Statement Presented to the Committee on Banking and Financial Services

of the United States House of Representatives

by

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Mr. Chairman, it is a honor to have the opportunity of addressing you and the members of the Committee here today. Before summarizing my remarks, I would like to ask that the full text be entered into the record.

Mr. Chairman, the debate over the Meltzer Commission's proposals for reforming the IMF, the World Bank, and the regional development banks got off on the wrong foot last week, with calumny and caricature, as some critics mischaracterized our proposals, and others dismissed our recommendations as "isolationist" less than a day after the release of our report. I believe that those reactions reflect formidable obstacles that any reform blueprint for the international financial institutions will have to overcome. It is not enough to offer improved means for achieving economic objectives; it is necessary to overcome the powerful forces that resist transforming the multilateral lenders into bona fide economic institutions.

Our recommendations presume a well-defined set of goals for the multilateral financial institutions. These include ensuring global capital market liquidity (what we take to be the IMF's appropriate mission), alleviating poverty and encouraging crucial institutional reforms in the legal and financial systems of the poorest countries, and providing under-supplied global public goods that will spur development, improve public health, and protect the environment (what we take to be the goals of the development banks).

We identified six principles that any credible reform strategy should satisfy, and which underlie our proposals: (1) respect for countries' sovereignty, (2) separation of tasks across institutions (to avoid waste and counterproductive overlap, and to enhance accountability), (3) credible boundaries on goals and discretion (to prevent undesirable mission creep), (4) effectiveness of aid (ensuring that the mechanisms chosen to channel

assistance are likely to succeed and to avoid waste), (5) accountability of management through clear accounting and internal governance systems, and (6) fair burden sharing in financing aid.

That combination of goals and principles underlies our specific recommendations. 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 global liquidity. By providing lines of credit to countries that meet minimal standards, and 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.

For poverty alleviation, we recommend relying on grants to service providers, rather than loans earmarked to governments, as a mechanism more likely to deliver results. We recommend focusing aid on the poorest countries, where it is needed most (a distinct departure from current practice). And we suggest devolving much of the authority over country-specific programs that combat poverty or support institutional reforms to regional development banks, leaving the World Bank to pursue neglected global public goods provision, for example, in the areas of health and the environment. The Commission also voted unanimously that the IMF and the development banks should write off all claims against the highly indebted poor countries (HIPCs) once those countries have established credible development programs.

The challenges of global development policy invite a thorough debate about ways to design institutions that will effectively satisfy the goals and principles our Commission identified, and thus promote stable, sustainable development in emerging market economies. But recently it has become

clear that a second, less apparent controversy lies beneath the surface of the economic debate over reform – one that explains the acrimony of some of our critics.

Not everyone shares the goal of narrowing the latitude of these organizations. Some believe that the IMF and the development banks should be used as cost-effective vehicles of U.S. foreign policy. From that perspective, any limits on the "flexibility" of these institutions are undesirable, as is transparency in accounting, open voting, 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. Aid can be delivered, and the embarrassing deals that lie behind it are not easily traced. Time-consuming parliamentary appropriation debates can also be avoided. This point of view is not often voiced openly, but it is nevertheless a very important part of the current debate over reform.

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, which is counterproductive even from the standpoint of foreign policy. 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 of the emerging market countries, or that the development banks maintain so poor a track record, even by the standards of their own internal evaluations. In my view, 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, even from the perspective of foreign policy.

Second, the use of multilaterals to pursue broad foreign policy objectives undermines their integrity as economic institutions, and leads to erosion of popular support for funding the important economic goals on which they should be focused. It is ironic that some of the public officials who complain loudest about the reluctance of Congress to fund international organizations have done more than their share to produce the cynicism about these organizations that makes them so unpopular. The Meltzer Commission recommends substantial increases in the budgets of the development banks. But the popular support necessary to raise new appropriations will not be forthcoming until these institutions regain their credibility.

Third, the subversion of the process of Congressional deliberation over 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. If Congress wishes to delegate power over a limited amount of resources to a multilateral "political emergency fund" funded by the G7 countries, then let it do so openly, establish the appropriate governance and oversight to accompany that delegation of authority, and keep the management and funding of that entity separate from the other multilateral institutions. I am not recommending that such a fund be established, but rather suggesting that if it were, it should be created by, and be made accountable to, the governments and taxpayers who authorize and finance its activities.

