

Statement of Allan H. Meltzer on the
Report of the
International Financial Institution Advisory Commission

Senate Committee on Banking, Housing, and Urban Affairs

March 9, 2000

Mr. Chairman and Senators:

This is a proud moment for me. I have appeared many times as a witness before this Committee in the past. Today I appear as Chair of the International Financial Institution Advisory Commission to testify on the bipartisan report that the Commission released yesterday.

Congress asked the Commission to consider the changes that should be made in seven international financial institutions in light of the major changes in financial markets and the economic environment in recent decades and to report in six months. That was a very challenging assignment. It could not have been completed without a prodigious effort by the Commission and its staff. I am pleased to have had the opportunity to lead that effort and to have produced a substantive report that attracted bipartisan support.

Today, the six months are up. The Commission approved the report by an 8 to 3 vote. In two cases, we voted unanimously. My testimony concentrates on the IMF. My colleague, Professor Sachs, will present the Commission's proposals for the multilateral development banks.

The Commission agreed unanimously at the outset that, to fulfill the mandate that Congress gave us, it was best to start by answering the question: How, if at all, should the international financial institutions be restructured to meet current and prospective economic and financial conditions? That question focused our attention on the benefits to the United States and the world from increased financial stability, reductions in poverty, and sustained growth in all parts of the world economy.

Proposals for Change

The Commission accepted some basic criteria for judging the changes it proposed. The changes should: (1) increase transparency, (2) improve accountability, (3) reduce corruption in the countries receiving assistance, and (4) greatly increase effectiveness of IMF and development bank programs. The Commission found no reason why the development banks and the IMF should each have poverty reduction programs. Duplication reduces accountability and wastes resources that could be better used to finance programs. The Commission voted unanimously that “the International Monetary Fund should restrict its lending to the provision of short-term liquidity. The current practice of extending long-term loans for poverty reduction and other purposes should end.”

The Commission was unanimous also that all international financial institutions—the IMF and the development banks—should write off all claims against heavily indebted poor countries (HIPC) that implement an effective economic and social development strategy in conjunction with the development banks. Our report makes clear what we mean by an effective development strategy.

The Commission made several recommendations to strengthen the IMF and reduce the frequency and cost of financial crises. While the IMF's role as a quasi-lender of last resort is still needed in emergency circumstances, the IMF's lender-of-last resort operations need fundamental restructuring. Current practices are rife with moral hazard. The expectation of future IMF bailouts helps to fuel the volatile short-term capital flows that have played a key role in recent crises. Therefore, with a phase-in period of up to five years, member governments should have to satisfy pre-conditions if they seek to borrow emergency IMF funds in the future. The conditions should be redesigned to prevent crises, not just to respond to them after they occur.

The Commission identified four such pre-conditions. First, governments should ensure the adequate capitalization of domestic banks, so that these banks won't have to be bailed out by the IMF. Second, the banking systems in the emerging markets should be opened to the participation of foreign banks, in order to increase the capital base and efficiency of the banking sector and reduce corruption. Opening the banking system to foreign banks that make long-term commitments to the country reduces reliance on volatile short-term capital flows. Third, member governments should commit to fiscal standards so that IMF funds do not merely feed fiscal profligacy. Fourth, governments should guarantee much more timely and accurate financial information, so that markets are no longer subjected to wild swings of euphoria and panic because of the delayed availability of crucial financial information. The Commission recognizes that rare emergencies on a global scale might still arise in ways not foreseen today. Thus, if a truly global financial crisis explodes, the IMF should retain freedom of maneuver even in cases where key countries do not qualify for loans.

Other long-standing traditions of lender-of-last resort operations should also be observed. The IMF lending should be short term, not stretching out over years (or even decades!) as currently. The loans should be at penalty interest rates, so that governments

would come to the IMF as a last resort, not first resort. And there should be a clear doctrine of IMF priority over all other creditors, so that IMF funds would truly be repaid in the future, and private creditors would have to take their lumps as necessary when they have over-lent to sovereign borrowers.

Under these recommendations, the IMF would remain an integral and useful part of the global system, but in a very different form than now. Rather than routinely lending, year in and year out, to fifty or more countries, there might be a handful of emergency operations in a year. The IMF would stop trying to micro-manage the governments of the developing world, vainly hoping that they will follow the dozens of conditions often attached to IMF lending programs. The terms for borrowing, in those emergency cases when needed, would be based on pre-qualifications, rather than conditionality. The borrowing would be short-term, not indefinitely renewable long-term finance. The IMF would still play an important role in annual consultations with its member governments about the appropriateness of macroeconomic and financial policies, but these consultations would be advisory, not linked to borrowing from the IMF. And of course the IMF would continue to play a role in information dissemination, through its useful work of standardization of global data and its frequent and widely read publications.

