Report of the

INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Allan H. Meltzer, Chairman

MARCH 2000

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Preface

In the last two decades, large crises in Latin America, Mexico, Asia, and Russia heightened interest in the structure and functioning of international financial institutions. Calls for additional capital for the International Monetary Fund to respond to these crises raise questions about how the Fund uses resources, whether its advice increases or reduces the severity of crises and its effect on living standards.

Growth in private lending and capital investment, and the expanding objectives of the international development banks, raise questions about the adequacy and effectiveness of these institutions. Repeated commitments to reduce poverty in the poorest nations have not succeeded. A large gap remains between promise and achievement.

Disputes about the functioning of the World Trade Organization have increased as its role in service industries expanded. Concerns for the environment and the welfare state clash with concerns elsewhere to maintain open trading arrangements, avoid protection, and spur development.

Frequent, large banking crises focus attention on financial fragility, inadequate banking regulation, and the role of the Bank for International Settlements and its affiliated institutions. Are financial standards inadequate? How should they be improved? What should be done to reduce the role of short-term capital in international finance?

In November 1998, as part of the legislation authorizing approximately $18 billion of additional funding by the United States for the International Monetary Fund, Congress established the International Financial Institution Advisory Commission to consider the future roles of seven international financial institutions:

the International Monetary Fund,
the World Bank Group,
the Inter-American Development Bank,
the Asian Development Bank,
the African Development Bank,
the World Trade Organization, and
the Bank for International Settlements.

The Commission was given a six-months life. It held meetings on twelve days and public hearings on three additional days. All Commission meetings and hearings were open to the public. And, to make its work accessible to a broad public, the Commission established an interactive web site. All papers prepared for the Commission and unedited transcripts of all meetings and public hearings are available on the Commission's web site; http://phantom-x.gsia.cmu.edu/IFIAC. All documents will be published as a permanent record of the Commission's work.

The Commission did not join the council of despair calling for the elimination of one or more of these institutions. Nor did it decide to merge institutions into a larger multi-purpose agency. A large majority agreed that the institutions should continue if properly reformed to eliminate overlap and conflict, increase transparency and accountability, return to or assume specific functions, and become more effective. These changes are most important for the International Monetary Fund and the multilateral development banks, so the report directs most attention to those institutions.

Since it had a short life, the Commission relied heavily on people with expertise gained through years of research or experience working with or for the seven institutions we were asked to consider. We are grateful to all who assisted us by writing papers, on very tight deadlines, to inform us and help us understand the functioning, roles, and responsibilities of these institutions, and the effects and effectiveness of their programs. We are grateful, also, for their suggestions for changes. Many of the authors of commissioned papers contributed further by testifying before the Commission and by answering questions. Other witnesses at Commission meetings and public hearings brought a broad spectrum of opinions that illuminated areas of public concern or supplemented the information in the commissioned papers. A list of the witnesses and authors is included at the end of the report.

The members of the Commission benefited also from the opportunity to meet informally with the Managing Director of the International Monetary Fund, the Presidents of the World Bank and the Inter-American Development Bank, the U.S. Executive Directors of the Fund and the Bank, the Secretary of the Treasury, and their staffs. We are especially grateful to Dr. Stanley Fischer, Acting Managing Director of the International Monetary Fund, and President James Wolfensohn of the World Bank who presented their views and responded to questions at one of our hearings.

The Commission operated under Treasury Department rules. We had the pleasure of working with Mr. Timothy Geithner, Ms. Caroline Atkinson, Mr. William McFadden, Ms. Lauren Vaughan, and many other Treasury personnel.

The Commission's report recommends many far-reaching changes to improve the effectiveness, accountability, and transparency of the financial institutions and to eliminate overlapping responsibilities. These proposals should not be taken as criticism of the individuals who work in and guide these institutions. We have been impressed repeatedly not only by the dedication and commitment of many of the people we met but also by their willingness to assist us, inform us, and supply the information that helped us complete our task.

The Commission depended on the work of a dedicated staff that arranged meetings, organized material, and prepared research reports and drafts of the final report. Their names are listed in the report. Mr. Donald R. Sherk, though not a member of the staff, helped us in numerous ways, improved our understanding of the development banks and allowed us to benefit from his long experience and deep knowledge of their problems and prospects.

I am personally grateful to the members of the Commission who worked together in a spirit of comity and harmony, who gave willingly of their time and counsel, and never complained about the heavy demands placed on them. It has been my great pleasure to work with them. Each of them recognized the important contributions that the international financial institutions have made and can make in the future. They joined enthusiastically in this bipartisan effort to suggest reforms and restructuring that the majority believes will improve the functioning of financial markets, the stability of the world economy, and the incomes of people in rich and poor countries.

Allan H. Meltzer
Chair
March 2000

Votes of the Commission

The Commission approved the following report by a vote of 8 to 3. Voting affirmative were: Messrs. Calomiris, Campbell, Feulner, Hoskins, Huber, Johnson, Meltzer and Sachs. Opposed were: Messrs. Bergsten, Levinson and Torres.

The Commission voted unanimously that **(1) the International Monetary Fund, the World Bank and the regional development banks should write-off in their entirety all claims against heavily indebted poor countries (HIPCS) that implement an effective economic and social development strategy in conjunction with the World Bank and the regional development institutions, and (2) the International Monetary Fund should restrict its lending to the provision of short-term liquidity. The current practice of extending long-term loans for poverty reduction and other purposes should end.**

Executive Summary:
General Principles and Recommendations for Reform

In November 1998 as part of the legislation authorizing $18 billion of additional U.S. funding for the International Monetary Fund, Congress established the International Financial Institution Advisory Commission to recommend future U.S. policy toward seven international institutions: the International Monetary Fund (IMF), the World Bank Group (Bank), the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), the African Development Bank (AfDB), the Bank for International Settlements (BIS), and the World Trade Organization (WTO).

The economic environment in which the founders expected the IMF and the Bank to function no longer exists. The pegged exchange rate system, which gave purpose to the IMF, ended between 1971 and 1973, after President Nixon halted US gold sales. Instead of providing short-term resources to finance balance of payment deficits under pegged exchange rates, the IMF now functions in a vastly expanded role: as a manager of financial crises in emerging markets, a long-term lender to many developing countries and former Communist countries, an advisor and counsel to many nations, and a collector and disseminator of economic data on its 182 member countries.

Building on their experience in the 1930s, the founders of the Bank believed that the private sector would not furnish an adequate supply of capital to developing countries. The Bank, joined by the regional development banks, intended to make up for the shortfall in resource flows. With the development and expansion of global financial markets, capital provided by the private sector now dwarfs the volume of lending the development banks have done or are likely to do in the future. And, contrary to the initial presumption, most crises in the past quarter century involved not too little but too much lending, particularly short-term lending that proved to be highly volatile.

The frequency and severity of recent crises raise doubts about the system of crisis management now in place and the incentives for private actions that it encourages and sustains. The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.

High cost and low effectiveness characterize many development bank operations as well. The World Bank's evaluation of its own performance in Africa found a 73% failure rate.[1] Only one of four programs, on average, achieved satisfactory, sustainable results. In reducing poverty and promoting the creation and development of markets

[1] Based on World Bank data from the Bank's web site.

and institutional structures that facilitate development, the record of the World Bank and the regional development banks leaves much room for improvement.

The Commission's Aims

In 1945, the United States espoused an unprecedented definition of a nation's interest. It defined its position in terms of the peace and prosperity of the rest of the world. It differentiated the concepts of interest and control. This was the spirit which created the International Financial Institutions and which has guided the Commission's work. Global economic growth, political stability and the alleviation of poverty in the developing world are in the national interest of the United States.

The Commission believes that performance of the IMF, the Bank, and the regional banks would improve considerably if each institution was more accountable and had a clearer focus on an important, but limited, set of objectives. Further, the IMF, the Bank, and the regional banks should change their operations to reduce the opportunity for corruption in recipient countries to a minimum.

Accountability, accomplishment, effectiveness, and reduction in corruption will not be achieved by hope, exhortation, and rhetoric. Programs must be restructured to change incentives for both recipients and donor institutions. Each institution should have separate functions that do not duplicate the responsibilities and activities of other institutions. The IMF should continue as crisis manager under new rules that give member countries incentives to increase the safety and soundness of their financial systems. For the Bank and the regional banks, emphasis should be on poverty reduction and development not, as in the past, on the volume of lending.

IMF

The IMF should serve as quasi lender of last resort to emerging economies. However, its lending operations should be limited to the provision of liquidity (that is, short-term funds) to solvent member governments when financial markets close. Liquidity loans would have short maturity, be made at a penalty rate (above the borrower's recent market rate) and be secured by a clear priority claim on the borrower's assets. Borrowers would not willingly pay the penalty rate if financial markets would lend on the same security, so resort to the IMF would be reduced. It would serve as a stand-by lender to prevent panics or crises. Except in unusual circumstances, where the crisis poses a threat to the global economy, loans would be made only to countries in crisis that have met pre-conditions that establish financial soundness. To the extent that IMF lending is limited to short-term liquidity loans, backed by pre-conditions that support financial soundness, there would be no need for detailed conditionality (often including

dozens of conditions) that has burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual.

Four of the proposed pre-conditions for liquidity assistance that we recommend are: First, to limit corruption and reduce risk by increasing portfolio diversification, **eligible member countries must permit, in a phased manner over a period of years, freedom of entry and operation for foreign financial institutions.** Extensive recent history has demonstrated that emerging market economies would gain from increased stability, a safer financial structure, and improved management and market skills brought by the greater presence of foreign financial institutions in their countries. A competitive banking system would limit use of local banks to finance "pet projects," or lend to favored groups on favorable terms, thereby reducing the frequency of future financial crises.

Second, to encourage prudent behavior, safety and soundness **every country that borrows from the IMF must publish, regularly and in a timely manner, the maturity structure of its outstanding sovereign and guaranteed debt and off-balance sheet liabilities.** Lenders need accurate information on the size of short-term liabilities to assess properly the risks that they undertake.

Third, **commercial banks must be adequately capitalized either by a significant equity position, in accord with international standards, or by subordinated debt held by non-governmental and unaffiliated entities.** Further, the IMF in cooperation with the BIS should promulgate new standards to ensure adequate management of liquidity by commercial banks and other financial institutions so as to reduce the frequency of crises due to the sudden withdrawal of short-term credit.

Fourth, **the IMF should establish a proper fiscal requirement to assure that IMF resources would not be used to sustain irresponsible budget policies.**

To give countries time to adjust to these incentives for financial reform, **the new rules should be phased in over a period of five years. If a crisis occurred in the interim, countries should be allowed to borrow from the IMF at an interest rate above the penalty rate.**

Maintenance of stabilizing budget and credit policies is far more important than the choice of exchange rate regime. **The Commission recommends that countries avoid pegged or adjustable rate systems.** The IMF should use its policy consultations to recommend either firmly fixed rates (currency board, dollarization) or fluctuating rates. Neither fixed nor fluctuating rates are appropriate for all countries or all times. Experience shows, however, that mixed systems such as pegged rates or fixed but adjustable rates increase the risk and severity of crises.

Long-term structural assistance to support institutional reform and sound economic policies would be the responsibility of the Bank and the regional banks. **The IMF should cease lending to countries for long-term development assistance (as in sub-Saharan Africa) and for long-term structural transformation (as in the post-**

Communist transition economies). The Enhanced Structural Adjustment Facility and its successor, the Poverty Reduction and Growth Facility, should be eliminated.

The IMF should write-off in entirety its claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy in conjunction with the World Bank and the regional development institutions.

In keeping with the greatly reduced lending role of the IMF, the Commission recommends against further quota increases for the foreseeable future. The IMF's current resources should be sufficient for it to manage its quasi lender of last resort responsibilities, especially as current outstanding credits are repaid to the IMF.

The Development Banks

At the entrance to the World Bank's headquarters in Washington, a large sign reads: "Our dream is a world without poverty." The Commission shares that objective as a long-term goal. Unfortunately, neither the World Bank nor the regional development banks are pursuing the set of activities that could best help the world move rapidly toward that objective or even the lesser, but more fully achievable, goal of raising living standards and the quality of life, particularly for people in the poorest nations of the world.

Collectively, the World Bank Group and its three regional counterparts employ 17,000 people in 170 offices around the world, have obtained $500 billion in capital from national treasuries, hold a loan portfolio of $300 billion and each year extend a total of $50 billion in loans to developing members.

There is a wide gap between the Banks' rhetoric and promises and their performance and achievements. The World Bank is illustrative. In keeping with a mission to alleviate poverty in the developing world, the Bank claims to focus its lending on the countries most in need of official assistance because of poverty and lack of access to private sector resources. Not so. Seventy per cent of World Bank non-aid resources flow to 11 countries that enjoy substantial access to private resource flows.

The regional institutions overlap with the World Bank in several ways. They compete for donor funds, clients and projects. Their local offices are often in the same cities. The regionals repeat the World Bank's organizational structure, which focuses on subsidized loans and guarantees to governments, zero-interest credits to the poorest members, and loans, guarantees and equity capital for private sector operations. Recently, the World Bank expanded its field offices, increasing duplication and potential conflict in the regions. The Commission received no reasonable explanation of why this costly expansion was chosen instead of closer cooperation with the regional banks and reliance on the regional banks' personnel.

All the Banks operate at the country level, defining their objectives within the nation-states instead of the region or the globe. Their patterns of lending over the past 3 years are very similar: to the same countries and for the same purposes. Four to six of the most credit-worthy borrowers, all with easy capital market access, receive most non-aid resource flows: 90% in Asia; 80-90% in Africa; 75-85% in Latin America.

Performance is one of the Commission's principal concerns. Ending or reducing poverty is not easy. The development banks cannot succeed in their mission unless the countries choose institutions and government policies that support growth. Developing country governments must be willing to make institutional changes that promote improved social conditions, reward domestic innovation and saving, and attract foreign capital. To foster an environment conducive to economic growth, the development banks must change their internal incentives and the incentives they offer developing countries.

The project evaluation process at the World Bank gets low marks for credibility: wrong criteria combined with poor timing. Projects are rated on three measures: outcome, institutional development impact and sustainability. The latter, central to progress in the emerging world, receives a minimal average 5% weight in the overall evaluation. Results are measured at the moment of final disbursement of funds. Evaluation should be a repetitive process spread over many years, including well after the final disbursement of funds when an operational history is available.

The Banks seldom return to inspect project success or assess sustainability of results. After auditing 25% of its projects, the World Bank reviews only 5% of its programs 3 to 10 years after final disbursement for broad policy impact. Though the development banks devote significant resources to monitoring procurement of inputs, they do little to measure the effectiveness of outputs over time.

Recommendations for the Development Banks

To function more effectively, the development banks must be transformed from capital-intensive lenders to sources of technical assistance, providers of regional and global public goods, and facilitators of an increased flow of private sector resources to the emerging countries. Their common goal should be to reduce poverty; their individual responsibilities should be distinct. Their common effort should be to encourage countries to attract productive investment; their individual responsibility should be to remain accountable for their performance. Their common aim should be to increase incentives that assure effectiveness. The focus of their individual financial efforts should be on the 80 to 90 poorest countries of the world that lack capital market access.

All resource transfers to countries that enjoy capital market access (as denoted by an investment grade international bond rating) or with a per capita income in excess of $4000, would be phased out over the next 5 years. Starting at $2500 (per capita income), official assistance would be limited. (Dollar values should be

indexed.) Emergency lending would be the responsibility of the IMF in its capacity as quasi lender of last resort. This recommendation assures that development aid adds to available resources (additionality).

Performance-Based Grants

For the world's truly poor, the provision of improved levels of health care, primary education and physical infrastructure, once the original focus for development funding, should again become the starting points for raising living standards. Yet, poverty is often most entrenched and widespread in countries where corrupt and inefficient governments undermine the ability to benefit from aid or repay debt. Loans to these governments are, too often, wasted, squandered, or stolen.

In poor countries without capital market access, poverty alleviation grants to subsidize user fees should be paid directly to the supplier upon independently verified delivery of service. Grants should replace the traditional Bank tools of loans and guarantees for physical infrastructure and social service projects. Grant funding should be increased if grants are used effectively.