Fourth, it is worth considering the adverse impact that loans from multilateral lenders with too broad a mandate can have on emerging market countries. The financial distress of the highly-indebted poor countries (HIPCs) is as much an indictment of multilateral lenders (and the governments that control them) as it is of the leaders in the borrowing countries who often wasted those funds or used them for personal gain, leaving their impoverished citizens with an enormous debt burden.

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. Progress in the global economy will make that approach to those institutions increasingly anachronistic. A decade from now the global economy will be much more polycentric. Europe and Japan are likely to enjoy a golden era of productivity growth over the next decade, as well as substantial improvements in the sophistication of their financial systems and increases in their living standards. Many emerging market countries – including Korea, Argentina, Brazil, and Mexico – will soon become full-fledged industrial nations, as well. Multilateral agencies focused on bona fide economic objectives, with a more decentralized administrative structure – one that relies more on regional development banks in Asia and Latin America, financed by new benefactor countries as well as the G7 – will fit the global economy of the future better than the current structure, which is rooted in and subservient to U.S. foreign policy. And a World Bank that can focus cooperative efforts among a growing number of benefactor countries to address global public health and environmental problems will be increasingly valuable for the same reason. Sooner or later, global economic progress will mandate the kinds of reforms our Commission is recommending.

Mr. Chairman, before turning the microphone over to my colleague, Mr. Lerrick, who will provide a detailed description of the Commission majority's proposals for reforming the development banks, let me describe in more detail our proposals for the IMF.

Our proposals would substantially strengthen the IMF's ability to combat liquidity crises, while avoiding counterproductive subsidization of bank bailouts, the intrusiveness and ineffectiveness of IMF conditionality, and IMF interference in sovereign debt restructurings. The details of the rationale for that approach can be found in the report, as well as the addendum to this testimony.

As I mentioned at the outset, the Commission voted unanimously to end IMF long-term lending (which is better left to the development banks, to avoid counterproductive overlap). The 8-3 bipartisan Commission majority in favor of the report went further, recommending that the IMF focus on liquidity assistance, rather than "emergency assistance" in general. We propose that the IMF lend to pre-qualifying countries through pre-established lines of credit. Why?

Liquidity crises – self-fulfilling avoidable financial implosions – 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. I note that the testimony before our Commission of the IMF's acting managing director, Mr. Fischer, concurred with the majority's view on that point.

The terms under which the IMF would lend are also crucial to our reform proposal. Under current practice the IMF lends at a markup over its

cost of funds. That is not a penalty rate – for many countries it implies a substantial subsidy. Our proposed penalty rate removes that subsidy. Countries facing a bona fide liquidity crisis (including those with past fiscal problems that have decided to improve their fiscal discipline) would benefit by borrowing at a penalty rate, since such borrowing would allow them to avoid unnecessary collapse. But countries seeking financial assistance for bailouts would get no benefit from senior IMF lending at a penalty rate. Countries facing both a liquidity crisis and a banking crisis would still likely access IMF lending, but doing so would discourage fiscally costly bailouts of banks. Borrowing on senior terms from the IMF at a penalty rate would not channel subsidies to a country that chose to expand its public deficit by bailing out its banks; indeed, it would hamper that country's ability to raise and retain private funds. Thus IMF complicity in bailouts would be avoided.

Some critics of our proposals have said that lending without ex post conditionality will worsen moral hazard. That criticism is misplaced. If loans are senior and at a penalty rate, then there is no subsidy (or "bailout") resulting from the loans, and therefore, there can be no moral hazard. This is an important point: If one narrowly confines oneself to protecting only against liquidity risk (rather than against all economic emergencies, broadly defined) one can provide protection without subsidies, and in doing so manage to avoid the destabilizing effects of moral hazard.

The proposed pre-qualification requirements are few. They include meeting IMF fiscal standards and prudential banking standards (that is, requiring that banks maintain adequate capital and liquid reserves). IMF discretion would be relied upon in setting and enforcing prequalification standards. Those standards reduce the likelihood that borrowing countries would access IMF lending to sponsor bailouts at their taxpayers' expense.