The IMF would have a stand-by role. It would act in a crisis, but it would not rush in with loans that can be used, and have been used, to let bankers and other favored lenders escape the risks that they voluntarily undertook and for which they receive a premium payment.

Many of the worst crises occur when there is a financial collapse in a country with pegged exchange rates. Both successful and unsuccessful defenses of a pegged exchange rate require large expenditure of foreign exchange reserves that could be used for investment or consumption. Both also require strong deflationary measures that severely reduce income, wealth, and living standards. The report recommends that the IMF counsel

countries to avoid pegged exchange rates. Countries should adopt one of two exchange rate systems: Exchange rates should either float or be rigidly fixed, for example by adopting a currency board or dollarization.

The Commission recommends that the IMF (and all other international financial institutions) increase the transparency of their operations. The IMF should start by making long overdue changes in its accounting practices. The report offers some desirable changes. If adopted, the changes would permit the public and interested public officials to see at a glance how much the IMF has available to lend, the amount of its outstanding commitments, and the size of country borrowing.

A Bipartisan Approach

The report takes a bipartisan approach. The Commission voted on its principal recommendations several times in the course of its deliberations. These “straw votes” were taken to guide the Chair and the staff in drafting the report. Votes were overwhelmingly positive and bipartisan, 8 to 1 or 9 to 1 in favor of the recommendations. (During most of its deliberations, the Commission had only ten members. One of the original appointees resigned before the Commission met.) One member who was part of the majority on these straw votes announced that he would vote against the final report because it did not make a statement in support of worker rights. The majority agreed that issues about worker rights were far from the Commission’s mandate and expertise.

Before the report was released, some critics complained that the Commission’s recommendations would destroy the IMF. I am sure that we have not heard these charges for the last time. I want to state clearly that these charges are false. The fact is that the Commission explicitly considered abolishing the IMF. Some members supported that

position. Two members wrote statements, as part of the Commission's report, supporting the majority position, but added that they would have preferred to recommend terminating the IMF. That was not the majority position. The Commission operated under "sunshine" rules, so the discussion and votes on this issue, and all others, are part of the public record. They can be found on the Commission's web site, and they will soon be published with the rest of the Commission's papers and proceedings.

Further, when the report had been drafted but not yet voted on in its entirety, the Chair and members of the senior staff spent many hours presenting the principal recommendations to policymakers and their staffs. We asked for comments, criticisms and suggestions. Since we report directly to six committees of the Congress, we offered to brief the Chair and Ranking Minority Member of each committee. Several accepted our offer. Others suggested that we brief their staff. We met all of these requests. We also presented our principal recommendations for the IMF to the Treasury's senior staff, the Secretary of the Treasury, the Acting Managing Director of the IMF and his senior staff, the head of the President's National Economic Council, and many others.

No one at these meetings commented that our recommendations would damage, much less destroy, the IMF. I do not want to suggest that everyone agreed with our recommendations on all points. That would be an overstatement.

Dr. Stanley Fischer, now the Acting Managing Director of the IMF, testified before the Commission. His written and verbal statements are part of the public record. These statements show a willingness to consider seriously several of the Commission's proposals.

In particular, Dr. Fischer:

- (1) gave examples of successful IMF programs where the IMF gave advice and technical assistance but provided no financial aid;

- (2) agreed that debt relief for the poorest countries should be given only to countries that adopt appropriate policy changes;
- (3) agreed that the “issue of repeated borrowing needs to be dealt with”;
- (4) recognized, as the Commission did, that the evidence on conditional lending to countries in distress shows improvements mainly in the balance of payments and a temporary decline in output followed by a resumption of economic growth from the lower level reached after the crisis;
- (5) suggested, as the Commission recommended, that it was appropriate “to move in the direction of Bagehot’s classic prescriptions for the lender of last resort”;
- (6) recognized the value of pre-conditions for lending but added that countries that did not meet the pre-conditions should pay a rate above the penalty rate instead of being denied assistance; and
- (7) concluded “we are likely to see emerging market countries moving toward the two extremes, of either a flexible rate or a very hard peg”.

Many of these recommendations are central features of our proposals. Differences with the Acting Director on these central recommendations are not great. A larger difference may arise on other issues, such as whether conditional lending should continue or whether the IMF should continue to operate poverty programs instead of making the development banks responsible and accountable for reductions in poverty.

Mr. Chairman, the IMF, the development banks, and the rules that fostered freer trade and more open markets are part of the successful postwar system. Under that system, the rule of law has spread and democratic government has taken root in many countries where it was not known heretofore. More people in more countries, both developing and developed, have experienced larger increases in living standards than in any prior fifty year period. Our bipartisan proposals seek to continue that remarkable progress by extending the rule of law, maintaining open markets

for goods and capital, enhancing economic stability, sustaining growth, economic and social development, and reducing poverty.