, so there is only a limit of what you can do of this kind, but my sense is they are moving in the right direction. But as shareholders and representatives of the taxpayers, we need to continue to look at it carefully.

Representative English. Within the IMF, is there any ongoing process for evaluating those internal controls and corruption safeguards?

Dr. Taylor. They have created an evaluation office and recently have begun staffing that. I think that is a very good idea. It is just underway, and we will have to see how it works. We are very interested in it and its evaluating that and IMF programs in general, but they have appointed a person and they are staffing it up at this point, this new evaluation office. I hope that works effectively.

Representative English. Building on the line of inquiry that the Chairman developed, when we are talking about moral hazard, one of the obvious criticisms of the IMF in the past is that IMF loans are offered, and the whole risk premium is not necessarily included within the loan itself. How currently is risk handled under IMF loans?

Dr. Taylor. Well, the interest rate on the IMF loans is very close to the interest on the bonds of the donor countries -- United States, European countries, Japan, et cetera. So it doesn't reflect the risk that is imbedded in the interest rates that the borrowing countries have to pay.

Representative English. Right.

Dr. Taylor. So sometimes those interest rates are called risk free. Economists sometimes refer to these Treasury rates as nearly risk free. Treasury bill rates are the classic risk-free interest rate. So the extent that that interest rate or something close to it, it hovers around that, is charged on the loans then there is a subsidy because the country would otherwise have to pay a higher interest rate.

Representative English. In terms of the candidates for IMF support, in the past, there has been a very strong focus in terms of all aid programs on LDC's, trying to help those countries that are at the absolute bottom of the heap, that have the most desperate human needs. How do you evaluate the policy currently as far as loans to those sorts of countries, the so-called basket cases, versus loans to countries that are perceived as having the potential for near-term take-off in their economies are putting in place pro-growth policies and have the potential of developing a middle class and showing signs of entering the international trading system? How would you evaluate those two kinds of countries as candidates for IMF loans under current policy?

Dr. Taylor. The IMF has a loan program, called the poverty reduction growth facility (PRGF), which is aimed at the very poor countries. This program has actually suffered from much of the other activity that the IMF does. It is funded out of individual countries, not the United States for the most part. Those loans are always put in the context of advice the IMF is giving on the macroeconomic side.

So it focuses on good monetary policy, good fiscal policy, good exchange rate policy, and good financial markets in general. Those are, if put in place, all good pro-growth things to do, keep, in other words, the inflation rate low, the exchange rate stable, transparency in the markets so these loans target promotion of pro-growth strategies. However, not all the things necessary to promote growth are part of IMF lending conditions; the World Bank has to do things which are more pure development to try to get pro-growth activity going. We believe it is important to try to distinguish that activity from the IMF.

The other IMF activity through their normal windows is more for emerging markets, and those are countries which are a much higher level of income per capita and already beyond the very basics of development. My sense is that that is the area where the IMF's long-term specialty has been, in these emerging market countries, and they are only more recently going into the very poor and very underdeveloped countries. That requires skills and knowledge which frequently are different from what the IMF has had in the past.

So to the extent they continue to do that, and many shareholders want them to do it, they need to develop the skills to do that, which has traditionally been in the World Bank area. But your question had to do with being able to pick the countries that are going to do well and take the right policies, and I think what we have argued, and I think what the institutions would like to do, is to favor countries who are doing the right policies. That is, have a performance-based allocation. This refers more to the World Bank than to the IMF to be sure at this point, and therefore encourage countries who are taking serious pro-growth policies and to discourage countries who are not.

Representative English. Thank you, Dr. Taylor, and again, it is a privilege to see someone of your stature taking on such a difficult and thorny assignment, and we look forward to hearing from you again, and I thank you, Mr. Chairman for your indulgence.

Representative Saxton. Mr. English, thank you for the very thoughtful questions. We will now move to a new member of the Committee, Mr. Putnam. Thank you for being here.

Representative Putnam. Thank you, Mr. Chairman.

Representative Saxton. It was a short night, a long night followed by a short night.

Representative Putnam. For those of us fresh out of college, it is no big deal.

Representative Saxton. But the activities are different.

Representative Putnam. One of the advantages of being young in this process; isn't that right, Mr. Ryan.

