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Mr. Chairman, it is an honor and a pleasure to be here today to discuss the recommendations of the Meltzer Commission. *I'd like to summarize my written statement, and I wish that it also be included in the record.*

Since our Report was published, it has become clear to me that two separate debates are being waged over the new “financial architecture” – a narrow (visible) debate over the technical aspects of specific proposals for designing mechanisms to achieve well-defined economic objectives, and a broader (less visible) debate over whether the IMF, the World Bank, and the other development banks should have narrowly defined economic objectives or alternatively, be used as tools of ad hoc diplomacy. Until we settle that second, broader political debate, we cannot seriously even begin the constructive dialogue over how best to achieve economic objectives. Although open opposition to the Meltzer Report generally focuses on its details, behind closed doors ^{many} critics are candid about their primary reason for objecting to our proposals: “Forget economics; it’s the foreign policy, stupid.” For proposed reforms to succeed, then, they must face the challenges

posed not only by economic logic, but by the political economy of foreign policy.

The Commission's recommendations make sense as economics (that is, they were derived from logic and evidence in a sensible way). Just as important, the principles on which they are based are valid ethically and politically – specifically and most importantly, our premise that the World Bank and the IMF should not and cannot continue to serve the ad hoc political purposes of broad foreign policy.

The Meltzer Report begins with a well-defined set of economic objectives and political principles, and suggests mechanisms that would accomplish those objectives within the confines of those principles. The economic objectives include: (1) improving global capital market liquidity, (2) alleviating poverty in the poorest countries, (3) promoting effective institutional reforms in the legal and financial systems of developing countries that spur development, (4) providing effective global public goods, e.g., through programs to deal with global problems of public health (particularly, malaria and AIDS), and environmental risks

in developing countries, and (5) collecting and disseminating valuable economic data in a uniform and timely manner. The Commission viewed liquidity provision during crises, macroeconomic advisory services, and data collection and dissemination to be appropriate missions of the IMF, and saw poverty alleviation, the promotion of reform, the provision of global public goods, microeconomic data collection and dissemination, and related advisory services as the central missions of the development banks.

We identified six principles that any credible reform strategy should satisfy, and which underlie our proposals: (1) respecting member countries' sovereignty, (2) clearly separating tasks across institutions, (3) setting credible boundaries on goals and discretionary actions, (4) judging policies not by their stated objectives but by their effectiveness, (5) ensuring accountability of management through clear disclosure, accounting, internal governance rules, and independent evaluation of performance, and (6) sharing the financial burden of aid fairly among benefactor countries.

We began by evaluating the performance of the IMF, the World Bank, and the other development banks against the touchstone of these goals and principles and found these institutions quite deficient. They often failed to achieve their goals, even by their own internal measures.

Why is the IMF so ineffective? For one thing, the IMF's crisis lending mechanism is not designed to fulfill the role of providing effective liquidity assistance. Liquidity crises happen quickly. There isn't time to enter into protracted negotiations, or to demonstrate that one is an innocent victim of external shocks (as the IMF's stillborn contingent credit facility mandates). If the IMF is to focus on liquidity assistance, and if liquidity assistance is to be effective, there is no viable alternative to having countries pre-qualify for lines of credit. The current IMF formula of taking weeks or months to negotiate terms and conditions for liquidity assistance, and then offering that assistance in stages over a long period of time, simply is a non-starter if the goal is to mitigate or prevent liquidity crises.

IMF and development bank lending – which entails substantial subsidies to borrowing countries – does, however, manage to transfer resources to debtor countries during severe economic crises. But those transfers do not seem to improve securities markets or spur growth; rather, they are put to use for less laudable goals – most notoriously, for shady transactions in Russia or the Ukraine. But it’s the “legitimate” uses of IMF and development bank emergency loan subsidies that are even more troubling, especially their use in facilitating the bailouts of insolvent domestic banks and firms and international lenders, which ultimately are financed mainly by taxes on domestic residents.