From vaccinations to roads, from literacy to water supply, services would be performed by outside private sector providers (including NGOs and charitable organizations) as well as by public agencies. Service contracts would be awarded on competitive bid. Failure to perform on earlier projects would weigh heavily against participation in future bids. Quantity and quality of performance would be verified by independent auditors. Payments would be made directly to suppliers. Costs would be divided between recipient countries and the development agency. The subsidy would vary between 10% and 90%, depending upon capital market access and per capita income.

Institutional Reform Loans

Institutional reforms lay the groundwork for productive investment and economic growth. They provide the true long-term path to end poverty. Reforms are more likely to succeed if they arise from decisions made by the developing country.

Lending frameworks, with incentives for implementation, should be redesigned to fit the needs of the poorest countries that do not have capital market access. The government of each developing economy would present its own reform program. If the development agency concurs in the merit of the proposal, the country would receive a loan with a subsidized interest rate. The extent of the interest rate subsidy would range from 10% to 90%, as in grant financing of

user fees. **Lending for institutional reform in poor countries without capital market access should be conditional upon implementation of specific institutional and policy changes and supported by financial incentives to promote continuing implementation.** Auditors, independent of both the borrowing government and the official lender, would be appointed to review implementation of the reform program annually.

Division of Responsibility

To underscore the shift in emphasis from lending to development, the name of the World Bank would be changed to World Development Agency. Similar changes should be made at the regional development banks.

Development Agencies should be precluded from financial crisis lending.

All country and regional programs in Latin America and Asia should be the primary responsibility of the area's regional bank.

The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East.

Regional solutions that recognize the mutual concerns of interdependent nations should be emphasized.

The World Development Agency should concentrate on the production of global public goods and serve as a center for technical assistance to the regional development agencies. Global public goods include treatment of tropical diseases and AIDS, rational protection of environmental resources, tropical climate agricultural programs, development of management and regulatory practices, and inter-country infrastructure.

In its reduced role, the World Development Agency would have less need for its current callable capital. Some of the callable capital should be reallocated to regional development agencies, and some should be reduced in line with a declining loan portfolio. The income from paid-in capital and retained earnings should be reallocated to finance the increased provision of global public goods. Independent evaluations of the agencies' effectiveness should be published annually.

Debt Reduction and Grant Aid to the Poorest Countries

The World Bank and the regional development banks should write off in entirety their claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy under the Banks' combined supervision. Moreover, bilateral creditors, such as the U. S. government, should similarly extend full debt write-offs to those HIPC countries that pursue effective economic development strategies.

More generally, the **United States should be prepared to increase significantly its budgetary support for the poorest countries if they pursue effective programs of economic development.** This support should come in several forms: debt reduction, grants channeled through the multilateral development agencies, and bilateral grant aid. The current level of U. S. budgetary support for the poorest countries is about $6 per U.S. citizen ($1.5 billion total), so there is scope for a significant increase in funding if justified by appropriate policies and results within the developing countries.

The Bank for International Settlements

During its 70-year history the BIS has adapted well to large changes in the financial industry and central banking practices. Its ability to adapt was due largely to its limited and homogeneous membership. An example of such adaptation is the way the BIS quickly rose to the challenge of meeting regulatory deficiencies at the international level. The BIS has also demonstrated its ability to convince the most financially important countries to adopt its standards.

The Commission recommends that the BIS remain a financial standard setter. Implementation of standards, and decisions to adopt them, should be left to domestic regulators or legislatures. The Basel Committee on Bank Supervision should align its risk measures more closely with credit and market risk. Current practice encourages misallocation of lending.

The World Trade Organization

The WTO has two main functions. First, it administers the process by which trade rules change. Trade ministers (or their equivalent) negotiate agreements that national legislative bodies can approve or reject. Second, the WTO serves as a quasi-judicial body to settle disputes. Part of this process involves the use of sanctions against countries that violate trade rules.

Quasi-judicial determination, when coupled with the imposition of sanctions, can overwhelm a country's legislative process. As WTO decisions move to the broader range of issues now within its mandate, there is considerable risk that WTO rulings will override national legislation in areas of health, safety, environment, and other regulatory policies. The Commission believes that quasi-judicial decisions of international organizations should not supplant national legislative enactments. The system of checks and balances between legislative, executive and judicial branches must be maintained.

Rulings or decisions by the WTO, or any other multilateral entity, that extend the scope of explicit commitments under treaties or international agreements must remain subject to explicit legislative enactment by the U.S. Congress and, elsewhere, by the national legislative authority.

Chapter 1
Introduction

The postwar financial institutions established at Bretton Woods in 1944 are unique in many ways. The mission of the Bretton Woods institutions was to promote monetary and financial stability, to reconstruct countries devastated by war, and to expand the reach of the market system by offering open trade and market access to all countries. Never before have the victors in war established a framework to promote growth, development, and global prosperity.

These institutions, and the U.S. commitment to maintain peace and stability, have had remarkable results. In more than fifty postwar years, more people in more countries have experienced greater improvements in living standards than at any previous time. With the help of our allies, we have avoided global war. Our former adversaries are now part of the expanding global market system. They seek to achieve the benefits of freer trade and exchange in a system based on growth of personal liberty and increased ownership of private property.

The postwar economic order permitted countries to adopt a strategy of export-led growth. This policy required imports of technology, services, and raw materials that spread prosperity to other countries. The international framework provided a sufficient degree of financial stability to absorb costly oil shocks, regional wars, and occasional financial disturbances.

Expansion of trade, capital flows, and economic activity permitted improvements in health care, longevity, education, and other social indicators. Growth provided resources to solve old environmental problems and address new ones. Peace, economic and social progress, and stability contributed to the spread of democratic government and the rule of law to many countries.

The Congress, successive administrations, and the American public can be proud of these achievements. The United States has been the leader in maintaining peace and stability, promoting democracy and the rule of law, reducing trade barriers, and establishing a transnational financial system. Americans and their allies have willingly provided the manpower and money to make many of these achievements possible. The benefits have been widely shared by the citizens of developed and developing countries.

The dynamic American economy benefited along with the rest of the world. Growth of trade spread benefits widely. Per capita consumption in the United States tripled. As in other countries, higher educational attainment, improved health services, increased longevity, effective environmental programs, and other social benefits accompanied or followed economic gains.

Serious challenges remain. The beneficiaries of globalization must include the poorest members of the world economy. Instability of the world economy must be mitigated.

The Institutions

The principal Bretton Woods Institutions are the International Monetary Fund (IMF) and the World Bank Group (Bank). The initial role of the IMF was to smooth balance-of-payments adjustment in a system of fixed but adjustable exchange rates. The Bank's original charge was to foster postwar reconstruction in war-devastated regions and to encourage economic development by lending to developing countries. Initially, neither institution had the resources or the experience to make major contributions. The Marshall Plan and other assistance from the United States, and the prodigious efforts of people in the war-devastated countries, achieved postwar reconstruction.

Beginning in the 1960s, countries created regional development banks to supplement the Bank's work. The Inter-American Development Bank (IDB, 1959), the African Development Bank (AfDB, 1964) and the Asian Development Bank (ADB, 1966) provide loans and grants for development in their respective regions.

The General Agreement on Tariffs and Trade (GATT) joined the IMF and the Bank in 1948. Through successive rounds of multilateral negotiation, GATT reduced most tariff barriers to negligible values. Nontariff barriers remained. In 1995, GATT ended, replaced by the World Trade Organization (WTO) with broader powers and expanded responsibilities to settle trade disputes. The U.S. economy continued to benefit greatly from the expansion of world trade and participation in the WTO.

New Conditions, New Challenges

The economic environment in which the founders expected the IMF and the Bank to function no longer exists. The pegged exchange-rate system, which gave purpose to the IMF, ended between 1971 and 1973, after President Nixon halted U.S. gold sales. Instead of providing short-term resources to finance balance-of-payment deficits under pegged exchange rates, the IMF now functions in an expanded role as a manager of financial crises in emerging markets, as a long-term lender to developing economies and former Communist countries, as a source of advice and counsel to many nations, and collector of economic data on its 182 member countries.

Building on their experience in the 1930s, the founders of the Bank believed that the private sector would not furnish an adequate supply of capital to developing countries. The Bank, joined by the regional development banks, intended to make up for the shortfall in resource flows. With the development and expansion of global financial markets, capital provided by the private sector now dwarfs any volume of lending the development banks have done or are likely to do in the future. And, contrary to the initial presumption, most crises in the past quarter-century involved not too little but too much lending, particularly short-term lending that proved to be highly volatile.

Beginning with the Latin American debt problems of the 1980s, followed by Mexico's crisis in 1994-95, and the Asian financial and economic problems of 1997-98, parts of the world economy have experienced the largest financial traumas and recessions of the postwar years. Liabilities of bank failures in crisis countries often reached 20% of annual income, a far greater financial collapse than occurred in any developed country, including the United States, during the depression of the 1930s or the banking and U.S. savings-and-loan failures in the 1980s.

The crises in developing countries destroyed large parts of the wealth of their citizens. In an interrelated global economy, financial flows and trade declined, particularly U.S. and European exports and inter-regional exports and imports. The effects spread to other developing and developed countries. The frequency and violence of these crises, and the weakness of many emerging countries' financial systems show the need for a new framework and new policies to restore and strengthen economic stability, growth and development.

The Commission recognizes that financial crises have occurred throughout history and cannot be eliminated entirely. However, the frequency and severity of recent crises raise doubts about the system of crisis management now in place and the incentives for private actions that it encourages and sustains. The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.

High cost and low effectiveness characterize many development bank operations also. The World Bank's evaluation of its own performance in Africa found a 73% failure rate.[1] Only one of four programs, on average, achieved satisfactory, sustainable results.

In reducing poverty and promoting the creation and development of markets and institutional structures that facilitate growth, the record of the World Bank and the regional development banks leaves much room for improvement. Six principal reasons for the development banks' poor record in poverty reduction and institutional reform are:

(1) by far the largest share of the Banks' resources flows to a few countries with access to private capital;

(2) the amount of funds provided by development banks to their largest borrowers is small compared to the private-sector resources received;

(3) the host government guarantee, required by all Bank lending, eliminates any link between project failure and the Bank's risk of loss;

(4) money is fungible so that any linkage between development bank resources and specific projects or policy changes is difficult to trace and often nonexistent;

[1] Underlying data are from the World Bank's web site.

(5) countries do not implement reforms unless they choose to do so, and they rarely sustain reforms imposed by outsiders; and

(6) development projects typically succeed only if the recipient country has a significant interest in the project and directs its efforts to achieve success.

IMF and Bank Assistance

In the past, the Fund has worked to achieve growth and economic stability by making loans conditional on changes in monetary, fiscal, exchange rate, trade or labor-market policies. The World Bank has added other conditions. Countries often face a long list of conditions that, if followed, would restrict the role of national political institutions and the development of responsible, democratic institutions.

While it is always difficult to know what would have happened in the absence of the IMF's or Bank's conditions, their research, as well as considerable research by outsiders, finds no evidence of systematic, predictable effects from most of the conditions.[2] A recent summary of conditional lending concludes:

> "[I]t is now well-accepted that Fund-supported programs improve the current account balance and the overall balance of payments. The results for inflation are less clear…In the case of growth, the consensus seems to be that output will be depressed in the short-run as the demand reducing elements of the policy package dominate."[3]

A main reason for the IMF's modest success is that countries come to the IMF mainly when they have serious problems, often when they are in crisis. The IMF's relatively standard advice includes reducing domestic spending and permitting the country's currency to depreciate. Reducing spending lowers incomes. Reduced spending and a depreciated currency typically improve the current account and may reduce inflation.

If the IMF did not exist, the market would force a country in crisis to follow similar policies. Perhaps the IMF's assistance cushions the decline in income and living standards. Neither the IMF, nor others, has produced much evidence that its policies and actions have this beneficial effect. One reason may be that IMF loans permit some private lenders to be repaid on more favorable terms, so the benefits have gone mainly to those lenders. Or, the IMF's loans may permit governments to maintain spending that remains politically attractive despite its low social value.

The last possibility receives support in recent work at the World Bank. Assessing Aid summarizes the results of experience and research:

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[2] See Assessing Aid, Oxford University Press for the World Bank, 1998 and, at the IMF, the many papers by Mohsin Khan and his associates, most recently N. Ul Haque and M.S. Khan, "Do IMF-Supported Programs Work? A Survey of Cross-Country Empirical Evidence." IMF Working Paper, November 15, 1999 (unpublished).

"Foreign aid has at times been a spectacular success…

"On the flip-side, foreign aid has also been, at times, an unmitigated failure…

"Financial aid works in a good policy environment.…

"Improvements in economic institutions and policies in the developing world are the key to a quantum leap in poverty reduction.…

"Aid can nurture reform even in the most distorted environment--but it requires patience and a focus on ideas, not money."[4]

The Commission believes that the effectiveness of foreign aid and progress against poverty would increase and financial crises would be reduced in number, frequency and severity, if current programs of the IMF and the development banks change to focus attention on institutional reform, incentives for improved domestic arrangements and policies, greater transparency and accountability, reduced opportunities for corruption in developing and restructuring countries, and the provision of global public goods. These improvements will yield maximum benefit only if governments continue to foster open markets and further reduce barriers to trade in goods, services, and long-term capital.

The Role of the Commission

The international financial institutions have made signal contributions to prosperity and the spread of democratic government. These institutions have not adapted appropriately to the changes in the economic environment of the past quarter century. A majority of the Commission agrees that the main problems of the international financial institutions are:

--- overlapping missions and mission creep;

--- lack of transparency and accountability;

--- failure to prevent the increasing depth and severity of international financial and economic crises;

--- ineffectiveness, corruption in developing countries, and waste of resources;

--- commandeering of international resources to meet objectives of the U.S. government or its Treasury Department;

--- failure to develop successful regional and global programs to confront transnational problems in agriculture, transportation, forestry, environmental, and health care;

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[3] Ul Haque and Khan, *op. cit.*, pp. 16-17. Comments made by Graham Bird, when the paper was presented, suggest that the conclusion is supported in several previous studies.

[4] Assessing Aid, *op. cit.*, pp. 1-4. Much additional work at the Bank by David Dollar and his collaborators provides evidence for these conclusions.

--- overuse of conditional lending and the imposition of multiple conditions;

--- inability to enforce commitments on borrowers unwilling to meet them; and

--- reluctance to reduce lending to countries that do not honor their obligations.

Recognizing that international financial institutions have often achieved results at extremely high cost to the citizens of the crisis countries, or failed to achieve their missions, and that the rhetoric of their leadership is often distinctly different from the institutions' accomplishments, Congress established the International Financial Institution Advisory Commission. Its mandate was to examine:

--- the effects of globalization, increased trade, capital flows, and other relevant factors on these institutions;

--- the adequacy, efficacy, and desirability of current policies and programs at such institutions as well as their suitability for the beneficiaries of such institutions;

--- cooperation or duplication of functions and responsibilities of such institutions; and

--- other matters the Commission deems necessary to make recommendations pursuant to the preparation of its report.

Congress asked the Commission to report on:

- changes in policy goals set forth in the Bretton Woods Agreements Act and the International Financial Institutions Act;
- changes in the charters, organizational structures, policies and programs of the international financial institutions;
- additional monitoring tools, global standards, or regulations for, among other things, global capital flows, bankruptcy standards, accounting standards, payment systems, and safety and soundness principles for financial institutions;
- possible mergers or abolition of the international financial institutions, including changes in the manner in which such institutions coordinate their policy and program implementation and their roles and responsibilities; and
- any additional changes necessary to stabilize currencies, promote continued trade liberalization and to avoid future financial crises.

