International Monetary Fund Reform

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Mr. Chairman and members of the Committee: It is a privilege to have this opportunity to review progress on reform of the International Monetary Fund (IMF). I commend the Chairman and the members for their continued interest.

I am pleased to report that there has been progress on central issues. On other important issues, much is unfinished, and in some cases, unstarted. From the comprehensive list of topics proposed by your staff, I have chosen to discuss progress toward the adoption of recommendations of the Meltzer Commission, but I touch on other questions that the staff raised.

In the view of the Meltzer Commission, the IMF has two main tasks. Its most important activity is to increase the stability of financial markets or, if crises cannot be prevented, to localize problems or crises and keep them from spreading to countries or markets that would be unaffected. A related but distinct activity is to reduce market risk by improving the quality and increasing the quantity of information available to lenders and creditors.

The IMF has made a sustained effort to improve the quantity and quality of information on member countries. More is desirable. Especially needed are reductions in the time before information becomes generally available.

A remarkable change came to fruition this year. Argentina settled its defaulted debt with about 75 percent of its bondholders. This was the largest default ever, and it involved tens of thousands of individual debt holders and many separate debt issues. Coordination did not, at first, seem promising, but it was achieved without outside intervention.

Unlike earlier practice, the IMF was not a party to the negotiations. It did not make additional loans to Argentina to assist in the settlement and bailout the lenders. The settlement was based on decisions between the Argentine government and representatives of the bondholders. I am confident that in time, Argentina can settle with the remaining bondholders without IMF intervention. I consider this a big step forward because risks and returns were related. Lenders who received high interest rates on risky loans had to bear the risk when it came. This improves the functioning of markets and spares taxpayers from paying for lenders' errors of judgment.

Also Argentina's financial problems were mainly confined to Argentina. When they threatened to spread to its neighbor, Uruguay, the IMF arranged a large loan. This is keeping with its principal function – preventing the spread of crises.

In its response to Argentina and Uruguay, the IMF followed the spirit and often the letter of the Meltzer Commission recommendations. It was not always so. The Meltzer Commission made two unanimous recommendations. The first called for writing off "all claims against heavily indebted poor countries (HIPCs) that implement an effective economic and social development strategy." The second called on the IMF to limit its lending to short-term loans leaving long-term loans for poverty reduction to others. Instead, the IMF created the Poverty Reduction and Growth Facility (PRGF). The IMF had no special expertise in economic development and poverty reduction. These problems should be left to the World Bank. While I agree with those who say that the development banks are ineffective, unfocussed and should be thoroughly reorganized, duplication of their work at the IMF is not the right solution. The PRGF should be closed.

The IMF, the World Bank, and the G-7 countries have not agreed on rules for debt relief for several of the heavily indebted poor countries (HIPC). Some agreements have been made, and countries have agreed to use the resources released thereby for education and health. Great Britain is pressing for new agreements at the 2005 summit in Scotland.

Part of the discussion of debt relief is misleading. The HIPC countries do not actually service most of their debt. To prevent default, the IMF lends the country enough to make payments, increasing the countries' indebtedness. A HIPC country receives credit for payment but little or no new money. Debt relief, as usually discussed, is actually a way of increasing HIPC country borrowing. It would increase the countries' available resources, since debtors would receive the same payment but would not have it offset by a debt service payment of similar size to the IMF. The net transfer would increase.

The main issues in current discussions are how the transfer should be financed and how the increased net transfer should be used to improve social and economic conditions. Gold sales by the IMF are one option that has been proposed. As you know, the Congress wisely disallowed the sale of the U.S. gold deposit at the IMF without its consent. The gold should be returned to the members and revalued by them. Part of the profit could be used to reduce HIPC debt.

One of the Meltzer Commission's main recommendations called for replacement of conditional loans with loans based on a limited number of pre-conditions accepted in advance by the troubled country. The purpose of this proposal includes reducing risk, increased incentives for reform, and giving the borrowing country a large part in the choice of policies. To its credit, the IMF has reduced substantially the number of conditions attached to its loans. It considered, but did not adopt, pre-conditions. As part of the comprehensive review of its strategy that is now underway, it proposes that future lending should be “anchored in strong country ownership.” (IMF Survey, 34, number 7, April 25, 2005, 105)

This is a good step away from the command and control of the 1990s based on the so-called Washington consensus. “Ownership” means that the country has a major role in the choice of policies. Much evidence suggest that reform is made more likely when political leaders in the country choose it, support it and decide to implement it. The Fund’s own research suggests that much of the time countries did not implement the conditions to which they agreed to get a loan.

Pre-conditions reduce risk in other ways. Countries that avoid pegged but adjustable exchange rates, improvident fiscal and inflationary monetary policies, and weak financial systems are more prone to crisis. Reducing or removing these sources of instability reduces the chance of a crisis. Further, negotiated pre-conditions accepted in exchange for a commitment to assist in a crisis reduce the long delay that often occurs before assistance is given.

A critical part of this proposal is that countries would have greatly increased incentives to reform. If they did not agree to pre-conditions, they would not be eligible for assistance. This, alone, increases the incentive for reform. But this incentive increases because lenders would distinguish between countries that adopted reforms and those that did not.

The international private capital market is the principal supplier of loans. It offers 5 to 10 times the volume offered by international financial institutions. The private market would offer more loans at lower interest rates to countries that adopt pre-conditions. Reformers in the countries could replace arguments claiming the IMF requires reform with citation of the benefits to the country, more capital at lower interest rates.

The IMF faces many possible challenges. Will other countries follow Argentina by defaulting and renegotiating debt? Will recognition of increased risk reduce the amount of lending? Does the large accumulation of reserves by Asian countries, and other recent changes, signal a decision by these countries to manage future crises without the IMF? Have the Asian countries taken a further step toward development of a regional financial bloc? If the IMF no longer bails out private lenders, will the private lenders object to the IMF's preferred creditor status?

The IMF's loans are heavily concentrated in the debts of a small number of countries. Will one or more of these countries default on the IMF?

We should recall that the IMF's original purpose included monitoring and maintaining a fixed exchange rate system. The IMF should take more responsibility for the exchange rate system to adjust under or overvalued exchange rates. It is well known that if more countries allowed their exchange rates to adjust, there would be fewer crises. Many observers claim that undervalued Asian exchange rates and the large U.S. current account deficit will end with a major financial crisis. They use the word "unsustainable" when they discuss the U.S. current account deficit. I am far from certain, even skeptical, about these claims. But we should recognize that there is a risk that will not be removed and may be increased, by an appreciation of China's exchange rate. In keeping with its original purpose, the IMF should try to implement a cooperative solution that revalues the yuan and reduces the U.S. deficit.

Finally, corruption is a major problem in some developing (and developed) countries. No one can rid the world of bribery and corruption, but the IMF could do more than it now does to limit corruption.