Consider the current IMF program being established with Ecuador. Ecuador has been suffering a deepening fiscal crisis for several years. As yet, there is no consensus for reform in Ecuador, and there is no reason to believe that reforms will be produced by a few hundreds of millions of IMF dollars. Why in the world is the IMF sending money to Ecuador? Some observers claim that IMF aid to Ecuador is best understood as a means of sending political payola to

the Ecuadoran government at a time when the United States wishes to ensure continuing use of its military bases there monitoring drug traffic. Will that sort of IMF policy be likely to produce the needed long-run reforms in fiscal and bank regulatory policy? Hasn't the IMF learned anything from the failure of its lending to Russia in 1997-1998?

Argentina, perhaps more than any other country, has depended on IMF conditional lending over the past several years to maintain its access to international markets. It is now widely perceived as ^{possibly} on the verge of a public finance meltdown, which many commentators blame, in part, on the IMF and U.S. Treasury. IMF support, in retrospect, was counterproductive because it put the cart of cash ahead of the horse of reform. Now Argentina is faced with ^{a growing, and possibly} an unsustainable debt service burden. Furthermore, at the IMF's behest, Argentina substantially raised its tax rates last year, choking off its nascent recovery. Instead, Argentina should have cut government expenditures. The notion that tax hikes are an effective substitute for expenditure cuts as a means of successful fiscal reform is an article of faith at the IMF, but unfortunately, one that is

~~utterly~~ at odds with the evidence. The chronology of policy failure in Argentina is aptly summarized in a recent financial markets newsletter: ✓

“Between 1996 and 1999, the IMF and IDB all but led the marketing effort for Argentina bonds. The two institutions voiced strong endorsements each time that there was a confidence crisis in Argentina. The IDB went so far as to dispatch its most senior economist to New York last summer to recommend that U.S. portfolio managers buy Argentine bonds. At the same time, the Street came to realize that the U.S. Treasury was the real force behind the IMF and IDB support for Argentina. It was never clear why there was such unwavering support. The motivation could have been geo-political. Argentina was a staunch supporter of U.S. political policies around the world and across the region. Argentina was also the poster-child of the so-called Washington Consensus. ...Therefore, the U.S. needed Argentina to succeed. At the beginning of the year, when the Machinea team traveled to Washington to seek a revised Standby Facility, the team met first with the U.S. Treasury before meeting with the IMF and the World Bank.

These actions sent clear signals to the market that the country had an implicit guarantee from Washington. Otherwise, it would have been irrational for any creditor to lend so much money to such a leveraged country with such little flexibility.”

How Argentina will ^{extricate itself} ~~exit~~ from its current ^{debt trap} ~~debt crisis~~ is unclear. What is clear, however, is that the U.S.

Treasury/IMF-sponsored debt inflows and tax hikes of the past several years ~~have~~ put Argentina ^{into this risky} ~~in an unsustainable~~ position. More market discipline, less U.S. Treasury/IMF “assistance,” and less debt, at an earlier date would have encouraged the needed reforms of government expenditures and labor market regulations.

The World Bank’s record, and the records of the regional development banks, in sponsoring successful programs are also poor. The World Bank’s internal evaluations of performance (which are made shortly after the last disbursement of funds) identify more than half of its projects as failing to achieve “satisfactory, sustainable” results.

The multilaterals do not follow the principle of separation. The IMF's mission warrants short-term lending, yet the IMF typically makes long-term loans. Seventy-three countries have borrowed from the IMF in more than 90% of the years they have been members of the IMF. The development banks participate in short-term emergency lending, despite the fact that this is not consistent with their long-term focus on development, and even though their managements sometimes privately complain about having to do so.

There is little disclosure of relevant information about accounting or decision making. In the case of the IMF, its own staff admits that its accounting system is an exercise in obfuscation:

“The cumulative weight of the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for

which the balance sheet...contains no information whatever on the magnitudes of its outstanding credits or its liquid liabilities. More seriously, the Fund's outdated financial structure has been a handicap in its financial operations."

Proposals for Reform

The Meltzer Commission's recommendations for reform follow directly from the perceived gap between actual performance of these institutions and the combination of bona fide objectives and principles that we viewed as non-controversial. With respect to the IMF, the Commission *unanimously* voted to end long-term lending. The 8-3 majority went further, recommending that the IMF focus on maintaining liquidity for emerging economies.