Representative Ryan. Right.

Representative Putnam. The United States has been under substantial criticism over the years for the perception of its withdrawal from the international stage on aid programs as well as monetary funds and other developmental assistance. What percentage of the IMF funding comes from the G8 nations, and how many nations benefit from that through the IMF?

Dr. Taylor. The G7 provides 51 percent of the IMF's non-concessional lending resources. And the countries that benefit, well, ultimately there are 183 members of the IMF, so they are all – anyone is potentially able to benefit; but, of course, there are many fewer countries at any one point in time. There are now approximately18 countries with concessional arrangements. In addition, the IMF has concessional programs under the PRGF, which are funded separately, as I just indicated to Mr. English. Those are very poor countries, their levels of —

Representative Putnam. Are those the ones he referred to as the basket cases?

Dr. Taylor. I didn't refer to them as the basket cases, but that term was used here and there are also loans to emerging markets, which is actually a lot larger in terms of its magnitude. So those are Brazil, Turkey, Argentina, Indonesia – those countries receive a large part of the support.

Representative Putnam. What percentage of the usable quota comes from the United States?

Dr. Taylor. It's about 25 percent right now.

Representative Putnam. Now, in identifying other nations who can help us implement the President's new strategy on grants over loans and things of that sort, how many other nations have we identified that could be pulling a little bit more of the load than they have in the past, in other words, spreading some of the responsibility beyond the G8? How many other nations out there are in a position to be helpful?

Dr. Taylor. The grants are more for the World Bank and any other multilateral development banks. In the case of the U.S. support to the World Bank to the IDA program, that is around 20 percent; so the numbers are less than what I just gave for the IMF current available funds. And in terms of getting more support from those countries for our grants proposal, as I indicated before you came in, and I am sorry, Mr. Putnam, we are getting some support, but we need more and they are moving towards the President's proposal by moving a larger fraction of grants, but we need more support from the large donors, the British and the French and the Germans, in particular.

Representative Putnam. Let me change gears one second and talk a little about mission creep, which has been an issue. The President's Council of Economic Advisers report noted that in recent years, the missions of IMF and MDBs have sometimes overlapped with the IMF providing some non-emergency financing for developing economies and the MDBs contributing to crisis financing packages.

What efforts are ongoing in the administration to clean up some of the mission creep, and shouldn't these missions be more refined and more focused than they have been in the past?

Dr. Taylor. I think they should be more focused and we have argued that – as a shareholder argued in favor of that. Other shareholders, such as the G7, have argued for it, and I think in the last year or so, we are beginning to see more of that. The managing director of the IMF has made an effort to have the conditions of the loans more narrowly focused, more targeted on the so-called core responsibilities of the IMF: monetary, fiscal policy, and exchange rate policy. So I think that is moving in the right direction in terms of its scope. We put a great deal of emphasis on crisis prevention, and crisis prevention means having a greater specialty in the IMF on crises, which means narrowing the focus to these particular issues as well, so I think it's moving in the right direction.

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

Representative Saxton. Mr. Ryan.

Representative Ryan. Thank you, Mr. Chairman. Thank you for holding this hearing too, I appreciate it. Dr. Taylor, I wanted to focus a little bit on Argentina. Specifically, I wanted to get into dollarization, but first, I wanted to ask you about the recent actions in Argentina, and I don't think that the Chairman asked this question, but do the recent actions in Argentina's government, in your opinion, qualify as triggering Title XXII, section 2370 (a) of the U.S. Code, which says that the President shall instruct the United States executive directors of each multilateral development bank and international financial institution to vote against any loan or other utilization of the funds of such bank or institution for the benefit of any country that has expropriated the property of any U.S. person or nullified any contract with any U.S. person? So has the fallout from Argentina and the expropriation of funds, and basically the violation of property rights of international investors led you to believe that you must invoke this code?

