

Reform of the International Monetary Fund

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It is a pleasure to testify before the Committee again concerning your ongoing oversight of the International Monetary Fund. The topic remains of great importance and our Institute for International Economics will in fact be holding a major conference on IMF reform on September 23 to address a number of specific proposals for strengthening and enforcing the rules of the monetary system, improving the governance of the Fund itself, reforming its lending programs and reassessing the ways in which it might be financed in the future. All members of the Subcommittee and staff are cordially invited to participate in our event!

Exchange Rates in China and East Asia

The most important and urgent issue facing the international monetary system and the IMF at the present time is the huge imbalance in major national economies and exchange rates. The global current account deficit of the United States is very large (nearing an annual rate of \$800 billion, almost 7 percent of our GDP) and growing rapidly. The global current account surplus of China is very large (over \$100 billion this year, about 6 percent of its GDP) and also growing very rapidly. A number of other Asian countries – most notably Japan but also Korea, Taiwan, Hong Kong, Singapore and

Malaysia – are also running substantial global surpluses that are the counterparts of the US global deficits.

We in the United States must lead the correction of these imbalances by raising our rate of national saving so that we will not be so reliant on inflows of foreign capital – which we must now borrow at the rate of \$5 billion every working day – and thus condemned to run the counterpart current account deficits, which generate enormous pressures for trade protection (which are now being rapidly realized, especially against China) as well as huge international financial risks. This requires a combination of restoring the budget surpluses that we were running just a few years ago, to reduce public dissaving, and increasing our pitifully low rate of private saving.

One essential element of the global correction will be a further large decline in the exchange rate of the dollar, probably by at least 20 percent on a trade-weighted average against the currencies of our major trading partners. The dollar has already declined substantially against the currencies that float freely in the exchange markets: notably the euro, pound, Swiss franc, Canadian dollar and Australian dollar. The next phase of the dollar's decline needs to take place against the currencies of the East Asian countries that are running the world's largest surpluses and have the world's fastest growth rates – but have intervened massively in the exchange markets to block any appreciation of their currencies at all (China, Malaysia) or to limit that appreciation far below what market forces would have produced.

China is the key country. Its surplus is now the largest among the major Asian economies as a share of its economy. It has been increasing its competitiveness by riding the dollar down against most other currencies, thus achieving a trade-weighted

depreciation of about 10 percent over the past three years. Moreover, the other Asian countries (from Japan to India) are terrified of losing competitive position against China so will resist the rise of their currencies against the dollar as long as doing so also means rising against the renminbi. The need for appreciation of the Asian currencies is particularly acute from a US standpoint now that the euro, which had risen 65 percent against the dollar from its lows of late 2000 to its peak earlier year, is under downward pressure as a result of the apparent rejection of the proposed constitution for the European Union.

It is the responsibility of the International Monetary Fund to take the lead in promoting correction of such huge, costly and potentially destabilizing imbalances in the world economy. The Fund's Articles of Agreement in fact enjoin member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other member countries" (Article IV, Section 1, paragraph iii). In 1977, early in the era of floating exchange rates, the Fund laid out principles for its surveillance over members' currency policies that identified "protracted, large-scale intervention in one direction in the exchange markets" as indicating a need for Fund discussion with the offending country.¹

China clearly meets these criteria. (So does Malaysia and so would have Japan until it ceased its massive intervention a little over a year ago.) Our own Treasury indicated as much in its latest semiannual report to the Congress, after whitewashing

¹ A complete analysis of this issue can be found in Morris Goldstein, "The International Financial Architecture," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (Institute for International Economics, 2005). Goldstein also suggests a number of other important IMF reforms that should be pursued in the near future.

China's behavior for several years and still inexplicably failing to label it explicitly as a "currency manipulator" as called for under the relevant statute of US law.

The International Monetary Fund, however, appears to have limited its activity on this issue to quiet efforts to persuade China to reform its currency regime (as opposed to raising upward its exchange rate). It apparently was unwilling to endorse the critique of China's policy in the latest Treasury report, incomplete as that was.

The Fund is of course a creature of its major member countries, especially the United States and the rest of the G-7, so the responsibility lies with those governments at least as much as with the institution itself. Part of the problem is that the US Treasury and the rest of the G-7 have, at least until very recently, been proposing the wrong thing: they have been asking the Chinese to float their exchange rate, which is neither desirable (because it might float down, worsening the current account imbalances) nor feasible (because the Chinese banking system is far too fragile to support anything resembling a true float, especially with a sharp reduction in China's capital controls), rather than for the sizable one-shot revaluation of perhaps 25 percent that is essential to make a substantial contribution to reduction of the global imbalances.²

The Fund, with its systemic and global responsibilities, should nevertheless have been making a much more forceful and much more pragmatic effort to bring the global imbalances back under control. To its credit, it has been vocally pushing the United States to initiate (especially budget) actions that would reduce its external deficits. It has likewise been urging the Europeans to implement structural reforms to accelerate the

² Our estimate at the Institute for International Economics is that a Chinese revaluation of 25 percent and upward appreciations of one half that much by the other East Asian countries would reduce the US current account deficit by about \$60 billion after the full effects phased in over two to three years. The US gain would be at least \$100 billion if the exchange rates of the other Asian countries rose by the full amount of the Chinese move.

growth of domestic demand in their economies, to offset the adverse impact they will experience from the declines in their trade surpluses that are an essential counterpart of reduction in the US deficits. Without much stronger support from the G-7 countries, however, notably including the United States itself, there is little that the Fund can do to achieve realization of such policy alterations – including with respect to the Chinese and other East Asian exchange rates.