By providing lines of credit to countries (in general, those that meet minimal pre-established standards), and by lending to them as a senior creditor at a penalty rate, the IMF could prevent avoidable liquidity crises without sponsoring counterproductive bailouts of banks at taxpayers' expense.

With respect to the development banks, for poverty alleviation, we recommended relying on grants to service

providers with independent verification of performance, rather than loans earmarked to governments, as a mechanism more likely to deliver results.

With respect to promoting institutional reform, the Commission proposed making loans to governments at highly subsidized rates, but only *after* they had passed laws establishing reforms. The maturity of those loans would be extended (and thus the subsidies increased) conditional on the continuation of reforms – that is, only if independent verification indicates that promised reforms are continuing on track.

The Commission also voted *unanimously* that the IMF and the development banks should write off all claims against the highly indebted poor countries (HIPC)s once those countries have established credible development programs.

Reactions To the Report

Treasury Secretary Lawrence Summers, testifying before the House Banking Committee (while reserving the right to change his mind based on further reading of the Report) faulted the Commission on several specifics. In my

formal comments, I review each of the Secretary's concerns and explain why I believe they are misplaced. Let me touch on a few.

With respect to our proposals for reforming the IMF, Mr. Summers expressed several concerns. He claims that "few if any of the countries that have suffered financial crises in recent years...would have qualified for emergency IMF support." He goes on to recognize that the Commission recommended waiving prequalification standards in cases where global capital market stability was threatened, and that therefore, the Commission did not, in fact, recommend ruling out support to any country. Still the Secretary questioned, in light of our recommendation that prequalification could be waived, "how the rest of the Report's proposals in this area are to be interpreted and applied." He questioned whether many countries would prequalify for IMF support, and whether lending even to prequalified countries would create moral hazard problems (in comparison to the current practice of attaching "conditionality").

These criticisms are misplaced. We envision a phase-in period of five years for the new prequalification standards, and we think most emerging market countries would prequalify. Most or all of the crisis countries in Latin America and Asia would face strong incentives to meet our proposed standards, particularly since failing to do so would likely reduce their access to, and raise their costs of, private finance. If our proposed standards had been imposed, say, in 1990, the severe crises suffered by these countries (which largely reflected weaknesses in their banking systems and the incentives of those weak banks to take on enormous exchange rate risks) may have been averted, and certainly would have been far less severe.

Furthermore, it is hard to see how our proposed IMF lending arrangements would worsen moral hazard. Moral hazard depends on the expectation of receiving a subsidy. Under current IMF arrangements, countries borrow large amounts at highly subsidized rates. Under our proposals, there is no subsidy, and therefore, virtually no moral hazard.

Mr. Summers also criticizes our recommendations for reforming the development banks. He objects (1) to limiting emergency lending to the IMF, (2) to our proposal to target country-level assistance to the poorest countries, and (3) to the use of grants rather than loans for poverty alleviation.

Our proposal to limit emergency lending to the IMF follows directly from the principle that separating the functions of the various multilaterals promotes greater effectiveness and accountability.

Nevertheless, the Commission Report envisions loans or grants from development banks to poor countries that have experienced crisis-induced trauma. We recommend that any assistance be channeled through appropriate long-term programs.

The Secretary also misunderstands the effect of our proposals on poor people who reside in developing countries with access to private capital markets or with per capita annual average incomes higher than \$4,000. He states that “the Report would rule out MDB support for the majority of the world’s poorest people.” That is not true.

Similarly, the Secretary's statement that "the Report's recommendations would drastically undercut the global role of the World Bank by limiting it to the 'knowledge' business" indicates a serious misunderstanding of our recommendations. We envision a substantial continuing role for the World Bank in providing financial assistance.

Finally, Mr. Summers' statement that "the shift to grant-based funding would drastically reduce the total amount of official resources that can be brought to bear in these economies" confuses the dollar amount of *lending* that the development banks currently provide with the dollar amount of *assistance* implicit in that lending (the amount of interest subsidy). Adam Lerrick of the Commission staff estimated that a grant-based program would support a volume of development projects for poverty alleviation and institutional reform 80% larger than that of the current loan-based programs.

"Forget Economics: It's the Foreign Policy, Stupid!"