Dr. Taylor. What we are doing now is trying to indicate to Argentina, and the IMF is working with Argentina, that they need to treat all investors fairly as foreign investors, domestic investors, so that there is no discrimination in any of these matters which would call forth, the kind of law you are referring to. Right now Argentina is making changes. There is a "pesification" they call it in some of these accounts, financial transactions, which basically are trying to deal with the adjustment that the devaluation of the currency has created, and what they are trying to do there is do something that they see is the right way to make this adjustment. And what we have been doing is listening to all the private sector firms, not just from the United States, by the way, but other countries who are investors, and trying to be sure that whatever is done is done fairly, and doesn't involve the kind of activities you are referring to, so that we won't have to call into play that particular law. But we are aware of it and our legal experts will be evaluating it—

Representative Ryan. But if you had to make a decision today, the answer would be no?

Dr. Taylor. That is correct. It would be no.

Representative Ryan. I think you testified over at the Financial Services Committee on January the 6th, and you said that in your personal opinion, the better answer for Argentina would be to dollarize, and I don't know if you are aware of this or not, but this is my second term, and I have authored a dollarization bill called the International Monetary Stability Act I had authored with Senator Connie Mack last term, which would share the profits from seigniorage with the countries who choose to dollarize and to make sure that countries do not put firewalls against any expectations that countries would have any say so in the conduct of our monetary policy.

The Canadians are now talking about it very, very seriously; the Mexicans have talked about it for many years; Latin America, Panamanians have already dollarized. It's spreading through the hemisphere possibly. What is your personal opinion and professional opinion on the need for Argentinians to dollarize and to share the profits of seigniorage, given that we can clearly state that we would not allow any influence in our monetary policy?

Dr. Taylor. I think the latter part is very important to keep stressing. I know that is certainly the position of the United States and the Federal Reserve Board members. With respect to my personal opinion about

Argentina, I did testify that I thought dollarization would have been useful in a particular time last year. That is my personal opinion, because I was asked for my personal opinion.

The United States opinion has always been that the exchange rate is an issue that is best left to the country. It involves political issues, historical issues. It is the classic issue in which country ownership should be stressed.

So this administration, I think, very wisely has taken the position that an exchange rate decision is the country's, and we are not going to take a position one way or the other. So if a country chooses to dollarize, that is fine. If a country chooses to have a flexible exchange rate, that is fine. We hope in either case, it's done in a sound Way. Obviously, I know about your bill and others. I think it's something that needs to be continued to be discussed.

But again I say, with respect to my personal opinion, I refer to a different period than we are now in, in Argentina.

Representative Ryan. Let me ask you this: If the Canadians get behind the idea, would you entertain a sharing of seigniorage with the Canadian central government if they decide to convert? For a lot of countries, that is a lot of money and in many of these Latin American countries it would be a substantial amount of revenue that they would have otherwise lost if we don't share the seigniorage, and it would be a revenue raiser for our Federal Government as well, because we would retain a percentage of the profits of seigniorage. Do you believe that if one of these countries were to approach you, that that would be something you would entertain?

Dr. Taylor. Right now the position of the administration is that that would not be something—

Representative Ryan. The administration officially is opposed to sharing seigniorage right now?

Dr. Taylor. Right now there are questions of appropriation and funds for this that need to be worked out. I don't think I have seen all the work that has been done on that, and I can't say there is a policy that applies uniformly across every country. But it is not something that has, to put it this way, been put on the table for us directly to consider.

So the answer must be it is a case-by-case situation but I would say at this point there are appropriation issues, there are budget issues that are serious and need to be worked out before we would consider—

Representative Ryan. We had problems with scorekeepers on this around here, and for some reason, they think that it costs money, the profits from seigniorage. I don't know if you looked at our bill very closely or not, but do you believe that if we were to engage in a seigniorage-sharing agreement, that we would actually raise money, that there would be an inflow of capital, of dollars to the Federal Government?

Dr. Taylor. With an economic perspective, Mr. Ryan, it certainly represents an increase in revenue.

Representative Ryan. Right. I think we have some problems with the scorekeepers on that. Do I still have one more – Mr. Chairman?

We have Euro now. It's fairly new. There aren't many in bank reserves around the world, but as bank reserves of Euros grow and as some of the Eurocentric African countries become accustomed to Euros and grow in bank reserves, do you believe that there is a growing trend of the spread of Euro through that region of the world, and then do you believe that it may be in our best interest to promote the use of dollars, even more so around the world and more importantly in our hemisphere, to promote dollarization more aggressively than we are right now, which is no promotion whatsoever? What is your take in the long haul, on the future long term?