At its start, the Commission agreed unanimously to consider the roles and tasks that should be assigned to these institutions if they were created anew in the year 2000. The members recognized that the new or changed roles and assignments might require changes in the institutions' charters, their size and the scope and directions of their activities. It agreed that the economic environment had changed greatly in the more than fifty years since the principal institutions

began operations and that the institutions had grown and changed in response to crises and changes in the world economy. Many of these changes were unplanned or opportunistic. Some of the institutions, particularly the World Bank, have become so large and have taken on so many different tasks that effectiveness has been sacrificed. Frequent reorganization and changes of mission have reduced efficiency and wasted resources. Programs that overlap with IMF or regional bank activities have led to conflict and failure to achieve agreed-upon goals.

The Commission believes that to encourage development, countries should open markets to trade, and encourage private ownership, the rule of law, political democracy and individual freedom. Market economies work best when they operate in an environment where national governments and international institutions follow predictable policies that maintain economic stability, protect political freedom and private property, and sustain incentives for efficient, purposeful behavior leading to wealth creation that benefits all members of the society.

The principal role of public-sector institutions is to provide global public goods, create and maintain the framework and rules that permit the private sector to function productively, generating wealth to reduce poverty and pay for social improvements. Effective international financial institutions can contribute importantly to this process.

In drafting its recommendations, the Commission sought to encourage these desirable outcomes by:

(1) assigning specific responsibilities to particular institutions, avoiding overlap wherever possible;

(2) increasing transparency of aims, decisions, and financial statements, and accountability for achievements and effectiveness;

(3) relying more on incentives and local decision-making and much less on programs and conditions imposed by multilateral agencies;

(4) sustaining and expanding opportunities for trade and sustainable, long-term capital movements; and

(5) increasing incentives for institutional reform, expansion of markets, and prompt provision of reliable information about economic, financial, and political changes.

The United States has a large role in the world economy. It is a leading exporter and importer of goods and services. U.S. citizens own, directly or through corporations and institutional investors, $2 to $3 trillion of foreign assets.

The U.S. interest is not entirely commercial, financial or mercantile. With the help of other democratic, market economies we have been the leader in spreading democracy, the rule of law, and economic stability. U.S. efforts to restructure international financial institutions should continue this tradition of leadership by fostering arrangements appropriate to the new environment these efforts will create. Reforms are necessary to enable the international

financial institutions to play an important role in promoting growth, stability, and responsible, democratic government for the next 50 years and beyond.

Chapter 2
The International Monetary Fund

Near the end of World War II, forty-four nations, led by the United States, met at Bretton Woods, New Hampshire to establish postwar economic and financial arrangements designed to prevent a return to the economic instability of the interwar years. The common diagnosis of interwar problems found the causes in competitive devaluations of principal currencies, exchange controls on current account transactions, protective tariffs and other restrictions on trade and payments. To prevent a reoccurrence of monetary and financial instability, the Conference established the International Monetary Fund (IMF).

The Articles of Agreement state that the IMF seeks to promote international monetary cooperation, facilitate the expansion of international trade, promote exchange-rate stability and avoid competitive depreciation. The agreement established a multilateral system for international payments for goods and services that assisted member states to correct balance-of-payments problems, while avoiding measures destructive of national and international prosperity.

The IMF's early goals reflected three main assumptions that the founding countries believed would, and should, characterize future financial relations:

(1) The world economy would remain on a system of fixed, but adjustable, exchange rates tied to gold or the dollar with the gold price fixed at $35 per ounce.

(2) After an initial postwar economic adjustment, payments for goods and services would be free of exchange controls.

(3) Capital account transactions such as lending, borrowing, investing, and repaying could be subject to exchange controls at the discretion of the home country government.

The founders expected the IMF to make short-term loans to assist countries with payments deficits and to advise countries that failed to remove controls on current account. Over the years, the IMF has increased the frequency and scope of consultations and advice. It now engages all members annually about their economic conditions and policies. These consultations, requiring huge documentation, consume more person-hours than any of the IMF's other activities.

Two of the founders' key assumptions are no longer valid. The fixed but adjustable exchange-rate system ended in August 1971 when President Nixon closed the gold window, ending the U.S. commitment to keep the dollar price of gold at $35 per ounce. In March 1973, major countries agreed that the fixed exchange-rate system would not be restored. Thereafter, currency values would be determined in various ways ranging from freely floating exchange rates at one end to firmly fixed exchange rates at the other.

By 1973, many countries had removed exchange controls on both trade and capital movements. The international economy faced a new challenge--to reconcile growth, low inflation and high employment with open trading arrangements and international capital mobility. The oil shocks of the 1970s and the mistaken economic policies in many countries that produced large deficits and inflation increased the difficulty of achieving these goals and objectives. Nothing in the founding mission or the accumulated experience of the IMF prepared it to deal with these evolving challenges.

Seeking New Roles

The end of the gold/dollar standard meant that the IMF's central mission---supporting a fixed global exchange-rate system based on the dollar---had disappeared. The IMF interpreted its original purposes broadly as it searched for new roles. It took responsibility for dealing with financial and economic problems affecting developing countries or the international economy. It provided advice to developing countries on monetary, fiscal and foreign-exchange policies that it believed to be conducive to stability in the balance of payments, and it offered loans to countries that agreed to follow its advice. The IMF's influence grew significantly during the 1980s, especially as the result of its role in the Latin American debt crises.

In August 1982 the Mexican government announced that it could not service its external debts. The IMF organized and supervised the administration of a plan to reschedule the private commercial debts that the Mexican government had incurred over the previous decade. IMF lending did not channel net new funding to Mexico. Rather it lent the money to enable Mexico to service the debt. Mexico's debt increased, but it avoided default.

The IMF made its loans conditional on the implementation of a package of long-term economic reforms. Many of the conditions required sacrifices by the local population, loss of jobs and deep reductions in living standards.

Other developing countries, particularly in Latin America, found that net private capital inflows declined or became negative. Unable to service their debts, these countries, too, agreed to the IMF's conditions. They borrowed to service their external debts and avoid default. Establishing the conditions was straightforward; enforcing them proved difficult.

It soon became apparent that the growing debt burdens of Latin America's debtor countries were not sustainable, regardless of whether countries followed or ignored IMF advice. IMF assistance postponed debt reduction. The postponement of the inevitable debt write-down and restructuring was costly. It delayed renegotiation of the debt and the resumption of capital inflows, investment and economic growth. As a result the decline in living standards was deeper and more prolonged. During the 1980s, as the unpaid principal and accumulated interest rose, Latin America

remained stagnant. Many critics of the IMF policy of lending to countries that could not service their debts viewed this policy as contributing to the delay of the necessary restructuring process and subsequent recovery.

Write-downs of Latin American debts were finally agreed upon at the end of the 1980s, under the Brady plan. On average, creditors wrote off about one-third of the face value of outstanding claims.

By the early 1990s, developing economies had experienced renewed growth of international trade and widespread privatization of state-owned enterprises. Many liberalized financial sectors and reformed fiscal and monetary policies. These changes ushered in a new era of large capital flows, especially to Latin America, Asia, and the transition economies of eastern and central Europe. Capital flows of the early 1990s were larger relative to income than at any time since the end of the 19th century. Unlike the earlier postwar years, the source of the funds was mainly from private lenders and investors. Much of the capital went to private firms and banks in developing countries.

The collapse of the Soviet Union and mass privatizations in eastern and central Europe, and the establishment of new fiscal and monetary institutions throughout the region, offered another opportunity for the IMF to expand its purview. Pressed by the United States and other industrial countries, the IMF undertook to advise and support the transformation of the former Soviet Union and its allies from socialist command and control to market economies with private ownership of the means of production and distribution. The IMF was ill-equipped for this task; it had no previous experience to guide it. Moreover, reliance on IMF funding bypassed the appropriations process in the U.S. Congress and foreign parliaments, a process that is the centerpiece of democratic government.

The new tasks undertaken by the IMF in the 1980s and 1990s transformed the institution from a short-term lender to support balance-of-payments adjustment to a source of long-term, conditional lending and macroeconomic advice to developing and transforming countries. With the assumption of this new role, the number, size, type and duration of long-term loans increased markedly. With the new tasks came new requests for increases in members' quotas or subscriptions.

The IMF is currently involved in structural adjustment programs in some seventy countries. Many have received IMF credit for more than twenty years. Four countries have remained almost continuously in debt. Table 2-1 shows, for the period 1949-99, the number of years during which countries have been in debt to the IMF.

Table 2-1

Years of Indebtedness by Countries

1949-99

Number of	Less than 10	10-19	20-29	30-39	40-49
Countries	29	25	46	20	4

Note: The table excludes countries that joined in the 1990s and first borrowed in 1995 or later.

Source: IMF.

Whatever the wisdom of these programs, their longevity is a clear sign that the IMF has departed from the principle of providing member states exclusively short-term balance-of-payments assistance as envisaged by its founders.

Transformation of the IMF into a source of long-term conditional loans has made poorer nations increasingly dependent on the IMF and has given the IMF a degree of influence over member countries' policymaking that is unprecedented for a multilateral institution. Some agreements between the IMF and its members specify scores of required policies as conditions for continued funding. These programs have not ensured economic progress. They have undermined national sovereignty and often hindered the development of responsible, democratic institutions that correct their own mistakes and respond to changes in external conditions.

Crisis Management

IMF assistance to developing countries increased in both scale and scope in the 1990s. These changes reflect the IMF's enlarged role in managing financial crises and the size and depth of recent crises.

1994-95: The Mexican Crisis

The 1994-1995 Mexican crisis is seen by many as a watershed in the history of the "new" international monetary system and the "new" IMF. It raised important questions about the effectiveness of IMF assistance in preventing such crises. Mexico had been the largest single recipient of IMF credit during the six years leading up to the crash of the Mexican peso in December 1994. With its loans it received frequent advice, conditions, and visits by IMF officials and staff. After the crisis, the IMF approved an eighteen-month standby credit worth $17.8 billion, the largest financial package ever granted a member state and one clearly beyond the borrowing limits that the IMF had always maintained. The U.S. Treasury offered to provide up to $20 billion in additional funds through its Exchange Stabilization Fund and the Federal Reserve's swap network. According to the General Accounting Office (GAO), Mexico eventually used some $13 billion of IMF money and $13.5 billion of U.S. official funds.

The Mexican program established several bad precedents. Congress had shown that it opposed a large expenditure to aid Mexico. The Treasury used the Exchange Stabilization Fund to circumvent the Congressional

budget process. And the IMF circumvented established procedures for approving loans and limiting their size in relation to the borrower's IMF quota.

The IMF and the U.S. Treasury view the Mexican bailout as a success. It certainly enabled the Mexican government to redeem some of its debts (tesobonos) as they matured. These were short-term, dollar-linked bonds that the government had issued in an unsuccessful attempt to avoid devaluation. Thus foreign private investors avoided large losses. The IMF-Treasury bridge loan allowed the Mexican government to maintain its debt payments, support insolvent Mexican banks, and protect many insolvent bank borrowers from being forced to repay their debts.

After the IMF, the U.S. Treasury, and the foreign creditors had been repaid, however, the Mexican taxpayer was left with the bill. The cost of the banking system bailout is currently estimated at roughly 20 percent of Mexico's annual GDP. Real income per capita in 1997, despite ups and downs, was no higher in 1997 than twenty years earlier. Real wages of the lowest paid workers, those receiving the minimum wage, have fallen 50% since 1985. Chart 2-1 shows these data.

[Chart 2-1 here]

As Chart 2-2 shows, Mexico's total (public and private) external debt, expressed in 1996 U.S. dollars, has grown fivefold over the period since 1973, or fourfold when expressed on a per capita basis. Real wages are lower and the burden of financing the debt is much higher for each Mexican worker.

The IMF is not entirely responsible for these failures. Policies of Mexico's government and changes in international oil prices have a role. But Mexico is one of the IMF's largest clients. Either IMF policy prescriptions have not worked, or the IMF has continued to lend despite Mexico's past failures to follow IMF policy conditions and advice.

[Chart 2-2 here]

1997-98: The East Asian Crisis

The East Asian crisis erupted in the summer of 1997 and went on to reverberate around the world. This crisis occurred for different reasons than the Mexican crisis and involved far larger capital movements. Its impact on the rest of the world was correspondingly greater and, not surprisingly, the IMF increased its promised assistance to more than $100 billion, much more than in the Mexican program.

The IMF's actions in Asia have been criticized on several counts. First, it provided no public warning of the impending catastrophe despite evidence that the IMF was aware of the problems developing in Thailand. Second, critics of the IMF's intervention in East Asia complained that liquidity assistance was too slow and inadequate, partly as

a consequence of the many conditions attached to disbursement. Third, critics claimed that the policy conditions set by the IMF were inappropriate, designed for countries with large budget deficits and high

inflation. The causes of the Asian crisis were very different. Cutting government expenditure, raising taxes, raising interest rates and closing banks aggravated the crises. These criticisms were not universally accepted, but the IMF subsequently modified some of its mandates, implicitly accepting some of the criticism.

Critics also claimed that, by preventing or reducing the losses borne by international lenders, the IMF's 1995 Mexican program sent the wrong message to international lenders and borrowers. By preventing or reducing losses by international lenders, the IMF had implicitly signaled that, if local banks and other firm institutions incurred large foreign liabilities and governments guaranteed private debts, the IMF would provide the foreign exchange needed to honor the guarantees. Economists give the name "moral hazard" to the incentive inherent in such guarantees.

The IMF has repeatedly denied this charge. What can be said with certainty is that: (1) to forestall outflows, Thailand, Korea, and others followed Mexico by guaranteeing private debts denominated in foreign currencies, (2) foreign lenders made the subsequent crises much worse by offering large short-term loans before the crisis under the guarantees and (3) as the size of the short-term debt increased, dependence on IMF or foreign government loans became increasingly likely; otherwise the guarantees could not be honored.

The importance of the moral hazard problem cannot be overstated. The powerful root of moral hazard lies in the IMF's encouragement, or lenders' perception of its encouragement, of short-term, foreign currency loans to developing countries, particularly where the domestic banking and financial infrastructure is weak. To address the core problem, the IMF should discourage excessive reliance on short-term borrowing and encourage financial institutions in the borrowing countries to adopt higher standards of safety and soundness. The IMF has belatedly accepted the importance of these problems.

Whether or not the IMF contributed to moral hazard in Asia, it did little to end the use of the banking and financial systems to finance government-favored projects, eliminate so-called "crony capitalism" and corruption, or promote safer and sounder banking and financial systems. Mexico, Asia and, subsequently, Russia and Latin America show the risk to international financial stability created by large short-term, foreign-denominated lending to countries with weak financial and banking systems.

1998-99: The Russian Crisis

Russia relied heavily on IMF lending in the mid-1990s. IMF assistance was supported enthusiastically by the G-7 governments, who sought to support Boris Yeltsin and the reform process in Russia. By using the IMF, the major donor members could supply aid without asking their legislatures to appropriate the money. Increasingly, concern about Russia's political stability---especially given its nuclear capabilities---underlay decisions to provide assistance. Aid continued even when the prospects for reform were bleak and there was little or no economic rationale for

assistance. By mid-1998, a number of factors, including a fall in oil prices, a weak financial system, lack of political and economic reform, and the East Asian financial crisis, encouraged private investors in Russia to withdraw their capital. This precipitated a financial crisis for the Russian government and the ruble.

The IMF announcement in July 1998 of more than $20 billion in emergency assistance failed to prevent the collapse of the Russian stock market and a default on Russian sovereign debt. The IMF suspended the program in late 1998 under pressure from the U.S. Congress and other critics, who viewed assistance to Russia's corrupt government as wasteful and counterproductive. In 1999 the IMF resumed assistance.

The role of the IMF in fostering large capital inflows, and the moral-hazard problem of anticipated assistance, is clearest in the case of Russia. The IMF agrees that foreign lenders made loans and bought securities fully expecting that the IMF would facilitate the orderly repayment of hard-currency-denominated debt to foreigners in the event of a crisis. In the view of many lenders, Russia was too important, politically, to fail.

In the event, foreign investors were not protected by IMF assistance. Some observers view the losses suffered by foreign investors in Russia as an antidote to future moral-hazard plays by investors in emerging markets; others see Russia as a special case because of the extreme difficulty the IMF had in making loans to the unstable and kleptocratic Russian government at the time of its crisis. It is not clear that investor losses in Russia will prevent future moral-hazard problems elsewhere.