We also recommend requiring that countries with access to IMF credit be required to permit free entry into their financial systems by foreign financial institutions. That requirement would go a long way toward ensuring competitive, stable banking in emerging markets, and in so doing would substantially reduce the likelihood and magnitude of bank bailouts. More than 50 countries already have agreed to this WTO provision.

Over the five years that we envision for the transition to this new pre-qualification system virtually all emerging market countries would be able to meet these standards.

Our pre-qualification requirements are designed to avoid, rather than increase, intrusion by the IMF into the sovereignty of borrowing countries. IMF conditionality now is ex post, customized micromanagement (which is necessarily very intrusive). We suggest, instead, making IMF liquidity assistance available based on clearly specified rules which are the same for all countries. The requirement that countries allow free entry into financial services is not designed to force countries into greater free trade, per se, but to protect borrowing countries' citizens from bearing the costs of IMF-sponsored bailouts. The IMF's complicity in the bank bailouts in Mexico, Asia, and elsewhere – which the pre-qualification standards and penalty rate would avoid – has been a far more important invasion of sovereignty than our pre-qualification standards would be.

What would happen if the stability of the global financial system were at stake because a large developing country in need of liquidity assistance had not pre-qualified? The report recognizes that the pre-qualification requirement could be waived in such a circumstance, but the lending limits, the IMF's senior status, and the penalty rate would still apply.

Mr. Chairman, in closing let me say that I believe the Meltzer Commission report has provided a credible blueprint 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. Thus I reiterate that resolving the often unspoken controversy over whether these organizations should act as foreign policy slush funds or as bona fide economic institutions is the necessary first step toward real reform. Thank you.

Addendum to Statement

Since the publication of the Meltzer Commission's report a number of questions have been raised about our recommendations. This addendum addresses many of the those questions.

Question 1: *Isn't it true that the majority's proposals would substantially limit the IMF's role even in providing emergency assistance to countries?*

The intent of the majority is to limit IMF assistance not only to short-term lending, but to lending geared toward preventing and resolving *liquidity crises*. It is important to be clear about what constitutes a liquidity crisis, and how the proposed mechanism would properly address those crises and not other "emergencies."

All of the formal economic models of liquidity crises can be divided into two classes of problems, which are distinct. One is the problem of self-fulfilling multiple equilibria. In essence, the problem here is that if a borrower is short of cash, a "run" on the borrower can cause an exchange rate collapse that is avoidable (i.e. that if only the borrower had the same value of assets in a more liquid form, the crisis would not happen). A second problem is of market collapse due to problems of acute asymmetric information. Here the problem is that temporary confusion in the marketplace drives an extreme flight to quality that raises the short-term liquidity premium. As in the multiple-equilibria case, a short-term injection of cash can keep a temporary liquidity problem from mushrooming into a serious collapse.

From the standpoint of these models, it is desirable to have an international quasi lender of last resort (the new IMF) that can supply large amounts of hard currency to sovereign borrowers facing a liquidity crisis. (I use the term "quasi" to indicate that the lender does not offer an unlimited supply of hard currency because it is not itself the central bank ultimately creating that currency.) To be effective such support must arrive as quickly as possible. Liquidity crises can become acute in a matter of days, and in today's electronic capital markets, conceivably in a matter of hours.

The challenge in designing a quasi lender of last resort is to provide credit to solve these two kinds of liquidity problems (collapses due either to self-fulfilling expectations or temporary asymmetric information problems) without creating unintended costs. The primary unintended costs the majority seeks to avoid are (1) facilitating undesirable bailouts of emerging market countries' financial systems, (2) intruding excessively into borrowing countries' sovereignty, and (3) creating excessive discretion over lending that permits the IMF to be used as a political "slush fund" for non-economic purposes.

Fortunately, true liquidity assistance can be provided without offering countries access to credit subsidies on loans (which would attract countries seeking funding for a bank bailout or access to a slush fund), and without ex post "conditionality" – that is, promises of future policy changes by the government. Thus we avoid the undesirable intrusiveness and delay that come with the setting of borrowing conditions in the midst of

a crisis. It is also worth emphasizing (and some critics have missed this) that it is not necessary that the IMF be able to ascertain whether a potential borrower is actually suffering from a bona fide liquidity crisis. In fact, our proposals operate under the assumption that the IMF cannot tell whether a country is suffering from a liquidity crisis or not.