Dr. Taylor. That is a good question. I think the position now where we would like countries to make their choice and take ownership is a good one. We should continue with that. With respect to providing competition, if you like, with the Euro, I think that countries that would like to Euroize rather than dollarize, I think that should also be their decision—

Representative Ryan. Sure.

Dr. Taylor. They are located close to Europe and it would make a lot more sense than dollarization, and again, ownership is very important on that. I don't think there is a problem if Euros become more useful for people. I think there is no reason why it shouldn't only be the dollar. I think for many, many years in the future, the dollar will be the chosen asset for people to hold in countries which have high inflation or are unstable for other reasons, so the dollar will be used in many countries. And I think it's just fine if some countries choose to dollarize with Euros if you like.

Representative Ryan. In Quebec, it is my understanding that the issue of currency stability was not really a top issue at the G7 meeting. Is this an issue that the administration is going to take more of an in-depth hands-on approach with the other industrialized nations? Will currency stability, which has always been more the dominant discussion of these meetings – do you believe that given the problems in Argentina, the problems still moving around Central and South America, do you believe that the administration is going to take more of a hands-on approach, more of a leadership role in promoting currency stability, and sound money across the world as opposed to just this last meeting.

Dr. Taylor. Well, I think there has been an emphasis at these meetings, and certainly this administration, that sound money, keeping inflation low, keeping interest rates low thereby is a good policy for countries to follow. We think it's an important part of pro-growth strategy for the world to have low inflation, stable interest rates and good monetary policy. So that is something that we have no problem talking about positively, but with respect to exchange rates per se, that is something that it is the Secretary of the Treasury who should speak about it when you have a chance to have him testify.

Representative Ryan. I would suggest that they are looking to us and leadership—

Dr. Taylor. I think the leadership is there on the importance of a good sound monetary policy. If a flexible exchange rate is chosen, then to have a policy that keeps that exchange rate stable, and that is a good inflation policy, and if dollarization is chosen that is fine to. We will make every effort to make that smooth, and I know the Federal Reserve will be willing to do that as well.

Representative Ryan. Thank you.

Representative Saxton. Thank you very much, Mr. Ryan. Dr. Taylor, let me turn to two final questions on the International Monetary Fund. One of the issues that we found interesting as we began to search through the information that we could get our hands on relative to the IMF, and as we worked through that process in the late 1990s, we came to the conclusion without any difficulty that there were inadequate accounting controls and corruption standards at least at that time.

One of the things that stunned me and the Committee was finding several years ago that no effective procedures or safeguards were established by the IMF to verify information and monitor funds of disbursements through the IMF. And inasmuch as we noted at that time that a large percentage of the usable quotas were provided by the United States taxpayers. We felt some kind of a special obligation to look into this. And right after the Russian debacle, I led a delegation of Members of Congress to Moscow to see what we could find out in a direct way about what happened to the funds, and of course, the Russian officials that we talked with weren't forthcoming about what happened to the funds or we suspected that they were used in inappropriate ways. As a matter of fact, in some discussions with the Russian members, particularly Russian members of the Duma, particularly Communist members of the Russian Duma, we were told, in no uncertain terms, that those funds were stolen by American banks. It wasn't humorous at the time, but looking back, you have to grin at the charade that the Russians, or some Russians, were able to pull off at that time.

So my question is, have we made any progress in putting in place better accounting controls and corruption safeguards? And I guess the second part of the question is do you have any recommendations as to how we can be helpful to kind of move this ball forward?

Dr. Taylor. I think it is a very, very important issue, and there have been efforts put in place to have more audits. That is underway. The IMF has had experts in to help set this up. It is difficult, and I think in terms of what you can do is to continue to speak out on its importance. We are going to do that as well. There are problems that arise with respect to misreporting of data and information. When that occurs, we want to know about it and take actions. Ultimately, it seems to me if problems like that persist, there shouldn't be programs, there shouldn't be loans going into situations where you can't verify and can't audit. So I want to work very hard on that and think your support is helpful, Mr. Chairman.