No less important, the economic results of the program are poor. Although private markets have developed in Russia, there is an immense poverty problem. Russia has not privatized land, reformed its tax system, established a credible rule of law, established a sound financial system with transparent accounting, or raised living standards. Chart 2-3 shows that real income (GDP) has fallen almost every year since the IMF's programs started.

[Insert Chart 2-3 here]

On the positive side, Russia has established a political democracy for the first time in its history. There are many private enterprises, no shortages of goods, and after the 1998 devaluation and the 1999 rise in oil prices, the prospect that output will start to rise.

Summary on the Mexican, Asian and Russian Crises

The crises in Mexico, Asia and Russia were large by any standard. Financial failures wiped out a vast amount of wealth. Gains in income achieved over a decade were, in some cases, destroyed in a few weeks. Poverty increased as living standards fell. This is the most serious cost of these crises.

For the United States, there were benefits as well as costs. Import prices fell, thereby permitting consumers to benefit from the decline in prices abroad and the devaluation of foreign currencies. The United States absorbed imports

from the countries struggling out of crisis. This has been beneficial to consumers and purchasers of inputs for domestic production but costly to the workers and firms that compete with imports.

The role of the IMF has evolved along with the changing nature, causes and size of the crises faced. While the IMF can point to some successes, it has presided over, and fostered, a crisis-prone system. Moreover, IMF efforts have not been particularly effective, relative to resources utilized, in maintaining financial and economic stability.

There is little evidence that IMF efforts have prevented the periodic financial crises that can set back income growth for many years. IMF programs and prescriptions frequently delay necessary adjustments to emerging problems, resulting in a protracted period of growth suppression. Reform of this system is essential not only for growth and improved living standards in developing countries, but also to avoid the periodic crises that can threaten worldwide financial stability.

Broadening the IMF's Mission

While some see the crises of the 1990s as reason to limit the IMF's influence and narrow its focus, the IMF and its member governments reacted to recent problems and criticisms by seeking to enlarge the scope of the IMF's role in developing countries. Three recent expansions of IMF authority reflect this conclusion. First, in 1998, the Interim Committee of the IMF endorsed a proposal to amend the IMF charter to add yet another function to the IMF's mission: the promotion of capital account liberalization.

Second, the IMF proposed in September 1999 to transform its Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility. The principal reason for this initiative is the poor economic record of developing countries that receive IMF assistance. In many cases, these economies have contracted over the past twenty years. The IMF has been criticized for not taking the problem of poverty into account when it advises countries.

The ESAF is the mechanism by which the Fund provides concessional lending to poor countries in exchange for macroeconomic adjustment and structural reforms. The new plan requires governments seeking assistance to submit a poverty-reduction plan for IMF approval. With this expansion of IMF programs, the Fund has added the job of making long-term development loans to emerging countries to its long-standing practice of supervising and setting conditions for cyclical macroeconomic policies.

When the Poverty Reduction and Growth Facility is added to its traditional tasks, the IMF will be responsible for monitoring and setting conditions for virtually all aspects of developing countries' economic and social policies. Moreover, the new facility duplicates the responsibilities of the development banks, a source of potential conflict and waste.

Third, the IMF has established a Contingent Credit Line (CCL) facility to offer pre-qualified members immediate access to financing during a liquidity crisis. This was in response to a U.S. Treasury initiative to enhance the IMF's ability to provide rapid liquidity assistance to member countries during an emergency. The CCL is so poorly designed that, to date, no country has applied.

The CCL has four serious flaws. First, availability of CCL credit is not automatic but depends on the IMF's judgment that the country has not contributed to its problems. This is a subjective judgment and a possible reason for delay and negotiation. Second, the IMF does not mandate a penalty rate for CCL loans. Once again, the IMF is fostering counterproductive borrowing incentives by offering subsidies. Third, countries must apply in advance for admission to the CCL program. To date, they have been unwilling to do so, perhaps concerned that the application would be interpreted as a sign of impending or potential crisis and, therefore, detrimental to their perceived creditworthiness. Fourth, part of the reason countries have little interest in applying for the CCL is that other channels

of IMF assistance remain available. This undermines the incentive for countries to undertake reforms in order to gain access to the CCL.

Old and New Criticisms

The IMF contributed to the remarkable success of the postwar economic order, the IMF has also been criticized from many different perspectives. Here we consider twelve of the principal criticisms. Members of the Commission do not necessarily endorse or subscribe to all of these criticisms. They are listed to summarize the context in which reform must occur and some of the problems that reform proposals must address.

(1) The IMF creates disincentives for debt resolution when it lends to insolvent sovereign borrowers. This is contrary to an early hope that IMF lending to insolvent countries would facilitate debt renegotiation. The opposite often seems to transpire; the provision of an apparently unlimited external supply of funds forestalls creditors and debtors from offering concessions. One commentator wrote:

> "Rather than the policy providing the IMF with a lever to encourage burden sharing by the banks, the banks realized that they could use it as a club in their battle with governments."[5]

Indeed, it is often argued that IMF lending to insolvent sovereign debtors strengthens the long-run bargaining position of creditors by avoiding the short-run crisis precipitated by default on debt service and by involving an agent of creditor country governments in the bargaining process. Countries become more resistant to writing down their debts. There are large potential gains to be achieved by hastening workouts of unsustainable levels of debt. Delay is socially costly. Lenders wait for resolution of outstanding claims, so the country cannot borrow for investment and growth. Unemployment rises and living standards fall.

(2) The IMF wields too much power over developing countries' economic policies. The use of IMF resources and conditionality to control the economies of developing nations often undermines the sovereignty and democratic processes of member governments receiving assistance. IMF staff often admit (with pride) that the executive branch of borrowing nations likes to use IMF conditions to exact concessions from their legislatures. While this mechanism may sometimes work to achieve desirable reforms, it often does so by shifting the balance of power within countries in ways that distort the constitutionally established system of checks and balances. A related complaint, often voiced by union advocates, is that the IMF's policies interfere with the rights of workers in developing countries by promoting "labor-

[5] B. Eichengreen, Toward a New International Financial Architecture: A Practical Post-Asia Agenda. Washington: Institute for International Economics, 1999, p. 71.

market flexibility" as a condition for assistance. The critics regard these policies as inimical to the growth of trade unions in developing nations.

(3) Despite its influence on developing countries, the IMF often fails to enforce its conditions. Enforcement of conditions is not uniform or predictable, and differences in enforcement may reflect the political power of recipients to avoid compliance.

(4) There are shortcomings in the ways the IMF funds itself and in the way it accounts for its funding and reports its financial position. Jacques Polak, a highly influential staff member and later an Executive Director of the Fund, described the problems:

> "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."[6]

One consequence of this lack of transparency is that member governments do not know whether the Fund has sufficient resources to carry out its missions. Also because many countries pay most of their quota in inconvertible currency, member countries' true shares of funding costs cannot be computed readily. The U.S. share of funding costs has been larger than its quota share and has varied over time depending on the demand for dollars as the form of borrowing from the IMF.

(5) The G-7 governments, particularly the United States, use the IMF as a vehicle to achieve their political ends. This practice subverts democratic processes of creditor countries by avoiding parliamentary authority over foreign aid or foreign policy and by relaxing budget discipline.

(6) IMF interventions---both long-term structural assistance and short-term crisis management---have not been associated, on average, with any clear economic gains to recipient countries. Numerous studies of the effects of IMF lending have failed to find any significant link between IMF involvement and increases in wealth or income.[7] IMF-assisted bailouts of creditors in recent crises have had especially harmful and harsh effects on developing countries. People who have worked hard to struggle out of poverty have seen their achievements destroyed, their wealth and

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[6] J.J. Polak, Streamlining the Financial Structure of the International Monetary Fund. Princeton: Essays in International Finance 216. September 1999, p. 2. Emphasis added.

[7] This is the conclusion of many studies including S. Edwards, "The International Monetary Fund and the Developing Countries: A Critical Evaluation," *Carnegie-Rochester Conference Series on Public Policy*, 31, 1989, pp. 7-68. N. Ul Haque and M.S. Khan, "Do IMF Supported Programs Work? A Survey of Cross Country Empirical Evidence," IMF Working Paper, November 15, 1999, (unpublished). Brealey, R.A. and Kaplanis, E., The Impact of IMF Assistance on Asset Values. Working paper, Bank of England, September, (1999).

savings lost, and their small businesses bankrupted. Workers lost their jobs, often without any safety net to cushion the loss. Domestic and foreign owners of real assets suffered large losses, while foreign creditor banks were protected. These banks received compensation for bearing risk, in the form of high interest rates, but did not have to bear the full (and at times any of the) losses associated with high-risk lending. The assistance that helped foreign bankers also protected politically influential domestic debtors, encouraged large borrowing and extraordinary ratios of debt to equity. Further, this system encouraged unsafe banking practices including insufficient diversification, excessive political influences on the allocation of bank credit, and excessive reliance on short-term capital to finance long-term investment.

(7) The IMF's governance structure limits its independence to pursue bona fide economic objectives and insulates it from proper accountability. The IMF's management and oversight board are not distinct, its deliberations are not public, and formal votes are rare. If the G-7 finance ministers can agree on a policy that they wish to pursue, for whatever reason, they can use the IMF as the instrument of that policy. The assistance to Russia is a clear illustration.

(8) The IMF has at times encouraged countries to adopt pegged exchange-rate systems. These systems proved to be unsustainable. The reliance on pegged exchange rates increased developing countries' vulnerability to crises.

(9) Economists criticize the IMF staff's economic doctrines, which are the basis for IMF policy guidance. Edwards (1989) provided an early criticism of the IMF approach to economic modeling.[8] Other critics allege that forecasts are biased and inaccurate and that the IMF places excessive emphasis on short-term forecasting. A recent evaluation of the research department found insufficient attention to weak financial sectors in developing countries as a cause of macroeconomic instability.

(10) The IMF's mission has expanded until it overlaps and conflicts with other international financial institutions. Its recent decision to establish a poverty facility puts the IMF into the province of the development banks, weakening accountability and increasing cost. The IMF lacks expertise in poverty alleviation, so the broadening of its mandate diverts funding from the poorer countries to pay for redundant administrative costs.

(11) The IMF is deficient as a mechanism for providing liquidity during crises. The IMF could act as a quasi-lender of last resort during bona fide liquidity crises in emerging market countries. But conditional lending under existing programs---often requiring protracted negotiations for the disbursement of staged releases of funds over a long period of time---is not an effective means of responding to a sudden liquidity crisis.

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[8] See fn. 3 this chapter.

(12) The IMF relies too much on mandates and conditional lending dictated from abroad and too little on credible, long-term incentives that encourage local decision-makers to act responsibly and reform domestic regulations, laws, institutions, and practices.

This long list of criticisms reflects the enormous responsibilities the IMF has undertaken in the last two decades, the latitude it has been granted to act, the absence of provisions limiting its authority and ensuring its accountability to the public in developed and developing countries, its frequent lack of success in maintaining stability and the high cost of its crisis interventions. By reporting these criticisms, the Commission does not intend to voice unqualified support for each of them. Nor do we mean to suggest that the IMF always fails in its mission. As noted in the introduction, international financial institutions have played useful roles in the extraordinary postwar expansion. Many of these contributions occurred, however, under conditions that no longer exist. The Commission also recognizes many examples of the IMF's success in encouraging beneficial policies. At the same time, the Commission takes these criticisms seriously, and its recommendations to improve the IMF's effectiveness and the stability of the international economy respond to their valid aspects.

Recommendations

Six core principles guide our recommendations. These are:

- (1) "sovereignty" -- the desire to ensure that democratic processes and sovereign authority are respected in both borrowing and lending countries;
- (2) "separation" -- the desire to define a set of tasks for the IMF that are distinct from the tasks of other multilateral agencies, to avoid counterproductive overlap;
- (3) "focus" -- establishing clear priorities and placing credible bounds on authority to ensure that the IMF does not continue to experience mission creep;
- (4) "effectiveness" -- designing mechanisms that are likely to achieve desired objectives at reasonable cost while avoiding corruption and other undesirable side effects;
- (5) "burden-sharing" -- ensuring that the burden of financing IMF operations is shared equitably among nations;
- (6) "accountability and transparency" -- ensuring that the governance and accounting structure of the IMF provide accurate information about IMF actions, that IMF officials are accountable for their actions, and that reports are available and understandable.

The Mission of the New IMF

The Commission recommends that the IMF be restructured as a smaller institution with three unique responsibilities which, if properly performed, would increase global stability, improve the functioning of markets, and help countries improve domestic monetary and fiscal policies.

(1) to act as a quasi-lender of last resort to solvent emerging economies by providing short-term liquidity assistance to countries in need under a mechanism designed to avoid the abuse of liquidity assistance to sponsor bail outs and under a system that would not retard the development of those institutions within the recipient country that would attract capital from commercial sources;

(2) to collect and publish financial and economic data from member countries, and disseminate those data in a timely and uniform manner that permits market participants to draw useful information about member countries' economic performance across time and across countries; and

(3) to provide advice (but not impose conditions) relating to economic policy as part of regular "Article IV" consultations with member countries.

Except in unusual circumstances, where the crises poses a threat to the global economy, loans would be only to countries in crises that have pre-conditions that establish financial soundness.

The IMF should be precluded from making other types of loans to member countries. The current practice of extending long-term loans in exchange for member countries' agreeing to abide by conditions set by the IMF should end. Doing so would avoid duplication with other agencies and ensure that the IMF focuses on a clearly defined set of economic objectives.

The Commission recommends that **long-term institutional assistance to foster development and encourage sound economic policies should be the responsibility of the reconstructed World Bank or regional development banks** under a new mechanism---one designed to increase the probability of achieving bona fide objectives, without exerting excessive control over member countries' policies (see Chapter 3). **The IMF's Poverty and Growth Facility should be closed.**

Participation in IMF Programs

All IMF members should be expected to provide accurate economic and financial information in a timely manner. Increased reliance on private capital flows makes it imperative to improve the quantity, quality, and timeliness of information. Accurate information increases the number of market participants and improves market stability and efficiency.

Developed countries report on their economies and policies to the OECD. Central bankers discuss these topics at the BIS. Finance ministers of the G-7 countries exchange information and report on their problems and prospects at

G-7 meetings. OECD members should be allowed to opt out of IMF Article IV consultations. All other countries should be required to participate.

IMF consultations are valuable. They force countries to review systematically and explain their policies and contribute to the development of data sources. **To enhance the value of Article IV consultations, all reports should be published promptly**. The IMF has shown leadership in recent years by encouraging publication and dissemination of its reports. We recommend that publication become mandatory.

The Commission recommends two types of restriction on the IMF's role as quasi-lender of last resort. First, the central banks of large, industrial countries should continue to function as lenders of last resort for their own currencies and financial systems. The IMF does not have, and cannot be expected to have, the resources to protect the payments systems of advanced industrial countries against an internal drain. And these countries have fluctuating exchange rates, so they do not have to respond to an external drain.

Second, **to be eligible to borrow in a liquidity crisis, a member should meet minimum prudential standards. Countries that meet the standards would receive immediate assistance without further deliberation or negotiation.** The IMF would not be authorized to negotiate policy reforms. The policies necessary to improve economic performance and end a crisis are well-known. The IMF's role would be to provide liquidity, promptly, in a financial crisis under strict rules. These rules reflect experience in many financial crises where fragile financial systems could not bear the strain caused by repatriation of foreign capital or reductions in foreign lending. Further, IMF assistance should be limited to illiquid not insolvent borrowers. **IMF (or Development Bank) lending should not be used to salvage insolvent financial institutions, directly or indirectly, or to protect foreign lenders from losses.**

Rules for IMF Lending

First, to limit corruption and reduce risk by increasing portfolio diversification, **eligible member countries must permit freedom of entry and operation for foreign financial institutions in a phased manner over a period of years.** Foreign institutions hold a highly diverse portfolio of loans to borrowers in many countries and different industries. They would be expected to act in much the same way as global industrial companies with assets in many countries; they would stabilize and develop the local financial system. They would benefit by diversifying their risks on the international financial marketplace. Countries would gain from increased stability, a safer financial structure, and from the management and market skills that global banks would impart. A competitive banking system would limit use of local banks to finance "pet projects," or lend to favored groups on favorable terms.