Dealing with these detailed concerns, however, is the easy part of responding to critics' objections, and the less important part. Most critics of our proposals, including the

Secretary, have a deeper problem with our Report. They do not agree with our goals and principles. Specifically, many critics do not share the goal of narrowing the latitude of the IMF and the World Bank. To some, the IMF and the development banks should be used as cost-effective vehicles for “leveraging” U.S. foreign policy. From that perspective, any limits on the “flexibility” of these institutions are undesirable, as is transparency in accounting, open voting, independent evaluation of performance, and other procedural reforms we suggest, since they only get in the way of flexibility. Indeed, to those who view the multilaterals this way, their principal advantage is the absence of accountability.

Consider, for example, the ^{recent} ~~current~~ negotiations ~~underway~~ between Pakistan and the IMF. A knowledgeable insider informs me that the United States government has told Pakistan that its access to IMF subsidized lending depends on its willingness to sign a nuclear non-proliferation treaty. ~~This is not discussed openly at the IMF or in public, but it is an open secret that this is the deal on offer to Pakistan.~~ Unless it agrees, the

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U.S. will block its IMF program. In this case, the U.S. foreign policy objective seems laudable, but is the IMF the right tool for achieving it?

The view that the multilaterals should serve the broadly and flexibly defined goals of U.S. foreign policy is wrong for at least five reasons.

First, the flexibility necessary to permit the multilaterals to serve as broad foreign policy devices undermines their effectiveness as economic mechanisms. When the objectives of poverty reduction and institutional reform take a back seat to ad hoc foreign policy it is no surprise that aid mainly flows to the richest and most powerful of the emerging market countries, or that the IMF and the development banks maintain so poor a track record. There is no more important goal for American foreign policy than promoting stable economic development around the world. We should design multilateral institutions that are able to meet that challenge. Saddling those institutions with broader political mandates that weaken their ability to achieve bona fide economic objectives is counterproductive.

Second, the use of multilaterals to pursue broad foreign policy objectives forces the management of these institutions to depart from clear rules and procedures in order to accommodate ad hoc political motivations. This undermines their integrity as economic institutions, makes it hard to establish norms for the conduct of management and mechanisms to ensure their accountability, and leads to erosion of popular support for funding the important economic goals on which they should be focused.

Third, the subversion of the process of Congressional deliberation over foreign aid appropriations is no small cost to bear, even in the interest of pursuing desirable foreign policy objectives. It is beneath us as a democracy to sanction such behavior.

Fourth, it is worth considering the adverse impact that loans from multilateral lenders with non-economic objectives can have on emerging market countries. The debt burdens that plague the HIPC's today are primarily the result of inter-governmental or multilateral loans that were politically motivated, not private or public lending made to finance credible investments.

Finally, it may not even be feasible for the United States to continue to use multilateral financial institutions as an extension of U.S. foreign policy. A decade from now the global economy will be much more polycentric. Multilateral agencies focused on bona fide economic objectives will fit the global economy of the future better than the current structure, which is rooted in and subservient to the broad goals of U.S., or G7, foreign policy.

In the post-World War II era being an “internationalist” meant understanding the central importance of the strategic political struggle between the United States and the Soviet Union, and the need to make economic policy subservient to that struggle. But as the polycentric post-Cold War global polity and economy take hold, it will become increasingly apparent that the United States neither should, nor can, use the World Bank and the IMF as a tool of leveraged, “stealth” foreign policy.

The Meltzer Commission Report has provided a credible starting point for reforming the multilateral financial institutions, and has persuasively argued that it is

high time to begin that process. Before reform can begin, before these institutions can operate as effective economic mechanisms, they must narrow their focus, regain credibility as organizations, and recapture the trust of the taxpayers that finance their operations. And before any of that can happen, the developed countries, and especially the United States, must resolve the often unspoken controversy over whether these organizations should act as foreign policy slush funds or as bona fide economic institutions. That is the first step toward real reform.

Thank you, Mr. Chairman.

Senate bill seems like a waste of ink, and will not produce any meaningful reforms. It seems tailor-made to accomplish the objective of appearing to do something, while actually doing nothing.

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No bill would be better than this one, in my opinion.