How does this work? By structuring liquidity assistance in a form that would only attract those who need liquidity, per se. Specifically, countries can only borrow limited amounts in the form of *senior* debt at a *penalty* rate (a rate above the sovereign yield for that country in the period immediately before the crisis). If a country is suffering from a self-fulfilling multiple-equilibria problem, then it will benefit by borrowing briefly at a penalty rate (as we define it) and on senior terms from the IMF. Also, if there is an asymmetric-information problem underlying a shutdown in credit markets, then the country will also benefit by borrowing from the IMF. But if a country is suffering an "emergency" in the form of long-term deterioration in fundamentals (say, like Latin America in the 1980s) that is not a liquidity crisis properly defined. That country stands to lose by borrowing from the IMF on senior terms at a penalty rate; if the problem is a long-term one, borrowing from the IMF (which subordinates existing debts) will exacerbate the deficit (through the high borrowing cost) and make it harder to repay private debts. That, along with the prequalification standards we propose, would make it unlikely for a sovereign not experiencing a bona fide liquidity crisis to access the proposed IMF facility. Under current IMF rules, of course, long-term subsidized loans attract countries to the IMF even if they are not suffering a bona fide liquidity crisis.

Question 2: *Isn't it true that the majority report recommends that IMF loans be collateralized by liquid securities or export receipts, as in the 1995 Mexican oil loans? And isn't true that such a reliance on collateral is infeasible, or undesirable, for many countries?*

The Commission considered the costs and benefits of requiring physical collateral and determined that this was too limiting a requirement. For many countries, collateral would be hard to pledge, and requiring such collateral might even discourage privatization of important exporting sectors. Furthermore, what is really essential is that IMF claims be senior, which the Commission was able to ascertain could be accomplished without the pledging of collateral, so long as loan amounts were limited and legal protections were in place.

Question 3: *Isn't the Commission's recommended duration of IMF loans (120 days, with one rollover) too short for lending to be effective?*

The suggested time period of 120 days with one rollover is not crucial to our recommendations. I would have no problem with a maturity of one year with one rollover. The reason the Commission picked 120 days was that this time limit has a technical advantage over longer periods, especially during the transition period we envision during which sovereign debt contracts would be changed to explicitly exempt the IMF lending from negative pledge clauses. Our legal consultants told us that IMF

loans of 120 days or less (even when not explicitly exempted from negative pledge clauses) effectively would not be subject to limits on IMF seniority imposed by negative pledge clauses. I think it is fair to say that Commission members did not feel very strongly about a 120-day limit, and this could be expanded to one year with little controversy.

Question 4: *Would the Commission's recommendation that borrowers prequalify for liquidity assistance hamper the IMF's ability to deal with bona fide liquidity crises?*

On the contrary, the main thrust of our recommendations about improving IMF lending is to strengthen the IMF's role as a quasi lender of last resort. The Commission voted *unanimously* that the IMF should stop making long-term loans to countries (loans that are better left to the development banks, to avoid counterproductive overlap in responsibilities), and should instead focus on liquidity assistance. The majority report argues that the most effective means to provide liquidity assistance is by relying on *pre-qualification.* Liquidity crises – self-fulfilling avoidable financial implosions – always happen quickly. There simply isn't enough time for a country to enter into protracted negotiations with the IMF to gain access to the necessary hard-currency funds, to demonstrate that it is solvent, or to demonstrate that it is an innocent victim of a market shutdown (as the IMF's current contingent credit facility mandates). Stanley Fischer, the acting managing director of the IMF, expressed agreement with that majority view that prequalification is the appropriate means of channeling aid to countries suffering liquidity crises, even though there may remain some disagreements about the details of prequalification requirements (and Mr. Fischer does not agree that the IMF should relinquish its role as a long-term lender). If, as the Commission unanimously agreed, the IMF is to focus on liquidity assistance, and if liquidity assistance is to be effective, I can see no viable alternative to our recommendation that countries prequalify for access to liquidity assistance.

A further advantage to prequalification over ex post conditionality is that conditionality has drawbacks in addition to delaying access to funds. Analysis of IMF conditionality in several studies indicates that it is often not enforced, and on average, not effective in improving borrowers' economic conditions. It also has been abused by the IMF, which inappropriately uses loan applications as invitations to meddle into the internal affairs of borrowers.