Representative Saxton. Thank you and let me just say that I think we can make a good team on many of these issues, and what I would like to suggest is that as we move through this process, and as you see items that need to be changed by the IMF, I think we have shown that we can be helpful in making that happen, and if, as you see needs develop as to changes that the administration would like to see made in the way the IMF operates, we would more than appreciate hearing about that with an eye toward developing, perhaps, some statutory or suggest statutory changes as to how United States funds might be used in the IMF as we did before.

Last time the door to the IMF was completely shut, closed when we started. Frankly, the previous administration was not particularly forthcoming and helpful in helping us to pry the door open, but we got it open a little bit and with your help, as you move forward, you begin to see things that we can be teammates and help you move forward, we would very much appreciate hearing about them.

Transparency and interest rates and lengths of loans and accounting standards and all those things, we and our staff have a pretty good understanding of and we can certainly help you bring pressure to bear on the folks who can change these inside the IMF.

So thank you for being here this morning. We appreciate it very much. We are going to have a vote here for shortly and so we will draw this hearing to a close by thanking you for coming here and being as forthright and as revealing as you have with us and we look forward to working with you.

Dr. Taylor. Thank you very much, Mr. Chairman.

Representative Saxton. Thank you.

[Whereupon, at 11:14 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome Under Secretary of the Treasury John Taylor before the Joint Economic Committee this morning. Dr. Taylor enjoys a fine reputation as a distinguished academic economist from Stanford University, and has previously served as a member of the Council of Economic Advisers and held a number of other government positions. In his current position, Dr. Taylor deals with some of the most challenging issues of international economic policy.

A number of these issues relate to proposals for reform of the International Monetary Fund (IMF), an issue I have been involved in since the debate over the 1998 IMF quota increase legislation. In preparation for the 1998 debate, the JEC conducted an extensive research program on the IMF, resulting in a series of studies and hearings. This research concluded that the IMF was not financially transparent, it provided below market subsidized interest rates, and promoted moral hazard.

In addition, we found that 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. Committee research also found 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.

This research led to the introduction of the *IMF Transparency and Efficiency Act*, a version of which later became law as conditions attached to the IMF appropriation. This reform mandated much more IMF transparency and the use of risk adjusted interest rates in IMF bailouts. In the last few years, IMF operations have become more transparent, although its financial statements still lack transparency. Although the IMF has made some limited progress in the area of financial transparency, 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."

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 developed by this committee in 1998. A version of these transparency and lending reforms became law in 1998 as conditions attached to the IMF quota increase legislation. Thus Congressional actions already taken strongly support the Administration's position on needed reform of IMF lending programs.

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 better been used to alleviate poverty.

In conclusion, we now have an Administration that is serious about needed reforms of the IMF and World Bank. Although change in these institutions will not occur overnight, consistent and steady advocacy of responsible reform will produce results that will 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. And I'd like to thank Undersecretary Taylor for taking the time to testify before us today.

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 can be done to make the IMF and World Bank stronger players in our efforts to support global economic and national security.

PREPARED STATEMENT OF DR. JOHN TAYLOR, UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Thank you Chairman Saxton, Vice-Chairman Reed, and other members of the Committee for inviting me to participate in this hearing on the international financial institutions. I know that reform of these institutions has been a high priority for this Committee. Indeed, many ideas coming out of the Committee's hearings—including calls for greater transparency and better accounting of costs—are already having a positive impact on these institutions.

Reform of the international financial institutions has also been a high priority of the Bush Administration. Our fundamental goals in this reform effort are to raise economic growth and improve economic stability in the world economy. The international financial institutions can help us achieve these goals, but there is room for improvement.

The Bush Administration—in a series of speeches by President Bush and Secretary O'Neill—has put forth a substantial reform agenda for the World Bank and the International Monetary Fund. In my written testimony today, I would like to discuss two key parts of that reform agenda —the use of grants rather than loans and the creation of an improved sovereign debt restructuring process. Both reforms are now a major focus of international discussion and negotiations.

Higher Economic Growth Through World Bank Grants

Clearly there is too much poverty in the world. We know that the key to reducing poverty is higher productivity growth. But productivity growth is far below its potential in many poor countries. We know that we can raise productivity growth by improving education and by increasing private investment. But educational achievement remains low as do private capital flows to developing countries and emerging markets in general.