Second, consistent with the Basel Commmittee's recent reform proposal, the Commission believes that bank regulation should incorporate market discipline as a means of measuring and enforcing prudential capital standards. **To establish market discipline in the domestic financial sector and protect the soundness of financial institutions, commercial banks must be adequately capitalized. This can be achieved in different ways including a significant equity base and the issuance of uninsured subordinated debt to non-governmental and unaffiliated entities.** The function of the subordinated debt is to encourage prudent behavior by banks and monitoring by the subordinated investors.

Third, to encourage prudent behavior, safety and soundness **every country that borrows from the IMF must publish regularly the maturity structure of its outstanding sovereign and guaranteed debt and off-balance-sheet liabilities in a timely manner.** Lenders need accurate information on the size of short-term liabilities to assess properly the risks that they undertake.

Fourth, **the IMF should establish a proper fiscal requirement to assure that IMF resources would not be used to sustain irresponsible budget policies.**

Under any system of minimum standards for access to assistance, including the standards used by the central banks of the industrialized countries, the entire financial structure may be put at risk by the inability of one large participant to meet the minimum standards for assistance. This "too big to fail" argument has been used to rescue many insolvent institutions. The responsibility of the lender of last resort should be to the market, not to the individual participant. In recent decades, the collapse of the Penn Central, Drexel Burnham, and Russia have been met by loans to the market and solvent borrowers. Direct assistance was not given to the insolvent entity.

Terms for Lending

The Commission envisions a liquidity assistance mechanism that would be used to alleviate crises when private sector financing is temporarily unavailable. Historical experience suggests that liquidity crises typically last for a matter of weeks or, in extreme cases, for several months. To ensure that liquidity assistance is only used as a last resort, **IMF loans (1) should have a short maturity (e.g., a maximum of 120 days, with only one allowable rollover), (2) should pay a penalty rate** (that is, a premium over the sovereign yield paid by the member country one week prior to applying for an IMF loan), **and (3) should specify that the IMF be given priority in payment over all other creditors, secured and unsecured**.

The penalty rate premium could increase with the length of time the loan remains outstanding. This would provide an incentive for early repayment.

Phase in

The new rules should be phased in over a period of three to five years. If a crisis occurs before the new rules are in place in most countries, countries should be permitted to borrow at an interest rate above the penalty rate. The "super penalty rate" would give countries an additional incentive to adopt the new rules.

Some countries may choose not to adopt the proposed rules. The names of the countries should be disclosed along with their ineligibility for IMF lender-of-last-resort services. Defaults should not always be prevented in these countries or elsewhere.

Ensuring Priority of IMF Claims on Sovereigns

One way to ensure priority of IMF claims is to require security or collateral. There are some practical difficulties in this approach for many countries. For example, commodity exports can serve as collateral, but this is a cumbersome process. Also, it may unintentionally encourage countries not to privatize important export-producing sectors (so that the government can retain control over exports to serve as collateral).

Second, "negative pledge clauses" may prevent some governments from effectively subordinating existing creditors by pledging collateral on new loans. Many existing sovereign debt contracts specifically exempt from negative pledge clauses short-term debt, debt to foreign monetary authorities and multilateral institutions, and debt which is not publicly offered. There are various possible approaches to resolving the legal and practical problems of ensuring IMF priority when negative pledge clauses apply. For example, IMF advances can be treated as "exchanges of assets," rather than as loans, to avoid the application of negative pledge clauses. Another approach, in a crisis, would take advantage of the grace period allowed before the enforcement of negative pledge clause violations (typically 90-120 days). This would permit collateralized (secured) IMF loans of sufficiently short maturity.

Perhaps the most promising and simple approach to ensuring IMF seniority, while waiting for markets and governments to resolve the practical and legal problems of providing collateral, would be to require IMF members to agree to three debt management rules as part of the prequalification requirement for access to IMF liquidity assistance: (1) **Member countries must specifically exempt the IMF from the application of negative pledge clauses in all new sovereign debts issued by the member country**. Most sovereign debt outstanding by developing economies is of relatively short maturity. Within a period not much longer than the phase in, contracts could be amended to give priority to the IMF. Issuers interested in hastening the conversion process could also repurchase outstanding debt, or

ask creditors to accept an exchange of new debt (containing the exemption) for old debt. (2) **Borrowers would give the IMF explicit legal priority with respect to all other creditors, secured and unsecured.** (3) **Member countries that default on their IMF debts would not be eligible for loans or grants from other multilateral agencies or other member countries.**

Credit Limits

Credit limits are necessary to restrict the amount of assistance that a country can receive from the IMF. The limit should reflect the capacity of the sovereign to repay its debt to the IMF. A borrowing limit equal to one year's tax revenues might be a reasonable credit limit.

Other Recommendations

Extraordinary Events. The Commission recognizes that countries may need to borrow for reasons other than a liquidity crisis. In such cases, vehicles other than the IMF are available. For example, countries should apply to a multilateral development bank or a United Nations' agency, if emergency assistance to alleviate starvation or disease is called for. Or, if a country undertakes institutional reform or poverty alleviation programs, it should apply for assistance to the development banks.

If extraordinary political events lead some group of countries to determine that they wish to act jointly to provide foreign aid or loans to another nation (as, for example, appears to have been the determination of the G-7 finance ministers in the case of Russia in the late 1990s), the lending countries---acting through appropriate constitutional and parliamentary procedures---should provide the aid directly.

Following a financial crisis, a country will often find that it wishes to undertake institutional reforms. It may want to spread the burden of adjustment to the crisis differently than the market solution. For example, it may wish to shield the weakest or poorest parts of the society from bearing the full burden determined by market processes. Expenditures for these purposes can be financed either domestically, or by borrowing abroad if the country has established credit, or from multilateral development institutions, if the access to capital markets is restricted.

The IMF should not be used as a "slush fund" to satisfy decisions of the G-7 finance ministers or other groups of powerful members. Such practices undermine the IMF's role as a supplier of liquidity, distort the incentives of lenders and borrowers in international capital markets, bypass the budget process in the lending countries and, by imposing conditions, undermine the development of responsible, democratic decision-making in the borrowing countries.

Exchange Rates. A pegged exchange rate is neither permanently fixed nor flexible. A country commits to maintain its exchange rate only as long as it chooses to do so. Pegged exchange-rate systems have proved to be costly and usually unsustainable in a crisis.

Countries have spent billions of dollars and raised domestic interest rates to unsustainable levels in fruitless attempts to prevent devaluation. Stanley Fischer, First Deputy Managing Director of the IMF, summarizes the experience in the 1997-98 Asian crises.

> "It is a fact that all countries that had major international crises…relied on a pegged or fixed exchange-rate system before the crisis; and it is also true that some countries that appeared vulnerable but that had flexible exchange rates avoided such crises. Countries with very hard [firm, non-adjustable] pegs have been able to sustain them. Accordingly, we are likely to see emerging market countries moving toward the two extremes of either a flexible rate or a very hard peg--and in the long-run, the trend is almost certainly to be towards fewer currencies."[9]

A majority of the Commission agrees with this conclusion. **Countries should choose either firmly-fixed rates or fluctuating rates.** Neither system is ideal for all countries, at all times, and under all conditions. Mixed systems typically work poorly, as they did in Asia.

Rigidly-fixed systems require large reserves or lines of credit. They acquire needed credibility gradually, often only after the country surmounts a crisis. To increase credibility, some countries, adopting a fixed exchange rate, have chosen to establish a currency board or, in a few cases, have taken a strong foreign currency---such as the dollar or the Euro---as their domestic money. The eleven countries that joined the European Central Bank have taken a different route, a common currency internally and a fluctuating exchange rate against the rest of the world.

A critical point is often overlooked. The long-run position of an economy does not depend on the choice of the exchange-rate system. Exchange-rate systems determine how a country adjusts to external events or domestic policies. A fluctuating exchange-rate system adjusts by currency appreciation or depreciation. A fixed exchange-rate system adjusts by raising or lowering the domestic price level relative to foreign prices. The adjustment cannot be prevented in either system, and it occurs quickly with capital mobility.

Two important lessons of experience under many different exchange-rate regimes are: First, countries that follow stabilizing monetary, fiscal (and other) policies can successfully maintain either a fixed or a fluctuating exchange rate. Second, countries that adopt policies that are excessively expansive or contractive have difficulty maintaining a fixed exchange rate or avoiding appreciation or depreciation of a fluctuating rate.

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[9] Stanley Fischer, "Presentation to the International Financial Institution Advisory Commission." Washington: International Monetary Fund, February 2, 2000, p. 12. The paper is available on the Commission's web site at http://phantom-x.gsia.cmu.edu/IFIAC.

Stabilizing policies are more important than the choice of exchange-rate regime. If domestic policies, or external events, destabilize a country, the country will have to adjust. It is not an accident, but instead a necessary consequence of the adjustment process, that countries with fixed exchange rates---China, Hong Kong, and Argentina---experienced deflation in the late 1990s, while Australia, Canada, the United States, and the Euro adjusted by allowing their exchange rates to appreciate or depreciate.

The Commission recommends that countries avoid pegged or adjustable rates. The IMF should use its Article IV consultations to make countries aware of the costs and risks of pegged or adjustable rates.

Debt Renegotiation. The Commission does not approve of the IMF's policies in Latin America in the 1980s and in Mexico in 1995, or in many other cases. IMF loans to these countries protected U.S. and other foreign banks, financial institutions, and some investors at great cost to the citizens of the indebted countries. The loans delayed resolution of the 1980s crises by permitting lenders and borrowers to report the debt as fully serviced.

Many suggestions have been made to change contractual terms or to impose costs on private lenders in a crisis. Most of these proposals seek to share the costs of resolving crises between the public and private sector. The Commission believes that lenders who make risky loans or purchase risky securities should accept the true losses when risks become unpleasant realities.

Proposals for bankruptcy courts, collective action clauses and other contractual changes, or other attempts to share losses between private and public lenders and institutions, raise many unresolved problems. None is problem free. Unlike bank debt, there are often many holders of emerging market bonds, each interested in protecting their own, frequently divergent, interests.

Lee C. Buchheit, an expert on these issues, points out that debt renegotiation practices are evolving rapidly, without official intervention.[10] **The Commission believes that the development of new ways of resolving sovereign borrower and lender conflicts in default situations should be encouraged but left to the participants until there is a better understanding by debtors, creditors, and outside observers of how, if at all, public-sector intervention can improve negotiations.**

Finance and Accounting Reforms. **The IMF's accounting system should be simplified and rationalized to improve transparency. The recent use of gold sales and repurchases as an accounting device for forgiving HIPC debt is an example of budgetary obfuscation which is substantively unrelated to the act of forgiving debt.** Contrivances of this kind have no place in a multilateral lending agency dedicated to increasing transparency of member governments' policies and operations.

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[10] Lee C. Buchheit. "Sovereign Debtors and their Bondholders". Prepared for the Commission and presented on February 1, 2000. The paper is available on http://phantom-x.gsia.cmu.edu/IFIAC.

IMF accounts should be reformed to mimic standard accounting procedures for representing assets and liabilities and income and expenses. Loans should be specifically identified in IMF accounts (as opposed to the current practice of including loans under currency and securities holdings), **and loans should be divided according to their maturity and delinquency status** unlike current practice. **Currency holdings should be divided into categories that make their usefulness as a funding resource clear. Currencies should be divided into G-5 currencies, other currencies considered useful for intervention purposes, and nonusable currencies**. Liabilities should be separated from equity. Undrawn commitments under operative credit arrangements should be disclosed. Quotas, reserves, and deferred income should be set forward under a separate heading as equity. Quotas should be divided according to whether they represent contributions from G-5 countries, other possibly useful subscriptions, or subscriptions from countries with nonusable currencies. Undrawn borrowing capacity should be similarly divided into three groups separating G-5 currencies, other usable currencies, and non-usable currencies. Income accounts should recognize all implicit subsidies to borrowers (which would no longer occur under the proposed lending rules.)

The "SDR Department" accounts should be incorporated into the IMF's overall accounts, recognizing countries with SDR holdings above cumulative allocations as net suppliers of credit and countries with holdings below cumulative allocations as net recipients of credit. These net positions should be combined with the countries' reserve positions in the "General Department" to obtain an accurate view of net providers and users of subsidized funding. The Appendix shows a recommended pro forma balance sheet for the IMF.

The Commission's proposal would make the IMF a stand-by lender. Lending would decline, so fewer resources would be required. In keeping with the greatly reduced lending role of the IMF, the Commission recommends against further quota increases for the foreseeable future. The IMF's current resources should be sufficient for it to manage its quasi-lender of last resort responsibilities, especially as current outstanding credits are repaid to the IMF.

In a crisis the Fund should borrow convertible currencies as needed to finance short-term liquidity loans. IMF members would be jointly liable for its borrowings, on a pro rata basis depending on quota shares. Borrowing could either be made from the private sector or from credit lines of member countries.

Transparency. The IMF should conduct its operations in a fully transparent manner. **The IMF should maintain and publish full details of its assistance to each country in a timely manner and should publish its Article IV consultations.**

The IMF should take and record votes at Executive Board meetings and publish summaries of its meetings after a reasonable lag.

Debt Relief. Debt of HIPC countries cannot be repaid under any foreseeable future developments. IMF or other lending to make debt service appear current repeats the mistake made in Latin America in the 1980s.

Private ownership, open markets, and the rule of law encourage growth and development. **HIPC debt should be forgiven in its entirety conditional on the debtor countries implementing institutional reforms and an effective development strategy.**

Chapter 3
The Development Banks

At the entrance to the World Bank's headquarters in Washington, a large sign reads: "Our dream is a world without poverty." The Commission shares that objective as a long-term goal. Unfortunately, neither the World Bank nor the regional development banks are moving rapidly toward that objective or the lesser, but more fully achievable, goal of raising living standards and the quality of life, particularly for people in the poorest nations of the world.

Collectively, the World Bank Group and its three regional counterparts---the African Development Bank, the Asian Development Bank and the Inter-American Development Bank---employ 17,000 people in 170 offices around the world, have obtained $500 billion in capital from national treasuries, hold a loan portfolio of $300 billion and each year extend a total of $50 billion in loans to developing members.

Unlike financial institutions in the private sector that have measurable bottom lines and stockholders who can leave if performance is unsatisfactory, the Banks' shareholders are permanent and their objectives diffuse. Reviews of performance are subjective, but even the World Bank's self-audited evaluations reveal an astonishing 55-60% failure rate to achieve sustainable results.

There is a wide gap between the Banks' rhetoric and promises and their performance and achievements. The World Bank is illustrative. In keeping with a mission to alleviate poverty in the developing world, the Bank claims to focus its lending on countries denied access to the capital markets. Not so; 70% of World Bank non-aid resources flow to 11 countries that enjoy easy access to the capital markets.

The Banks claim that funding their activities is costless to donor members. We find that the costs to members reached $22 billion a year. The Banks claim that their interest-bearing loans are made at market rates. We find that borrowers in the aggregate benefit from a subsidy of as much as $31 billion annually, $13 billion on interest-bearing loans.

The past decade has seen large changes in the global economy affecting the development banks. The Cold War is over and, with its end, any rationale disappeared for aid to corrupt or unstable regimes that once had strategic importance. Private capital flows now dwarf any foreseeable value of future annual flows from the four multilateral banks.

The Banks have been slow to adapt to these changes by redrawing the line between public and private activities, by identifying their comparative advantage under the new circumstances, by increasing their effectiveness, and by exploiting their individual strengths in a global effort to reduce poverty. Reform is essential to assure that every dollar

of aid carries with it incentives that encourage performance and achieve results that can be monitored by independent reviewers.