Question 5: *Are the IMF prequalification requirements so onerous that few emerging market countries would qualify?*

No. The requirements are few and are easily met. They include basic prudential banking standards (that banks be adequately capitalized and maintain adequate liquid reserves), which would reduce the likelihood that borrowing country governments would access IMF lending to sponsor massive bailouts of insolvent banks at their taxpayers' expense. They require, for the same reason, that countries permit free entry into their banking systems by foreign institutions. More than 50 countries already have agreed to this provision. Over the five years that we envision for the transition to this new

prequalification system, there are few if any important emerging market countries that would fail these prequalification standards.

Question 6: *What would happen if the stability of the global financial system were at stake because a large developing country in need of liquidity assistance had not prequalified?*

The majority recognizes that the prequalification requirement would be waived in such a circumstance. It is important to note that, even in this case, where prequalification standards are relaxed, the IMF would still lend at a penalty rate, and ensure the seniority of its debt. Because the relaxation of prequalification would be a special case, and because lending would still be done in the form of senior loans at a penalty rate, the moral-hazard consequences of this relaxation of lending rules would be small.

Question 7: *Are the prequalification requirements too permissive, and would they encourage insolvent (rather than illiquid) sovereign debtors to borrow from the IMF?*

No, for two reasons. First, prequalification standards that limit fiscal profligacy and bank bailouts (a major source of fiscal risk for developing countries) would provide some protection against abuse of IMF lending. Second, and perhaps more important, unlike current IMF lending policy we propose that the IMF lend at a *penalty rate* – that is a markup above the pre-crisis sovereign yield of the borrower. That substantially reduces the incentive for an insolvent borrower to borrow from the IMF. This is a point worth emphasizing. Under current practice the IMF lends at a markup over the cost of funds of the *lending countries*. That is not a penalty rate – in fact, for many countries with poor sovereign credit ratings, it implies a substantial subsidy. Our penalty rate removes that subsidy. Countries facing a bona fide liquidity crisis (including those that have had weak fundamentals in the past, but that have decided to improve their fiscal discipline) would benefit by borrowing at a penalty rate as we define it. Such borrowing would allow them to avoid self-fulfilling liquidity crises. But long-term insolvent countries seeking bailouts would get no benefit from IMF lending at a penalty rate. Why? Because the IMF would be a *senior creditor* lending at a *penalty rate*. Borrowing from the IMF would not channel subsidies to a country that is already hopelessly insolvent; indeed, it would hamper that country's ability to raise or retain private funds.

Question 8: *Is the Commission recommending an end to "conditional lending" to encourage long-term institutional reform?*

While the IMF would not provide such loans, the development banks (or development agencies, as we would rename them) would provide a better version of the same thing – long-term subsidized loans to encourage policies that build strong institutional foundations in developing countries. By removing that function from the IMF we avoid counterproductive overlap. By improving the mechanism for delivering those subsidies to reward real reform, rather than empty promises of reform, we expect to make such assistance more effective, while also avoiding micro-management of countries' policies by the multilateral agencies.

Question 9: *The Commission report claims to avoid the intrusions into borrowing countries' sovereignty that IMF conditional lending has created in the past, but aren't its prequalification standards also intrusive?*

All lenders have to have limits on who they lend to, when they lend, and how they lend. Our prequalification requirements are minimal and designed to avoid, rather than produce, intrusion into the sovereignty of borrowing countries. IMF conditionality now is ex post, customized micromanagement (which is necessarily very intrusive). We are suggesting, instead, making IMF liquidity assistance available based on clearly specified rules that are the same for all countries. Furthermore, the requirement that countries allow free entry into financial services is not designed as a means to force countries into greater free trade, per se, but rather as a means of ensuring that borrowing countries' citizens are protected from bearing the cost of IMF-sponsored bailouts of banks. The IMF's complicity in the bank bailouts in Mexico, Asia, and elsewhere – which the prequalification standards would discourage – has been a far more important invasion of sovereignty than our prequalification standards would be.