So, in order to achieve our goals of raising standards of living around the world, the World Bank and other multilateral development banks must address the problems of productivity growth. That is why we have chosen productivity growth as a major theme of our reform effort. And to be sure that the actions taken actually increase productivity growth, we have emphasized the importance of measuring results of all actions taken, so we can see what works and what doesn't. Achieving measurable results and raising productivity growth are the rationales behind the proposal to shift from loans toward grants at the multilateral development banks.

Last summer in a speech at the World Bank, President Bush first put forth this grant proposal for the World Bank and the other multilateral development banks. And last month in a speech to the World Affairs Council at the Organization of American States, he forcefully reiterated that proposal. He "urged the World Bank to provide up to 50 percent of its assistance to the world's poorest nations in the form of grants rather than loans—grants for education, for health, for nutrition, for water supplies and for sanitation." Why is this grants proposal so important? Why is moving from loans to grants a major element of our reform effort? How does it relate to the theme of measurable results?

The Advantages of Grants

The part of the World Bank that provides assistance to the poorest countries is the International Development Association, or IDA. Funds for IDA are replenished at three-year intervals by the United States and other donor countries, and U.S. contributions to IDA must be appropriated each year by Congress. Virtually all of the IDA assistance to poor countries is now in the form of loans (these loans are sometimes called IDA credits). The terms on these loans are highly favorable to the borrowing country—far more favorable than the government of the country could obtain in private capital markets. The loans have a 40-year maturity; the interest rate (referred to a "service charge") is 0.75 percent; and there is a 10-year grace period.

Because the terms on these IDA loans are so favorable, they are really not loans in the everyday sense of the word. The total interest and principal that must be paid back is much less, in present value terms, than the amount loaned. For example, the present discounted value of all future payments on a $1,000,000 IDA loan at a 6 percent discount rate is only $337,671. Most developing countries, however, face interest rates much higher than this: if the discount rate were 15 percent, then the present discounted value would be only $97,569. Moreover, because the grace period is so long, a finance minister of a borrowing country could be out of office long before any principal has to be paid back on such a loan; and while in office there is only the small 75 basis point interest payment. It is misleading to call such assistance "lending." Such terminology is not consistent with basic goals of transparency in government. Thus, one reason that grants are better than IDA-type loans is simply that they are more straightforward and transparent.

Another reason to prefer grants to loans as a form of IDA assistance is that many of the countries now borrowing from IDA are part of the Heavily Indebted Poor Country (HIPC) initiative. HIPCs are poor countries that have unsustainable amounts of debt. As many have argued, by forgiving this debt the hope is that these countries can achieve a more sustainable debt situation. Through the HIPC initiative, the international financial institutions, in effect, write off their loans to these poor countries and relieve the countries' debt burden. However, at the same time we are writing off loans to these poor countries, by creating more loans from IDA—even at favorable terms—we are adding to their debt burden. This approach seems counter productive. Grants, on the other hand, are better than loans because they do not add to the debt burden of these countries.

Grants are particularly advantageous in cases where it is unrealistic to assume that the activity being supported will generate enough direct economic returns to pay back IDA loans. The use of grants thus removes a disincentive for governments to focus on the most disadvantaged people and sectors, e.g., rural poor, girls, indigenous people, and AIDs orphans. For example, issuing a loan rather than a grant for humanitarian assistance or major social crises—for instance, to provide assistance to HIV/AIDS patients—seems particularly inappropriate. That is why President Bush emphasized that grants should be used in certain social sectors—for "education, for health, for nutrition, for water supplies and for sanitation."

Yet another advantage of grants is that they can easily be tied to measurable performance or results. Some people think that the President's proposal is for "free" grants. That is certainly not the case; on the contrary, the grants are to be tied to specific performance. For example, if there is a grant for education, then the grant would not continue unless there are results—unless enrollment rises, for example. If the grant is designed to assist HIV/AIDS patients, for example, then the grant will continue as long as the assistance is being provided. If the assistance becomes inadequate, then the grant funds should go to another provider. Month by month, quarter by quarter, the group receiving the grant has to keep delivering the service or the grant stops.