One new task is paramount if the poorest nations are to be empowered to join the global economic community. There must be an intellectual infrastructure that builds and sustains an environment in which productive investment flourishes, where goods and long-term capital flow freely across national boundaries, and where human and property rights are protected. Functioning legal systems, accounting rules, corporate and financial-system governance, and other institutional reforms will mobilize funds many times greater than all of the resources multilateral institutions will ever command.

The Commission recommends a major restructuring of the four multilateral development banks and the design of aid programs. Some will read our comments as criticisms of the individuals who work in these institutions or of their commitment to their tasks. That would mistake both our intent and our conclusions.

We have been impressed repeatedly by the dedication and concern shown by the staffs we met. Our criticisms are directed at the organization and the incentives under which people work. As evidence of the incentive problems, and the dedication of the staffs, we report that many current and former staff agree with the thrust of our recommended changes and volunteer that these steps would improve the effectiveness of their organizations and the lives of the poorest.

Origin and Description of the Development Banks

The origins of the development banks reach back into what now seems to be international financial pre-history. For the World Bank, at Bretton Woods in 1944, the universal view of the future was: a gold-based international monetary standard, capital controls, trade barriers in former colonies and less-developed economies, infant financial markets, and little private-sector interest beyond national boundaries. The Bank was to be the institutional meeting ground, where rich industrialized members would supply resources and AAA credit support to enable the Bank to gather money in the financial markets and redistribute the funds as loans to emerging members. The eventual goal: the alleviation of poverty worldwide.

Beginning at the end of the 1950s, members from each of the world's key borrowing regions, desiring more control of lending policy, united in three regional banks. Linked by geography, sympathetic by custom and culture, and staffed predominantly by their own citizens, they sought to serve their constituencies better than could a distant institution dominated by industrial countries. At first limited to local membership, all regional banks gradually acceded

to the need for expanded funding by joining with the developed countries while retaining the majority vote in regional hands. All now have a roster of outside participants from the entire industrialized world.

Until the 1980s, the development banks were the dominant source of international resources to emerging economies. Knowledge and resource transfer went hand-in-hand to establish the conditions for productive investment. Each of the Banks adopted a similar structure. One part provided development loans to governments at interest rates equal to the institution's cost of capital. A second offered highly subsidized long-term credits to the poorest members. The third provided loans, equity capital and loan guarantees to private-sector firms in emerging economies. The World Bank also offered insurance against political risks. Appendix A names and describes these programs. Appendix B shows the U.S.'s share of investment in each bank.

The last decade of the twentieth century saw the political and economic landscape transformed. With the end of the Cold War, lending as a strategic gesture became outmoded. The need to commit large blocks of capital for containment ended. A new generation of public and private-sector leadership in developing nations, educated in the graduate schools of the West, grew into sophisticated policymakers eager to exercise more control over the use of funds and development. Influenced by successful development and industrialization, particularly in Asia, countries opened their markets; international trade burgeoned; human, technological and financial capital moved more freely. Most importantly, the explosion of the financial markets both in scope and in willingness to assume risk challenged the comparative advantage of the Banks in resource transfer. In the space of 10 years, the international bond markets quintupled---from $185 billion in 1988 to $977 billion in 1998. The single year 1998 witnessed 170 bond issues greater than $1 billion in value.

Countries that join a development bank make two financial commitments. They pay in 5% to 7% of their capital commitment on joining. The remainder is "callable capital," subject to call on demand by the development banks. Almost all countries pay their entire paid-in capital commitment in convertible currency. Most of the effective callable capital, if needed to honor the Banks' liabilities, would come from members with convertible currencies.

The Banks differ greatly in size. Currently, the World Bank holds more than 2/3 of outstanding loans and 50% of paid-in capital. The African Bank is by far the smallest -- 5 to 10% of the total on these measures. Table 3-1 shows the comparative data on size, membership, and date of organization.

[Table 3-1 here]

Distribution of Aid and Lending

Annual World Bank Group lending continues to grow, rising from $1.8 billion in 1969 to $32.5 billion current dollars in 1999. After adjusting for inflation, the Bank has doubled in size in 30 years.

Despite this growth, the relative importance of the development banks has declined markedly. On average for the past seven years, lending and investments by the Banks represented 2% of total private-sector flows to developing countries.[11] In the past seven years, the World Bank provided $18 billion (net) to developing countries. This compares to the $1,450 billion provided by the private sector. The Banks must accept that they are no longer a significant source of funds to the emerging world and that they cannot provide more than a small fraction of what the markets offer.

Officials of the development banks claim that they devote the greater part of their efforts to countries denied access to market financing and to social projects that do not command the interest of private investors. In fact, all of the Banks lend mainly to the most credit-worthy countries, and they demand the host government's guarantee.[12] If the government offered the

[11] A World Bank: Global Development Finance, Washington, 1999.
[12] For the Inter-American Development Bank, replenishment documents attempt to limit the share of lending to the richer countries by setting a maximum target of 65% of lending to the large and rich countries in their region.

same guarantee to a private lender, the private lender would be indifferent about the ultimate use of the funds. The private sector is prepared to finance socially desirable projects with limited cash flow, if the government guarantees to service the debt, as it does when countries borrow from the development banks.

The World Bank's internal auditor (OED) agrees with this conclusion. The auditor has questioned whether the Bank's loans merely substitute capital at advantageous interest rates without providing net additions to available resources (called additionality in Bank jargon), even for social-sector projects. For example, in its review of loans to Brazil's health system, the OED wrote:

> "While financing can be a valuable contribution, Brazil can access the private capital markets with relative ease; it is (therefore) difficult to know whether the [Brazilian] government would have obtained the funds for Bank-financed projects from other sources" [and carried out the projects without World Bank assistance].[13]

In practice, most World Bank lending goes to countries that borrow in the capital markets. These countries have access to capital at market interest rates. A review of the World Bank Group's 4,100 operations approved over the last 7 years reveals that almost 80% of resources (excluding aid transfers) went to countries with an international bond rating of B or higher. Approximately 30% of resources flowed to nations with an investment grade rating and an additional 50% to countries with high-yield ratings at the time the loan was made. More disquieting, the share of nonrated recipients in the World Bank's International Bank for Reconstruction and Development (IBRD) lending has fallen from 40% in 1993 to less than 1% in 1999. The average for the period was about 20%.

[Insert Chart 3-1 and Chart 3-2 here]

The World Bank's rhetoric faults the private sector for concentrating 80% of its loans in a dozen economies. It claims that its own lending provides resources to the entire developing world. In fact, official lending closely parallels private-sector choices. At the World Bank, 11 countries commanded 70% of total nonaid resources over the last 7 years, while the other 145 developing World Bank members were left to divide the remaining 30%. The share of the favored group grew from 63% to 74% between 1993 and 1999: China received 12%; Argentina

[13] World Bank Operations Evaluation Department, Impact Evaluation Report 18142: The Brazil Health System, Washington: June 30, 1998, paragraph 12.

10%; Russia 9%; Mexico 7%; Indonesia 7%; Brazil 7%; Korea 6%; India 4%; Thailand 3%; Turkey 3%; Philippines 2%. Though these nations account for a majority of the developing world's population, that criterion should not be decisive. The Banks must focus on the economies that lack access to private sector resources, not just countries with large populations.

Together, the eleven large borrowers received $13 billion in net nonaid resources from the World Bank Group during the last six years. Though a large share of the World Bank's loans, this amount is only 1.4% of the $880 billion originating in private-sector medium and long-term external debt, portfolio equity and direct investment in the same countries.[14]

[Insert Chart 3-3 here]

The skewed lending pattern is not significantly changed when the crisis lending of 1998-99 is omitted. Data for the 1995-96 period, the most prosperous period in the history of emerging economies, show the share of these 11 borrowers at 67% of all World Bank non-aid resources.

The World Bank and the Regionals

The three regional banks together supply an amount of resources equal to about 50% of World Bank offerings. Table 3-2 shows the distribution of loans and credits by bank and type of program. The dominant characteristic is the relatively unchanging size and composition of the individual programs, until a crisis occurs. Inter-American Development Bank (IDB) lending rose in 1995-96, the time of the Mexican crisis and concern about spillover into other Latin American countries. The World Bank, the ADB and the IDB increased their lending to clients during the spreading Asian crisis in 1997 and 1998, and the repercussions in Latin America of Asian and other crises in 1998.

[Table 3-2 here]

Crisis lending is the responsibility of the IMF, not the development banks. Some officials of these Banks explained that, with hindsight, their involvement in crisis lending was a mistake, an inappropriate use of limited funds justified only, if at all, as an expedient solution to a pressing problem.

[14] Data in this sentence are for the 6-year period (1992-97), most recently available.

The Commission concurs; the mission of development banks should not include crisis lending. Their active participation in crises should be limited to institutional reform loans and poverty alleviation programs to reduce the costs borne by the poor and displaced.

The regional institutions overlap with the World Bank in several ways. They compete for donor funds, clients and projects. Their local offices are often in the same cities. The regionals repeat the World Bank organizational structure, which focuses on subsidized loans and guarantees to governments, zero-interest credits to the poorest members, and loans, guarantees and equity capital for private-sector operations. See Table 3-2. Recently, the World Bank expanded its field offices, increasing duplication and potential conflict in the regions. The Commission received no reasonable explanation of why this costly expansion was chosen instead of closer cooperation with the regional banks and reliance on the regional banks' personnel.

All the Banks operate at the country level, defining their objectives within the nation-states instead of the region. Their patterns of lending over the past 3 years are very similar: to the same countries and for the same purposes. Four to six of the most credit-worthy borrowers, all with easy capital market access, receive most nonaid resource flows: 90% in Asia; 80-90% in Africa; 75-85% in Latin America. Pure public-sector finance (excluding social expenditures on health, education, urban development, infrastructure, environment, and general social sectors) received 35 to 40% of total flows across all regions and among all institutions. Table 3-3 shows these data.

[Insert Table 3-3 here]

Countries with Little Market Access

Many countries have either very limited access to capital markets or none at all. IDA, the aid arm of the World Bank Group, assists mainly countries without capital market access. Countries not rated for capital market access receive 68% of IDA's loans and assistance. IDA's assistance was about 25% of World Bank Group lending in the years 1993-99. See Table 3-2.

More than half of the countries receiving IDA's assistance do not have the economic and political infrastructure needed to attract private lenders. Many of these countries remain poor because their political system is unstable, private property rights are very limited, the judicial system is weak or subservient, or the government is corrupt. Tariffs, duties, and taxes may be

high. Inadequate institutional frameworks are, of course, not the sole cause of poverty. Endemic health problems, population growth, and geographic location contribute as well.

Capital Remains Scarce

Much of IDA's assistance (and comparable programs at the regional banks) goes to such countries. At its best, it provides relief. At its worst, when IDA funds are misused, it supports corruption or programs that waste scarce local and external resources.

The IBRD also assists countries that are not rated for capital market borrowing; 22% of IBRD loans go to these countries. The total resource flow to public-sector activities in countries without capital market access, but with stabilizing policies and institutions, was $2.5 billion for the seven years 1993-99.[15] This is less than 2% of World Bank Group financing, excluding aid.

Counter-arguments

The Banks advance two claims to counter concerns about the misdirection of financing. One claim is that the private sector follows where the Banks lead. Without the Banks' signal of approval, private-sector funding would languish. That was a more plausible argument in the 1980s. The Banks' argument has lost its appeal now that private sector finance is fifty times the size of Bank offerings.

The signaling role, now shared by the private-rating agencies, need not entail resource transfer. The Banks could continue to signal through their reviews of institutional and policy environments by country. These reviews would be a useful supplement to IMF Article IV reports. In Chapter 2, we recommended that the IMF improve the quantity and quality of data, and publish the results, to remove this impediment to private-sector resource flows.

The second claim is that, in times of financial crisis, private lenders may run for the exits. In contrast, the Banks claim to offer a steady flow of official funding. It is true that private financial markets may close to emerging market borrowers when crises start. However, a review of the last two years, beginning with the Asia crisis in 1997, shows that the global marketplace recovers quickly. Three months after the crisis, Korea obtained $4 billion in the capital markets by selling debt with 5- and 10-year maturities. During the 3 months following Brazil's financial disruptions, 20 issues totaling $12 billion were sold to international investors by Latin American sovereign borrowers, $2 billion by Brazil itself. These securities had medium- to long-term maturities, 5 to 20 years. Private equity and foreign direct investment have accelerated in recent years.

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[15] This is the residual after eliminating World Bank non-aid resource flows to countries with (1) capital market access, (2) private sector activities but no market access and (3) public sector activities without capital market access and without institutional infrastructure to absorb the resources.

Foreign lenders were much more inclined to run in Asia, where financial systems in several countries collapsed as banks became deeply insolvent. The solution to this problem is not to increase the role of the development banks as crisis lenders or to encourage private lending to insolvent financial institutions. In Chapter 2, we recommended incentives to encourage countries to increase the safety and stability of their banking systems. The contrast between the viability of Brazil's financial system, after the 1998 devaluation, with the failures in Asia in 1997-98, supports this conclusion. Foreign banks that were long-term direct investors in Brazil did not run; they acted as safe havens for frightened residents. Banking stability reduced capital flight, thereby limiting currency depreciation and the crisis.

The Cost of Membership in the Development Banks

Multilateral agencies generally insist that the donor nations that provide the Banks' resources bear no cost. The development banks claim to be self-supporting, with operating expenses paid through surcharges on loans. More careful consideration shows that this claim is false. It ignores both the risk that member governments bear and the alternative uses for the funds the Banks receive or can call upon. A conservative estimate shows a current annual cost to members of about $22 billion; $15 billion of the total is cash outlays. The remaining $7 billion is based on a valuation of the annual allowance for risk on the portfolios of emerging market loans. The cost of risk will vary as the Banks' risk differs from one-half the market premium. The U.S. share of these costs exceeds $5 billion.

One way to assess the cost of these institutions is to ask: what would be the savings to world taxpayers if the Banks were liquidated and funds allocated to alternative uses? Table 3-4 answers that question. Table 3-5 shows the U.S. share of the Banks' costs to taxpayers. The tables show four components of total cost. We discuss them individually.

[Insert Table 3-4 and Table 3-5 here]

Interest on Paid-in Capital

Member governments deposit 5% to 7% of their subscription to form the operating capital of the development banks. The first line of Table 3-4 uses a 7% long-term cost of capital and the $24 billion of paid-in capital to compute this annual component of total cost ($1.7 billion). The U.S. share ($0.3 billion) in Table 3-5 is a weighted average based on its share of the paid-in capital at each Bank.[16]

Interest on Concessional Capital

The development banks extend long-term, interest-free loans to the poorest members. To finance these concessional credits, the Banks ask member governments to replenish the concessional fund. The cumulative sum paid to date is $140 billion. Table 3-4 shows the $9.8 billion annual cost of maintaining this capital at the development banks. In Table 3-5, the United States has a larger share of the cost of concessional funds ($2.1 billion) than its share of paid-in capital. Leading industrial, G-5, countries pay 70% of the costs of concessional capital.

Compensation for Risk

Markets treat the Banks' debts as low-risk obligations because the Banks are unlikely to default. They have the right to call on member governments to furnish additional capital to repay the Banks' indebtedness. This "callable capital" was committed by the member governments and remains available in an emergency such as defaults by the Banks' borrowers. To date, the Banks have not called any of the capital, but the possibility remains. Although they explicitly deny doing so, the Banks avoid possible defaults by extending new loans to countries in financial difficulty.

Only a few of the richer members could supply convertible currencies on demand. These members would be the main resource in an emergency. Callable capital committed by the richer countries is $181 billion; the industrial countries bear the risk on the $183 billion pool of loans to high-risk sovereign borrowers. Accepted accounting principles for private financial management requires that allowances for potential loss be made annually.

A private-sector evaluation of the risk of medium- to long-term emerging market sovereign debt is obtained from the difference between the yields on riskless U.S. Treasury securities and emerging market sovereign bonds. Over the 5-year period, July 1994 through June 1999, the average spread was 8.1% per annum. This premium varied from 4.3% for Asia, to 8.2% for Latin America, to 10.5% for Africa. Table 3-6 reviews the private-sector evaluation of sovereign risk. Based on a conservative per annum allowance for loss equal to one-half of the premium that capital markets assign, the value generated would be $7.1 billion per annum. The share of each member is determined by the

[16] The weights are based on Appendix B.

risk of the total loan portfolio and the country's proportion of the callable capital supplied by non-borrowers. The conservative allowance for risk provision is in part justified by the Banks' preferred creditor position and reserves.