Question 10: *If the Commission's recommendations for IMF lending had been in place prior to the Mexican and Asian crises, would those countries have been unable to access IMF funds? If they would have qualified for loans, then how would the proposed changes in IMF lending have affected the outcomes? Isn't it likely that the IMF still would have sponsored bailouts?*

Whether Mexico or the Asian crisis countries would have qualified for IMF assistance under the Commission's proposed rules is unclear. On the one hand, it is true that in all cases the countries' banking systems were insolvent and foreign entry was limited, indicating that they would not have pre-qualified. On the other hand, it is conceivable that the existence of the pre-qualification standards might have encouraged one or more of these countries to adopt different policies. Furthermore, under the Commission's proposals the IMF could have waived pre-qualification requirements if any of these cases were deemed a systemic threat to global markets.

Under the proposed lending rules, it is also possible that the governments would have made different decisions about bailing out private parties, and even if the governments had still chosen to bail out banks and others, the IMF would not have encouraged that behavior. If the IMF had lent to these crisis countries on senior terms at a penalty rate, then doing so would have discouraged the use of government funds to bail out domestic banks, foreign banks, and domestic debtors (in contrast to subsidizing those bailouts, as the IMF did under existing lending rules). IMF lending at a penalty rate would have made it possible for the crisis countries to roll over sovereign debts and defend against unwarranted speculative attacks so long as they pursued sustainable fiscal policies (i.e. fiscal policies consistent with debt repayment and exchange rate policies). But if the countries had also pursued costly bailouts (as, in the event, they did) IMF lending would have made it harder, rather than easier, to do so. As I have already noted, loans at a penalty rate offer no subsidies to finance a bailout, and senior loans subordinate

existing creditors. Thus, if a country facing a sovereign liquidity crisis also chooses to bail out banks and firms under the proposed lending rules, it would do so in spite of the IMF, not with its complicity.

Question 11: *Isn't it true that the Commission's recommendations would remove the IMF from the debt renegotiation process? Wouldn't this make debt default resolutions all the more difficult?*

The majority do not want the IMF to intervene in debt renegotiations, either by strengthening or weakening the bargaining positions of creditors and debtors, as they have in the past. For example, in the 1980s, the IMF's interventions are widely believed to have delayed the desirable resolution of the Latin American sovereign debt crisis.

Question 12: *Didn't the Commission fail to address the key problem of debt resolution? For example, shouldn't it have recommended mandatory majority-voting collective-action clauses for debt workout?*

The Commission considered recommending changes to the mechanisms and laws that currently govern sovereign workouts. We struggled with these questions, heard testimony, and debated at length what might be done. I think it is fair to say that it was not clear whether existing mechanisms, and the ongoing improvements to them that were reported at our hearings, could be improved by some sort of interventions or mandates on the part of the multilateral institutions. In the interest of "doing no harm" the Commission did not make specific recommendations in this area. Certainly, there is room for further debate on this question.

Question 13: *Is the Commission's recommendation that grant funding, rather than lending, be employed in development agencies' poverty alleviation programs politically feasible? Isn't it more likely (as Mr. Wolfenson has argued) that the Congress will ignore the Commission's recommendations to increase aid and supply it in the form of grants, and simply embrace the Commission's criticisms of the multilaterals, using those criticisms as a justification for reducing U.S. involvement in these institutions?*

I would like to address my answer to this question particularly to the members of Congress who have been at the forefront of the movement to reform these institutions. In my view, your positive reaction to our proposals to combine real reform with an increase in funding is absolutely crucial to the success of any and all of our proposals. While the current level of implied U.S. taxpayers' annual cost of supporting the multilaterals ($6 per capita) is too much to spend on ineffectual institutions, it is too little to spend on bona fide poverty reduction, economic institution building, and global public goods provision. We Americans have a lot to gain economically from helping the world's poor to climb out of poverty. It is also the right thing to do. I want to go on the record as saying that the recommendations in this report are presented *as a package.* I would not have voted for the report (nor, in my view, would a majority of commissioners) if I thought it would be used to tear down, rather than to rebuild, these important institutions. No one should use our report in pursuit of that agenda.