International Differences and Negotiations

Since the President made the grants proposal last summer, we have been working and negotiating with other IDA donors to move from loans toward more grants. Of course, the World Bank is an international institution, so to implement any reform a coalition of support must be developed. A number of non-governmental organizations and developing countries have expressed strong support for the proposal, but for the proposal to be implemented it is necessary to garner the support of major donors to IDA. The current international negotiations are taking place in the context of the current three-year replenishment of IDA, which we hope to settle soon. An important and extensive discussion on this subject took place among the G-7 Finance Ministers and Central Bank Governors in Ottawa last weekend.

There is now widespread agreement among G-7 donor countries that a larger proportion of IDA assistance should be given in the form of grants, as the President proposed. However, there are still differences of opinion among donor countries about the details and ultimately about how much should go to grants. For example, the President called for 50 percent grant assistance for the "world's poorest nations." But exactly how poor countries should be before they qualify for this percentage of grants rather than loans is still an unsettled question.

The United States has shown flexibility in the negotiations, stating that it would be acceptable to provide 50 percent grant assistance to those countries with annual per capita incomes less than $365, that is, less than $1 per day. But some donor countries would like a more exclusive definition of "poor"; some would exclude those countries with annual per capita incomes above $250. Another difference of opinion is how to define the categories of assistance that would qualify for grants. Some donor countries would like to exclude education, in contrast to the President's proposal.

One of the more strongly voiced objections to increasing the proportion of grant assistance beyond a certain level is that it would reduce the "re-flows" to IDA. Re-flows are primarily the funds that are paid back into IDA by countries with IDA loans. These payments can then be lent again to poor countries. But, of course, poor countries themselves pay these re-flows. In other words, under the current IDA program the poor are supporting the poor. So reduced re-flows through the grants really means more support for poor countries.

Significant Increase in U.S. Support for IDA, Based On Results

Another objection to moving further toward grants is the argument that U.S. assistance to IDA will decline under a grants program. The facts say otherwise. Indeed, the United States is offering a significant increase in its contribution to IDA. The United States in the last six years has been bringing down its contributions to IDA in real terms. The President intends to reverse this trend. He proposes to increase our contributions to IDA, as long as the contributions result in better performance. In the budget he submitted to Congress last week, he is proposing that the U.S. IDA contribution increase—from previous years' annual total of $803 million—to $850 million in the first year, to $950 million the second year, and to $1,050 million in the third year. These step-ups will only occur if there is an improvement in performance at the World Bank, but they would bring the annual U.S. contribution to a level 30 percent above what it was last year. That is a clear demonstration of support for economic development, tied to the idea that we want that support to create measurable improvements in peoples' lives.

A Better Sovereign Debt Restructuring Process

The second major reform initiative that I would like to discuss today is sovereign debt restructuring. It is part of our overall approach to emerging markets and the International Monetary Fund. The truth is that emerging markets have not been performing very well in the last four years. The flow of investments going through these markets has declined sharply. We would like more funds to go to the emerging markets and at lower interest rates. A more predictable sovereign debt restructuring mechanism can help achieve that goal.

An Emerging Markets/IMF Reform Strategy

Our sovereign debt restructuring initiatives are part of a multifaceted strategy toward emerging markets and the IMF. That strategy starts with a greater focus on crisis prevention, asking the IMF to look more closely at countries where economic trends appear unsustainable, giving more ownership to countries so that they can make the decisions before the crises get out of hand, and encouraging more transparency both on the part of countries and the IMF itself.

A related part of the strategy is to narrow the focus of the IMF—both its work and the conditions it imposes on borrowers. By narrowing the focus to core responsibilities—exchange rate regimes, monetary policy, fiscal policy, and the financial sector—the IMF will be able to concentrate more on preventing crises and give countries more ownership of policy.

Limiting official sector support to countries when they reach unsustainable debt situations is another key element of our emerging markets strategy. Large official sector support packages can distort incentives for countries and for investors. And, of course, such packages effectively bailout private sector investors who have already received high rates of return. I think it is becoming clearer that the official sector support in such cases is now being limited to a significant degree.