[Insert Table 3-6 here]

The G-5 countries provide 70% of this support. The U.S. share ranges from 17% for the African Development Bank to 62% for the Inter-American Development Bank, much larger than its 6% and 31% share of paid-in capital. The estimated U.S. cost of risk is $2.4 billion annually. This estimate varies with the assumed risk premium. A number higher (or lower) than 1/2 would change the values in Tables 3-4 and 3-5 in proportion.

Cost of Retained Earnings

The Banks receive donor funds and borrow in the market but do not immediately relend. In the interim, they hold earning assets unrelated to development lending and receive the difference between their borrowing cost and the return on investment. The Banks' lending rates only exceed their borrowing costs by an amount sufficient to cover administrative expenses, so there is not net income on loans financed by debt. Earnings come from assets financed by equity and the spread on market investments. Recently, the four Banks held $76 billion in investments, equivalent to 1-1/2 years of total lending. Of this total, the Banks hold as market investments $12 billion of the funds received for concessional lending, such as IDA appropriations. Unlike the borrowed funds, these funds have zero cost to the four Banks. The annual opportunity cost of foregone interest to the donors is $3.3 billion.

Subsidies: Another Measure of Cost

The Banks divide their lending into market-based and concessional loans. Both are subsidized. All recipients of "market-based" lending pay the same interest rate, equal to the

Bank's cost of funds plus 1/4 to 1/2% depending on the Bank and year. There is no allowance for differences in a borrower's risk or credit rating. All borrowers at the "concessional window" receive a 100% interest subsidy. They pay no interest, but the Banks charge a fee of less than 1% to cover administrative costs.[17]

To calculate the subsidy on interest bearing loans, we take the difference between the average rate on medium- to long-term sovereign emerging market bonds for each region from July 1994 to June 1999, 10.5% to 16.7%, and the average rate on loans by the development banks, 6.9 to 7.4%. The difference is about half the market rate, so countries with market access received subsidies equal to half the market cost of funds on development bank loans. Using the four Banks' sovereign loan portfolios of $183 billion at the latest year-end as the base, the subsidy on interest-bearing loans is approximately $12.7 billion.

[Insert Chart 3-4 here]

Concessional credits of $112 billion pay no interest. Using a 16.7% interest rate on loans to the poorest countries gives an annual subsidy of $18.7 billion on these loans. Countries are obligated to repay the loans 30 or more years from the time of the agreement. Allowing for the present value of these prospective payments, and assuming they are made, leaves the subsidy on the concessional loans at about 85% of the face value. It is not surprising, therefore, that countries are reluctant to graduate from the concessional window.

Table 3-7 shows the total subsidies and the distribution by lender and type of loan. If the Banks used grants instead of loans to carry out part of their mission, as proposed in our recommendations, in time many of these subsidies would be available to fund future grants.[18]

[Insert Table 3-7 here]

The principal beneficiaries of the subsidies are the countries with the largest outstanding debts to the development banks. The annual gift received by each of these borrowers is:

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[17] The IDB charges 1-3/4% and calls the fee interest.

[18] There are now two measures of the subsidy, $31 billion in Table 3-7 and $22 billion in Table 3-4. The main source of the difference is the different evaluations of risk. The $31 billion, assuming the market prices these risks correctly, is the likely upper bound.

India	$2.5 billion
Mexico	1.1
Indonesia	1.1
Brazil	1.0
Argentina	1.0
China	0.8
Russia	0.5

Performance

Performance is one of the Commission's principal concerns. Ending or reducing poverty is not easy. The development banks cannot succeed in their mission unless countries choose to develop and grow their economies. Governments must be willing to make structural changes that attract foreign capital and reward domestic saving.

Internally, the Banks should change their incentives and improve their methods of evaluating performance. Externally, in their dealings with client countries, the Banks have a role in encouraging the institutional reforms that are necessary for sustained development. Their dedicated personnel and abundant expertise are important resources. But expertise and dedication are not enough, if there are poor incentive structures, weak managerial controls, or misdirected effort. The Banks' systems for project evaluation, performance evaluation and project choice must be improved.

Incentives

In 1992, the World Bank's Wapenhans Report pointed to the Bank's excessive interest in "moving money" as a main reason for the deterioration of project quality.[19] The report said the

[19] "Effective Implementation: Key to Development Impact." Washington: The World Bank, 1992. Internal document. The regional banks prepared internal evaluations.

Bank had developed a lending culture. Rewards were closely related to the volume of lending, not to a project's value or program accomplishments. Subsequently, an Asian Development Bank portfolio review found that dedication to client interest was undermined by an "approval culture" aimed at achieving yearly lending targets.

Incentives to lend for lending's sake are built into the structure of the Banks. Internal budget resources are awarded where loan volumes are high, not where the number of worthwhile projects is highest or where technical assistance and knowledge transfer are favored over
funding. Long project cycles of 5-10 years render accountability at the operational level difficult to assess; those responsible for allocating funds will often have moved on before the results of lending are known. Often the staff is rewarded based on the amount of funds disbursed.

Although several of the Banks recognize the problem and call attention to the need for change, there is, at most, weak counterbalance to the incentive to lend. Host government guarantees, required on all loans, separate project failure from risk of loss to the Bank. Rewards for lending, and no penalties for project failure, dilute concern about project performance. The result of an open-handed and often uncritical disbursement is a 55-60% failure rate to achieve sustainable results based on the World Bank's own evaluation. Interim improvements in measured performance by the World Bank during the 1996-97 period were in large part due to general prosperity in emerging economies.

Project Evaluation

It has always been difficult to evaluate the outcome achieved with any particular loan. Money is fungible. The marginal project that a Bank loan makes possible is generally not the project that the Bank evaluates. When the Banks financed mainly infrastructure, they could, at least, assess the project's success. As the Banks moved away from project-based investment lending to adjustment financing and large-volume pure public-sector loans, now 63% of all World Bank operations, it has become easier to blur measures of project performance. By adding many new objectives in recent years the Banks made it possible to claim success on one dimension and ignore failures to improve living standards or reduce poverty.

The project evaluation process at the World Bank gets low marks for credibility: wrong criteria combine with poor timing. Projects are rated on three measures: outcome, institutional development impact, and sustainability. The latter, central to progress in the emerging world, receives a minimal average 5% weight in the overall evaluation. The Bank measures results at the moment of final disbursement of funds, a time which the Wapenhans Report criticized as

"just the beginning of operations."[20] Final disbursement often occurs more than one year before the project begins full operations. The start of operations is too early to judge sustainability of achievements. For structural programs, improvements often develop slowly. Evaluation should be a repetitive process spread over time including many years after final disbursement of funds, when an operational history is available.

Table 3-8 shows the World Bank's evaluations of project performance for the 1990s. The Bank includes "marginally satisfactory" outcomes as successes. Using their ratings, 59% of investment programs failed in the years 1990-99. The Bank's Operations Evaluation Department audits 25% of its projects. Most audits occur between 6 months and 3 years after final disbursement. If it reevaluated projects using independent auditors a number of years later, Asian Bank experience suggests failure rates might worsen but would not improve.

[Insert Table 3-8 here]

As the prosperity of recipients falls, so does achievement. Table 3-8 shows that the vast majority of World Bank "successes" are concentrated in upper-income countries that have significant domestic resources and access to private-sector funding. Here, failure is in the 30-40% range.

In contrast, the poorest countries have failure rates between 65 and 70%. The same pattern is found regionally. The 40% failure rate in the strong economies of East Asia contrasts with the 60-75% failure rate in South Asia and Africa. For total project-based investment lending, failure rates reach 59%; more generalized adjustment loans have a 47% failure rate.

All Banks should improve monitoring and performance evaluation processes. The Banks' incentive systems should be closely tied to project performance.

The Banks seldom return to inspect project success or assess sustainability of results. The World Bank reviews only 5% of its programs 3 to 10 years after final disbursement. These Impact Evaluations focus on such important, but poorly defined and subjective, measures as improvements in the environment, the role of women, the interaction of societal institutions, income distribution and general welfare. It is difficult to relate Bank activities to these social

[20] World Bank, Portfolio Management Task Force: Effective Implementation: Key to Development Impact. Washington: September 22, 1999, p. 29.

indicators. Thirty percent of the investigators found that lack of monitoring of project results precluded valid judgments. Though the agencies devote significant resources to monitoring the procurement of inputs, they do little to measure the effectiveness of outputs over time.

The Asian Development Bank is an exception. It is more concerned about sustainability, the sine qua non of success. Initial reports are made only after projects are fully operational. Presently, 30% of projects are audited 2 to 3 years later. The Asian Bank expects that all "successful" projects will soon be revisited to learn whether improvements continue. The Asian Bank has found that "unsuccessful" projects rarely improve, so later audits are not useful.

Banks' Self-Evaluation

In addition to evaluating the success of its lending, the World Bank evaluates its own performance using three criteria: project identification, project appraisal, and project supervision. On average for 1990-99, more than 40% of all projects failed to receive a satisfactory rating on all three criteria. Table 3-9 shows the Bank's self-evaluations.

[Insert Table 3-9 here]

Our study focussed on the World Bank's evaluation procedures because the Bank is generally the leader in the development field and its procedures are widely regarded as models for the other Banks.

Choice of Direction

The Banks have an important role in reducing poverty and promoting growth. Although their resources are a small part of global capital flows, more effective resource use can raise the Banks' contribution. This will happen only if the Banks gain a better understanding of their comparative advantage, where and how they can most effectively use their limited resources.

Assessing Aid, a 1998 World Bank report, concludes that aid can help a country develop only if the country adopts appropriate public policies that promote growth and encourage foreign investment. Earlier, the Wapenhans Report concluded: "Even very well designed projects cannot succeed in a poor policy…environment."[21]

[21] *Ibid*., p. 7.

The World Bank has not embraced this message. A 1997 World Bank review found that among 41 low-income countries, only one had a satisfactory institutional environment.[22] Many of the Bank's failures result from lending to countries unprepared or unwilling to adopt wealth-creating policies.

The Banks can improve their performance and the living standards of their clients by asking three questions:

Will the private sector perform this function?

Will the local public sector perform this function?

Will the Bank provide resources not otherwise available?

To show how the World Bank answered these questions in recent years, we divide the developing world into two sets of countries and two types of activities:

	Countries with capital-market access	Countries without capital-market access
Activities directly profitable to private sector	A 48%*	C 16%*
Activities not directly profitable to private sector (public interest)	B 30%*	D 6%*

*Percentage of World Bank Group operations (excl. aid) during 1993-99 period. Lerrick, Adam: "Whither the World Bank" IFIAC, Washington: October 1999. Public interest activities include health, education, rural transport, environment, social sector, urban development, public sector, and balance of payments.

The Banks should provide resources for global public goods and socially valuable activities which the private sector would not finance in countries with positive institutional environments, but without capital market access. There is no role for any public-sector lender, including the development banks, in region A. The private sector can and should finance these activities. The World Bank should not continue to devote half its funding to projects of this kind.

[22] World Bank, Operations Evaluation Department. 1998 Annual Review of Development Effectiveness. Washington, 1999, p. 21.

Region B, public-interest activities in countries with capital-market access, is the domain of local governments, financed by tax revenues and market borrowing. Regions C and D are the appropriate targets for Bank efforts. Region C includes profitable private-sector activities in countries without capital-market access. Countries should identify the obstacles that prevent the private sector from fulfilling its role and remove the impediments. These may take the form of a risk (including political risk) that private participants cannot assume efficiently, an institutional bottleneck, a distorted economic framework, a lack of information or an absence of clearly defined public policies. The development banks can help by financing the reforms that the government decides to undertake. Finally, region D has public-interest activities in countries without capital-market access. Often these require subsidization or the elimination of barriers to private-sector provision of services.

The World Bank's allocations show that only 22% of the activities it financed were in countries without capital-market access. Even if some allowance is made for incomplete or limited market access, most of the development banks' resources go to countries and projects that the market would finance.

Countries without capital-market access include those most in need of institutional reform. The Banks' goal should be to increase funding of activities in the poorest countries, while reducing funding of activities in regions A and B. The development banks should provide incentives for countries without capital-market access to reform their economies or political processes.

Recommendations

Evolution of the world economy since 1945 has changed the main suppositions and beliefs on which the World Bank and the regional banks were founded. The resources available for countries, that demonstrate by their policy choices that they desire to grow, greatly exceed any sums that the founders of the development banks imagined. The multilateral development banks have been slow to adapt to their changed relative position as suppliers of capital and to the lessons learned about development over the past half century.

An important role for development assistance remains. The development banks must increase their effectiveness in alleviating the consequences of poverty and encouraging institutional reforms that permit growth, development and release from poverty. Major reforms of the development banks are needed to increase effectiveness, accountability and transparency and eliminate overlapping responsibilities.

Five observations guide our recommendations:

- the dominant share of the Banks' resources is devoted to a small number of countries with ready access to private-sector capital;

- the total funding provided to these countries by the Banks is a small fraction of the resources received from the private sector;
- the host government guarantee, required to approve all Bank lending, would render private-sector investors indifferent to the end use of borrowing proceeds, whether they concern investment, institutional reform or social-safety nets;
- the fungibility of money eliminates any link between Bank financing and specific projects or promised policy changes;
- change cannot be imposed from the outside; countries implement and sustain only those reforms to which they are themselves committed.

To function more effectively, the development banks must be transformed from capital-intensive lenders to sources of technical assistance, providers of regional and global public goods, and facilitators of an increased flow of private sector resources to the emerging countries. Their common goal should be to reduce poverty; their individual responsibilities should be distinct. Their common effort should be to encourage countries to attract productive investment; their individual responsibility should be to remain accountable for their performance. Their common aim should be to increase incentives that assure effectiveness.

If the development banks remain as they are, they will be relegated to an insignificant role in the development process. If they reform, they can assume a valuable role that will justify the commitment of more resources by taxpayers in developed economies.

Targeting the Poorest Nations without Access to Private-Sector Resources

The Development Banks should be renamed Development Agencies.

The new name would underscore a change in the defining role of the development institutions -- no longer the lending of money but the alleviation of poverty in the developing world. Although the Banks would continue lending for structural reform, the advent of deep global capital markets, willing to bear risk and prepared to channel substantial resources to emerging economies, has destroyed the rationale for much of the costly financial intermediation function that has been the Banks' main activity.

All resource transfers to countries that enjoy capital-market access (as denoted by an investment-grade international bond rating) <u>or</u> with a per capita income in excess of $4000 would be phased out over the next 5 years. Starting at $2500 (per capita) levels, official assistance would be limited. (Dollar values should be indexed.)

The focus of institutional financial effort should be on the 80 to 90 poorest nations without access to private-sector resources. As the World Bank has noted: "Much of aid continues to go to middle-income countries that do not need it. It is possible to make aid more effectively targeted to poor countries…"[23] Table 3-10 lists the countries affected by this change in 1999.

[Insert Table 3-10 here]

When operations are confined to low income countries with little capital-market access, additionality of resource transfer is enhanced. Funds for the poor would grow dramatically if flows to countries with easy capital market access or high-income levels ceased and were reallocated to the poorest members: 100% at the Asian Development Bank; 640% at the Inter-American Development Bank; 70% at the African Development Bank. When concessional flows are included, augmentations are 63%, 390% and 40% respectively.

When inept policies and negative institutional frameworks restrict market access for middle-income economies, the absence of official assistance will be a powerful incentive to implement reform.

An investment grade rating (Baa/BBB or higher) is used to denote substantial capital market access. Countries with these ratings can finance projects without official assistance. They would continue to benefit from knowledge transfer and technical assistance, and the

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[23] World Bank, Assessing Aid, op. cit., p. 4.

development banks would continue to operate, but not lend, in these countries. Poor countries with high-yield ratings (Ba/BB/ or B), which may have limited access to private sector financing during times of uncertainty, will continue to be eligible for aid if the availability of private sector resources declines.