Question 14: *Isn't the discretionary authority to allocate loan subsidies that the IMF and development banks currently enjoy essential to their proper function, and doesn't the Commission's proposals to eliminate that discretion effectively eviscerate these institutions?*

Some discretion is essential, and our recommendations would preserve it; other discretion is counterproductive, and we endeavor to limit it. Our report recognizes an important distinction between *necessary discretion* (that is, discretion that operates appropriately within a framework of rules that ensure focus and accountability) and *excessive discretion*. Examples of necessary discretion pervade our report: Detailed IMF prequalification standards must be set and enforced, including standards relating to the long-run viability of fiscal policy and prudential banking standards. Thus, within the framework of the IMF's lending rules (which limit counterproductive IMF emergency lending) necessary discretion is allowed. With respect to the development agencies, discretion is also pervasive – for example, over the appropriate priorities set by the agencies. But limits on discretion must be enforced to ensure effectiveness – particularly, limits on subsidized lending that ensure that these agencies focus assistance on poor countries lacking access to international markets, and rules that require competitive bidding, third-party verification, and the payment of grants to service providers rather than governments.

Question 15: *The majority argues that poverty assistance should only be targeted to the poorest countries, but doesn't that argument neglect the fact that many middle-income countries are much poorer than the United States and thus are deserving of aid?*

We do not argue that poverty assistance to middle-income countries would be worthless, but rather that those countries are better able to fend for themselves than the poorest countries, that there are important problems currently being neglected which we would like the development agencies to address, and that there are better ways of addressing those problems than subsidized development bank loans. I can't see a very large social value to continuing to devote a large proportion of development bank resources to sending investment-grade sovereign borrowers small subsidies on 1% of their foreign capital inflows. But I can see a lot of value to using those same resources to build sound legal systems and improving education and health services in the poorest countries. While we suggest a big increase in the budget of the development agencies, we also recognize that the budget constraint always binds and we want to channel resources where they will do the most good.

Furthermore, while the Commission's proposals would eliminate *country-specific* grants to middle-income countries, those are only a part of what the development agencies would do. To the extent, for example, that poor people in middle-income countries suffer from malaria, AIDS, and other common maladies, our proposals to boost programs for global public goods provision by the development agencies would still provide substantial benefits to the poor in middle-income countries.

Question 16: *Wouldn't reduced lending to middle-income countries reduce the income available to finance poverty assistance to poor countries?*

No, for two reasons. First, we propose that the existing capital of the development banks and additional appropriations would be dedicated to financing future development agency activities. Second, the Commission's analysis of World Bank borrowing and lending rates showed that it would be incorrect to argue that, under current practices, the World Bank's loans to middle-income countries are a source of finance for subsidized lending to the poorest countries. Indeed, the opposite is true. If the World Bank reduced its subsidized lending to Brazil, for example, it would have more resources to channel to poorer countries. Furthermore, our recommendations would permit reductions in the World Bank's administrative costs (by reducing overlap among the development banks), which would also free up more resources to be channeled as subsidies to the poorest countries.

Question 17: *The World Bank has accumulated substantial expertise as an organization. For example, its bank regulation experts have unique institutional knowledge, skills, and data. Wouldn't devolving power to the regional development banks prevent the Bank's staff from continuing to play an important advisory role?*

Our report specifically points to the importance of this advisory function, and we share the view that in some areas the World Bank has special knowledge. We believe that because the World Bank's staff is knowledgeable, countries will continue to approach it for advice. Good consultants on issues of institutional reform are in great demand. Typically, private consultants charge high fees for their advice. It is strange to argue that clients will not listen to good policy advice unless they are paid to listen (by attaching a subsidy to the advice). Good advice, provided by knowledgeable World Bank staff at no charge, will continue to be solicited by reform-minded governments.

Question 18: *The Commission recommends that the debt of highly-indebted poor countries (HIPCs) owed to the development banks and the IMF be forgiven, so long as credible development plans are put in place. Isn't this a case of reliance on conditionality, and isn't this just as intrusive as existing programs the Commission criticizes?*

The HIPC debt relief proposal of the Commission is very different from IMF conditionality. First, HIPC debt relief is a one-time transitional problem. If our recommendations are adopted, multilaterals will no longer channel poverty assistance through loans to governments. The HIPC debt burdens are themselves an indictment of past lending programs to governments, which used those funds in wasteful or corrupt ways, leaving their impoverished citizens to pay the bill. If our proposed reforms are enacted, especially our grant proposals and our IMF reforms, such problems are far less likely to arise in the future.