Keeping contagion low is another part of the overall strategy and is a major reason why official sector support can be limited in many cases. Clearly contagion was an important characteristic of the Asian crisis in the late 1990s. However, coming into the Bush Administration, we re-examined this contagion issue and saw that important trends were developing. People in the markets were paying more attention to economic fundamentals, differentiating between countries and events. Countries were being more transparent in their policies. Market research was more thorough. We commented favorably on this change, noting that contagion is not automatic. This communication with the markets was meant to build on and encourage the changes in the markets by emphasizing that policy decisions would not be based on unfounded claims of contagion. In fact, contagion has come down dramatically over the course of the last year. This is illustrated by the fact that the terrible economic situation in Argentina has not spread to other countries in the world, let alone the region.

A Decentralized Contract-Based Approach

But even if we are successful in all parts of the strategy mentioned above there is still something that is missing. Currently, when countries get close to a situation where debt is unsustainable, it is like approaching a black hole: no one knows exactly what will happen next. This leads to uncertainty on the part of public officials and market participants alike. It leads to pressures for IMF bailouts even in situations where debt becomes unsustainable.

A more predictable sovereign debt restructuring mechanism—a workout strategy—for countries that reach an unsustainable debt position would therefore be useful. Of course, ideally such a mechanism would never have to be used, but simply having it in place would greatly reduce uncertainty. There are several alternatives now being considered. We at the U.S. Treasury have been in close contact with people in the private sector—market participants, lawyers, and academics—as well as people at the IMF and other governments, especially finance ministries and central banks.

The most practical and promising proposal now on the table is a decentralized approach that creates debtor and creditor ownership of, and participation in, the process. This proposal would encourage borrowers and lenders to put certain clauses in their debt so that when a country needs to restructure, there is a more orderly process. For example, now in many bonds, 100 percent of bondholders must agree to restructure the financial terms of the bonds. This makes it possible for a small minority to stand in the way of a restructuring that the majority of bondholders feel is in their best interests. Majority action clauses in bonds would allow a specified majority to agree to restructuring terms. The decision of this majority would be binding on the minority. The clauses would also provide for the process and timing through which debtors and creditors come together

There are several possible ways to create incentives for countries to use such clauses, and encourage them to overcome the urge to cut a few basis points from their interest rate by avoiding such clauses. For example, the official sector could require that these clauses be utilized by any country with an IMF program. Or the IMF could make it a condition of exceptional access to its funds that countries utilize these clauses in their debt contracts. A range of ways to implement this proposal is possible. Of course, introducing new clauses is something one can only do for new bonds. Consequently, we are also exploring options that would facilitate more predictable workout processes under existing bond provisions.

Another possible approach to sovereign debt restructuring that is receiving wide attention is an IMF proposal, in which the IMF would step in and impose a stay on legal actions in certain circumstances. This proposal obviously calls for a larger role for the IMF than the more decentralized market-oriented approach described here. But even with the market-oriented approach there will be a role for the IMF in assessing sustainability and deciding on a new IMF program, at least for countries that choose to work with the IMF on a program.

As with the grants proposal, it will be necessary to work with other governments to come to a common agreement on a sovereign debt restructuring proposal. It will also be important to consult regularly with the private sector and with Congress. And as these discussions proceed we should never lose sight of the overall objective: to increase predictability and reduce uncertainty in the emerging markets so that more funds flow through them at lower interest rate spreads.

Concluding Remarks

In conclusion, there is one final point I would like to make about our reform efforts with the international financial institutions. A high priority with us is to make our own work with the institutions more effective and efficient. Currently, we are required to implement a very large number of mandates legislated by the Congress. These mandates including requirements for directed voting at the institutions, certifications, notifications, and reports. Our effectiveness in carrying our responsibilities with the IMF and the development banks could be strengthened if we are able to reduce and better rationalize these mandates. Some mandates go back 50 years. Some provisions overlap, or are inconsistent. We have 32 directed vote mandates, over 100 policy mandates, plus numerous reports, certifications, and notifications. We want the Congress to be fully informed, but numerous reporting requirements have increased the amount of time staff spends on these reports to levels that warrant serious concern. We would like to work with you to rationalize and focus our mandated requirements and reports.

Thank you very much. I would be pleased to answer any questions that you may have about the reform issues I discussed here, about our overall reform strategy, or about any other issues relating to the international financial institutions.