Argentina

Another key question facing the IMF at present is its relationship with Argentina as that country emerges from its traumatic depression and debt crisis. The Fund badly mishandled Argentina virtually throughout the run-up to that crisis. It endorsed the country's rigid currency peg, even as it was becoming increasingly overwhelmed, and failed to insist on fiscal tightening during the boom period of the middle 1990s, setting the stage for the escalation of budget deficits and debt that brought on the biggest default in modern history when things turned sour. It then prolonged and deepened the agony by lending large amounts that enabled the Argentine authorities to further postpone the policy changes whose necessity had become blindingly obvious.³

At the same time, the lessons of the Argentine crisis for the international monetary system and the IMF are not yet clear. Argentina itself is recovering briskly. It is now receiving so much foreign investment that its currency is rising and it has recently adopted restraints on capital inflows. The global financial system suffered little contagion from the Argentine episode, despite the country's being both the largest borrower among emerging market economies and engineering the largest sovereign

³ The full story is in Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Institute for International Economics, 2002).

default in modern history. Emerging market economies are receiving near-record capital inflows so no significant “chilling effect” can be discerned at least for now. The apparent “success” of the Argentine default strategy does not seem to have tempted other countries to pursue a similar strategy and Brazil next door has in fact been a model of rectitude even under the Lula government.

All these results will of course need to be stress tested during the next global economic downturn and sharp rise in world interest rates before firm systemic conclusions can be drawn. One close observer of the process concludes that “Argentina’s crisis has done little so far to validate or discredit the idea of statutory sovereign bankruptcy” but adds that “It achieved impressive debt relief in a reasonably short time frame without either CACs (collective action clauses) or bankruptcy.”⁴

Debt Relief and IMF Gold Sales

Another operational issue confronting the Fund is whether to relieve some of its poorest member countries of their debt to the Fund itself (now about \$6 billion for the forty or so countries identified as Heavily Indebted Poor Countries, or HIPC’s) and, if so, how to finance the resulting impact on the Fund’s balance sheet. The most promising candidate is use of the Fund’s own gold reserves, which are worth more than \$40 billion. A limited version of this idea, which enabled the Fund to mobilize profits on its gold holdings without actually selling any of them into the market, was actually implemented in 1999 and yielded about \$2 billion for debt relief.

There is considerable debate over the desirability of debt relief as a mechanism for providing assistance to poor countries. Whatever the economics of the issue,

⁴ Anna Gelpern, “What Bond Markets Can Learn from Argentina,” *International Financial Law Review*, April 2005.

however, it is clear that this particular channel attracts more political support than most other methods of providing foreign aid. In addition, our own careful study of the issue suggests that debt relief has a number of advantages over more traditional forms of aid: increasing ownership of their development program by poor countries because of their greater autonomy in using the funds, reduced transaction costs, increased fungibility and hence utility of the resources, elimination of tying, and freeing donor countries of the need to extend new aid to the debtor countries simply to finance repayments of existing debt. We advocate several important changes in existing debt relief techniques but support the basic strategy, including through mobilization of another portion of the IMF's sterile gold stockpile.⁵

A related issue is whether the IMF should continue to lend to the world's poorest countries through its Poverty Reduction and Growth Facility (PRGF). This is one of the few issues, along with the desirability of comprehensive debt relief itself, on which there was unanimous agreement among the members of the Meltzer Commission: that the IMF should get out of the business of making poverty reduction loans. My own proposal, however, is not to eliminate the PRGF but rather to transfer it to the World Bank, whose primary mission is poverty reduction in poor countries. This would *inter alia* clear the decks for the IMF to extend debt relief to those poor countries without placing itself in the self-contradictory position of then extending new loans to the very same countries that had just been judged incapable of paying their existing debts.

⁵ The full analysis is in Nancy Birdsall and John Williamson, *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture* (Center for Global Development and Institute for International Economics, 2002).

Meltzer Commission Report

These were among the very few issues, however, on which there was agreement on the Meltzer Commission. I have testified to this Subcommittee or the full Banking Committee on these differences on a number of occasions including in March 2000 upon the release of the Commission's report, in April 2000 and most recently in May 2004. As the author of the dissenting minority report, I am pleased that the US Treasury and the G-7 Finance Ministers rejected the main proposals of the majority almost immediately and that those proposals mercifully enjoyed a very brief period of serious consideration.

Suffice it to note today that the majority's proposals look even worse in retrospect, if that is possible, than they did when issued. They would clearly not have precluded the mistaken program for Argentina described above because Argentina, which was (mistakenly) the Fund's "poster child" for much of the 1990s, would almost certainly have been deemed to meet the majority's requirements for prequalification for Fund assistance. Former IMF chief economist Michael Mussa notes that "On the criterion of having a sound banking system, with widespread participation of foreign banks, Argentina was clearly outstanding...and it was particularly praised in this regard by one of the members of the Meltzer Commission majority. Presumably, on those grounds (my note: which were the majority's chief criteria), under the Commission's proposals, Argentina would have qualified for a very large package of pre-committed support."⁶

On the other hand, the Meltzer Commission majority's requirement would almost certainly have precluded the very successful Fund program for Brazil (and the program for Turkey, whose ultimate outcome is less clear but which has succeeded to date). Their proposals to shut down several major sources of funding for poor countries, including the

⁶ Mussa, *Argentina and the Fund*, p. 73.

regular lending program of the World Bank, fly in the face of the revealed preferences of virtually every rich country in the world (including our own, in both the Administration and the Congress) to sharply increase the flow of resources to counter poverty and underdevelopment. I hope we can focus today's discussion on issues of current and future relevance rather than rehashing stale debates that were closed out for all practical purposes half a decade ago.