Second, we do not envision a long-term, intrusive monitoring and control relationship (as is the case under IMF conditionality), but rather the establishment of a

credible reform plan. Debt forgiveness would follow immediately. This is very different from IMF conditionality, where meeting conditions in the future (or more often, not meeting them, but offering excuses for not doing so) allows a country continuing access to fresh credit.

Question 19: *Isn't the Commission's report excessive in the extent to which it limits the U.S. Treasury's ability to use the multilateral institutions on an ad hoc basis, in pursuit of non-economic goals of foreign policy?*

I think it is fair to say that this concern has contributed to the opposition to our reform proposals by officials of the Treasury Department. The Treasury Department's recent use of the IMF to channel assistance to Russia is a prime example – recognized both by advocates and critics of the present Administration's policies – of how an unconstrained IMF can be enlisted as a foreign policy tool. Rather than summarize that specific debate, let me address the question more generally, in light of our report's recommendations. The majority opinion recognizes that "extraordinary circumstances" might call for assistance to countries outside the constraints of the proposed rules for IMF lending. In the interest of accountability and maintaining the proper balance of power in government, we recommended that, in general, the parliaments of developed countries should retain control over the appropriation of foreign aid to deal with such emergencies.

It is also important to recognize that, aside from his influence within the IMF, the Secretary of the Treasury retains direct control over a substantial amount of funds through the Exchange Stabilization Fund (ESF). Many scholars (including Anna Schwartz) have questioned the appropriateness of the Treasury's using those funds to lend to other nations. Nevertheless, as a matter of fact, the Treasury currently enjoys enormous latitude in allocating those funds (witness its use of the ESF during the Mexican crisis of 1995). The ESF is outside the mandate of our Commission. I raise it here simply to note that if our government wishes to vest in the Treasury a large discretionary fund to use on an ad hoc basis it need do nothing more than preserve the ESF in its current form. Surely it is not necessary to provide the Treasury with *two* distinct discretionary funds – one called the ESF and the other the IMF. Thus, no matter how much discretionary emergency lending power Congress wishes to delegate to the Treasury, the desire to do so is not an argument for unlimited Treasury discretion *with respect to the IMF*. The two issues are entirely separable.

However much control over resources Congress might wish to delegate to the Treasury (through the ESF), it is still important to define a clear focus for IMF policies in pursuit of a bona fide *economic* function. Doing so allows the IMF to serve a credible, predictable function as a source of liquidity. The predictability of IMF liquidity assistance – a consequence of clear prequalification standards and lending rules – would itself be a source of stability, as the expected availability of liquidity assistance would have a calming effect on markets during uncertain times.

Question 20: *Aside from the Treasury's ability to intervene unilaterally in pursuit of foreign policy objectives, isn't it valuable for the United States to be able to "leverage"*

its foreign policy expenditures by using its power over the multilaterals, since they are funded by many countries other than the United States, and don't the Commission's proposed reforms limit the ability to do so?

It certainly is true that our report presumes that the IMF, the World Bank, and the regional development banks should only pursue *clearly defined economic* objectives. The 8-3 majority in favor of the report sought to limit the latitude of the multilaterals, giving them clear and separate mandates, and establishing governance structures that assure transparency and accountability, so that officials of these organizations could not abuse or waste their resources. Doing so ensures that more resources are available and used more effectively in pursuit of bona fide economic objectives. We took for granted that procedural reforms that would place boundaries on the discretionary powers of officials and improve the mechanisms for delivering aid were desirable.

We recognize that not everyone shares the goal of narrowing the latitude of these organizations. Some believe that the IMF and the development banks should be used as cost-effective vehicles of U.S. foreign policy. From that perspective, any limits on the "flexibility" of these institutions are undesirable, as is transparency in accounting, open voting, 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. Aid can be delivered, and the embarrassing deals that lie behind it are not easily traced. Time-consuming parliamentary appropriation debates can also be avoided. This point of view is not often voiced openly, but it is nevertheless a very important part of the current debate over reform.

In the body of my testimony (pages 5-7 above) I explain why I disagree with the view that the multilaterals should serve the broadly and flexibly defined goals of U.S. foreign policy.