Performance-Based Grants

For the globe's truly poor, the provision of improved levels of health care, primary education and physical infrastructure, once the original focus for development funding, should again become the starting point for raising living standards. Yet, poverty is often most entrenched and widespread in countries where corrupt and inefficient governments undermine the ability to benefit from aid or repay debt. Loans to these governments are too often wasted, squandered, or stolen.

Outright grants rather than loans provide a realistic vehicle for poverty alleviation. Grants would be funded openly as direct subsidies provided by the industrialized nations. Performance would be audited by independent agents. In contrast to the current system of subsidy transfer, concealed through below-market financing, an explicit approach to aid would be more willingly supported if donors were assured that funds are used for an effective poverty-reduction program.

Auditors can quantify improvements in primary education skills, vaccination rates, miles of passable roads, provision of electricity, delivery of water and sanitation. Skilled international suppliers in the service sectors are increasingly mobile. The domestic public sector would be aided by the development agencies, but its role would be limited to partial payment for services, the mitigation of political risk, and the provision of public goods.

The share of the cost paid by the country would depend on its per capita income level and credit ranking. The poorest nations without capital-market access would receive grants equal to 90% of the service cost, while the development agency's contribution would fall to 10% as the country's income level or capital-market access increased. For example:

> A country with $1,000 per capita income qualifying for 70% grant resources decides that vaccination of its children against measles is a desired goal. If the development agency confirms the need, the government would solicit competitive bids from private-sector suppliers, nongovernmental organizations such as charitable institutions, and public sector entities such as the Ministry of Health. Suppose the lowest qualifying bid is $5 per child vaccinated, the development agency would agree to pay $3.50 (70%) for each vaccination directly to the supplier. The government would be responsible for the remaining $1.50 (30%) fee. Payments would only be made upon certification by an agent independent of all participants -- the government, the development agency and the supplier of vaccinations.

Under a system of user fees, grants are paid after audited delivery of service. No results, no funds expended. Payments would be based upon number of children vaccinated, kilowatts of electricity delivered, cubic meters of water treated, students passing literacy tests, miles of functioning roads. This system eliminates the distortionary effects of financing cost subsidies (traditional development bank loans and guarantees) by maintaining the relative prices of inputs. It creates a revenue guarantee for the vendor. Execution is substantially free of political risk. The supplier of the service, not the government, receives the payment. Since payment is directly ensured by the development agency's commitment, the supplier can borrow any required interim funding from the private sector. From the supplier's standpoint, the proposed system has the distinct advantage of giving them clear responsibility to deliver a product they understand, while eliminating the need to negotiate financing with several official lenders.

The same framework has the potential to extend beyond national projects to regional programs where cooperation between participating governments would provide economies of scale. Contractors would be compensated directly by the development agency for their share, on evidence of performance. Subsidies would vary according to the income and capital-market access of each country.

The development establishment resists grant-funding on two counts. First, they claim, the borrower would have no obligation to repay, leading to a lack of discipline. On the contrary, an obligation to pay an assigned portion of user fees on a current basis imposes discipline on the country that receives assistance. This current obligation replaces the deferred 20-50 year repayment schedules of the development credits now in use. Further, the receiving country initiates the program. It commits to a program that it finds valuable; it acquires "ownership" of an effective program. Decisions are made locally to meet local needs.

Second, for the multilateral development banks, grant-funding is a less certain source of funds than current arrangements that are based to a much greater extent on permanent capital commitments. As the share of grants rises, the development agencies would have to ask the legislatures of the donor countries for increased support.

The risk exists that legislatures would reduce funding. That risk has a positive aspect. The development agencies would have an incentive to improve performance. They would develop more careful procedures to assure the effectiveness of programs. This would strengthen accountability at the development agencies and concentrate their attention on results achieved, not dollars lent. Donor countries should be encouraged to increase aid for effective programs.

Many of the failures of development programs originate in perverse incentive systems created by the Banks in both the recipient countries and in the lending institutions themselves. As the Wapenhans Report remarked: "..the first measure of success for the [World] Bank [should] not [be] commitment of resources, but their effective use"[24] and "the

[24] Effective Implementation: Key to Development Impact; op. cit., p. 26.

cost of tolerating continued poor performance [of World Bank projects] is highest not for the Bank, but for its Borrowers."[25] The burden of irresponsible programs is unfortunately borne by taxpayers--by the poor recipient-country citizens if loans are repaid or by donor member constituents if the debt is forgiven.

In poor countries without capital-market access, poverty alleviation grants to subsidize user fees should be paid directly to the supplier upon independently verified delivery of service. Grants should replace the traditional Bank tools of loans and guarantees for physical infrastructure and social-service projects. Grant funding should be increased if grants are used effectively.

From vaccinations to roads, from literacy to water supply, services would be performed by outside private-sector providers (including NGOs and charitable organizations) or public-sector entities, and awarded on competitive bid. Quantity and quality of performance would be verified by independent auditors. Payments would be made directly to providers. Costs would be divided between recipient countries and the development agency. The subsidy would vary between 10% and 90%, depending upon capital-market access and per capita income.

The amount of money requested from legislatures to fund explicit grants should rise. Increased outlays will be offset partially as outstanding loans and credits, with hidden subsidies of $15-20 billion per annum in below-market interest rates, are repaid. Most of the repayments will be complete in the next 15 years. Grants would be given only to poor countries without capital-market access. This would increase funds available for bona fide poverty reduction.

Institutional Reform Loans

Institutional reforms lay the groundwork for productive investment and economic growth. They provide the true long-term path to end poverty. Reforms are more likely to succeed if they arise from decisions made by recipient nations. In the words of Gustav Ranis, a development expert, "It seems clear that the lending cum conditionality process works well only when local polities have decided, largely on their own… to address their reform needs…and approach the international community for financial help in getting there."[26]

Good intentions are not enough. Developing and emerging countries need incentives to continue long-term reform programs until they achieve sustainable results. In the past, the borrowers had access to total disbursement of funds long before execution. There were no means to enforce penalties for failure to perform and no incentives to continue, or even start, the reform process. Many countries have agreed to accept conditional assistance but either did not try or did not succeed in carrying through the reforms.

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[25] *Ibid*., p. 5.
[26] Ranis, Gustav. "On Fast Disbursing Policy Based Loans." New Haven: Yale University, 1995, p. 10.

A new mechanism is needed to promote steady implementation rather than superficial change. It must create incentives to sustain reform programs until reforms have become established. The mechanism should also reduce financial costs of reform until benefits have been realized.

Institutional lending frameworks can be redesigned to fit the needs of the poorest countries that do not have capital-market access. As an example, each developing economy would present its own reform program. If the development agency concurs in the merit of the proposal, the country would receive a 10-year maturity, equal annual amortization loan, with subsidized interest rate based upon the agency's own cost of capital. The extent of the interest subsidy would vary from 10% to 90% as in the grant financing of user fees. Loans would be conditional upon a precise set of reforms, and disbursement would begin after legislative enactment, the first step in the process.

Continuing the example, auditors, independent of both the borrowing government and the official lender, would be appointed to review implementation of the reform program annually. If performance is positive, repayment of the entire principal schedule would be deferred for one year. The loan would become an eleven-year loan with principal payments due in years 2 to 11. Interest would be paid on a current basis. Eligibility for deferrals, based on continuing implementation, would be renewable each year for up to ten years. In this example, if the program is successfully implemented and sustained, principal and interest would be paid on a fixed schedule in years 11 to 20. Continued execution can thus transform a 10-year loan with repayment spread over years 1 to 10 into a 20-year loan with repayments in years 11 through 20.

Failure to meet standards in any year would trigger a mandatory start on repayment of principal and the elimination of the interest subsidy. Repayments would continue until compliance resumed. The borrower would have an incentive to choose a program it wants to implement, and to continue it long enough to establish the new rules or procedures as part of the local policy environment.

Lending for institutional reform in poor countries without capital market access should be conditional upon implementation of specific institutional and policy changes and supported by financial incentives to promote continuing implementation. Results should be independently monitored to assess performance.

Division of Responsibility

Development Agencies should be precluded from financial crisis lending.

In the Commission's overview of all multilateral entities, the IMF has exclusive responsibility for financial crisis lending by multilateral institutions. Recently, the development institutions have been called upon to step outside their mandates and divert significant resources to crises in Korea, Indonesia, Thailand, Brazil, Argentina and Russia. Although this new role may have been a means for major shareholders to execute "off-balance-sheet" foreign policy

without submitting to the budget process in the appropriate legislative venue, this use of development funds should not be repeated.

All country and regional programs in Latin America and Asia should be the primary responsibility of the Asian and Inter-American Development Agencies. The transfer should be accomplished within five years.

Costly duplication and confusion arise from the overlap of function and resource flows between the World Bank and its regional partners. The comparative advantage of the regional development banks resides in strong relationships with borrowing members based upon a mutual understanding, common language, and common culture. Both the Asian Development Bank and the Inter-American Development Bank have reached a level of maturity and professionalism which qualifies them to take responsibility for the tasks of poverty alleviation and structural reform in their respective regions.

The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East.

In the past, the development institutions have focused almost exclusively on country-specific agendas. Economies of scale and expanded results can be achieved from transnational programs that address shared issues of environment, natural resources, infrastructure and health.

Regional solutions that recognize the mutual concerns of interdependent nations should be emphasized.

The World Development Agency should concentrate on the production of global public goods and serve as a centralized resource for the regional agencies. Global public goods include improved treatment for tropical diseases and AIDS, rational safeguarding of environmental resources, inter-country infrastructure systems, development of tropical agricultural technology, and the creation of best managerial and regulatory practices.

The production of international public goods, as opposed to country and region-specific programs, has been conspicuous by its absence in the work of the Banks.

"Knowledge is costly to create but inexpensive to transmit," said Ann Krueger, former chief economist at the World Bank. And it is in the gathering of knowledge, subsidized by grants and revenue guarantees and shared in international forums, that a new and demanding role is found for the World Development Agency.

There is much to address in agendas that confer benefits across society and beyond regional boundaries. Technical and scientific knowledge must be produced for: environmental challenges of air, water, and earth; sustainable management of natural resources; diversification of agriculture in tropical climates; restoration of the agricultural base in Africa; forestalling of health epidemics; development of vaccines and treatments for AIDS and tropical diseases; and, for economic growth, the design of best practices that will facilitate the flow of private sector

funds to the emerging world. The Bank should provide technical assistance on the creation of legal systems that support clearly defined property rights and fair judicial processes; transparent accounting, tax and public administration regimes; policies that promote the free flow of goods and long-term capital; and sound financial system regulation and corporate governance rules.

The World Bank's role as lender would be significantly reduced. Repayments on the World Bank's existing IBRD portfolio will amount to $57 billion (49% of loans outstanding) over the next 5 years and $102 billion (87% of loans outstanding) over the next 10 years.

In its reduced role, the World Development Agency would have less need for its current callable capital. Some of the callable capital should be reallocated to regional development agencies, and some should be reduced in line with a declining loan portfolio. The World Bank's paid-in capital and retained earnings would be used for its redesigned activities. The income from paid-in capital and retained earnings should be reallocated to finance increased provision of global public goods. Independent evaluations of the agency's effectiveness should be published annually.

National governments could redeploy the callable capital released to the regional development agencies, if the regional agencies' capital bases require augmentation to meet the needs of their expanded role. World Bank IBRD loan repayments over the next 5 and 10-year intervals are equivalent to 85% and 153% respectively of the $67 billion combined outstanding regional bank portfolio.

Private-sector involvement by the development institutions should be limited to the provision of technical assistance and the dissemination of best practice standards. Investment, guarantees, and lending to the private sector should be halted.

The International Finance Corporation should be merged into the World Development Agency to more closely integrate its function into the Bank's activities. Equivalent changes should be made at the regional agencies.

The International Finance Corporation should become an integral part of the redefined World Development Agency. Its capital base would be returned to shareholders as existing portfolios are redeemed. The U.S. share of the IFC's $5.3 billion capital is $1.3 billion. The capital of the Inter-American Investment Corporation should return to the ordinary capital of the Inter-American Development Bank.

MIGA should be eliminated. Many countries have their own national political insurance agencies. In addition, private-sector insurers have entered the market. The Commission did not find sufficient rationale for continuing MIGA.

The World Bank and the regional development banks should write off in entirety their claims against all heavily indebted poor countries (HIPCs) that implement an effective economic development strategy under the Banks' combined supervision.

The United States should significantly increase its support of effective programs to reduce poverty. The six dollars per capita currently spent is too much for ineffective programs but too little for effective programs.

Appendix A
Multilateral Development Banks:
Operating Financial Entities

World Bank Group:

the International Bank for Reconstruction and Development (IBRD) provides loans and guarantees to developing member governments;

the International Development Association (IDA) focuses on aid transfers (zero interest credits) to the poorest nations;

the International Finance Corporation (IFC) provides loans and equity capital to private-sector activities in emerging economies;

the Multilateral Investment Guarantee Agency (MIGA) provides political insurance to private-sector projects.

Asian Development Bank:

the Asian Development Bank (ADB) provides loans and guarantees to developing member governments;

the Asian Development Fund (ADF) focuses on aid transfers (zero interest credits) to the poorest members;

the Asian Development Bank provides loans and equity capital to private-sector activities in regional emerging economies.

Inter-American Development Bank:

the Inter-American Development Bank (IDB) provides loans and guarantees to developing member governments;

the Fund for Special Operations (FSO) focuses on aid transfers (1% interest credits) to the poorest members;

the Inter-American Development Bank Private Sector Program and the Inter-American Investment Corporation provide loans, guarantees and equity capital to private-sector activities in regional emerging economies.

African Development Bank:

the African Development Bank (AfDB) provides loans to developing member governments;

the African Development Fund (AfDF) focuses on aid transfers (zero interest credits) to the poorest members;

the African Development Bank provides loans and equity capital to private-sector activities in regional emerging economies.

Chapter 4
The Bank for International Settlements

The Bank for International Settlements (BIS) is one of the world's oldest international financial organizations. It started operating in 1930, mainly to facilitate Germany's reparations after World War I. The bank's other original tasks included acting as a bank for central banks and promoting central bank cooperation. It is viewed widely as a club of central bankers.

The BIS's main mission, reparations, ended at World War II. The 1944 Bretton Woods Conference considered liquidation but made no decision. Instead of expiring, the BIS undertook new duties.

Central bankers comprise the BIS membership and meet monthly to discuss matters of relevance to economic and banking policy. The success of the organization, it is often said, derives from the secrecy of its meetings and the trust created among central bankers through their frank discussions at their frequent meetings.

In the mid-1960s, the BIS started to analyze international financial markets, including the new Eurocurrency markets, and it developed new databases on international capital and currency stocks and flows. During the 1970s, the BIS began to study potential country risk in developing economies. It was among the first to warn of the possibility of a sovereign debt crisis.

The BIS also took a prominent role in establishing committees to recommend standards of practice in various areas. The most influential of these is the Basel Committee on Banking Supervision, formed by the G-10 central bank governors in 1974. The Basel Committee sets voluntary standards for the international banking industry, and operates as a semi-autonomous organization, located at the BIS.

Membership

The BIS is a publicly-owned international organization, located in Switzerland. Central banks own 86 percent of the bank's issued share capital. Private shareholders own the rest. The private shareholders do not have a right to attend, or to vote at, the BIS's general meetings.

BIS membership has expanded in the past five years. Since 1994, the members of the bank's board were drawn from the 11 countries that comprise the Group of 10 (G-10). After 1996 nine additional central banks from Asia, Latin America, the Middle East and Europe joined the BIS, reducing the previous heavy European concentration of members. As of March 1999, 45 central banks were represented and could vote at general meetings.

The bank has no legislative power; its committees simply offer guidance to financial institutions and their supervisors. After they are issued, BIS standards may or may not be adopted by each country's legislative or regulatory bodies.

Current Functions

BIS's current tasks can be divided into three categories: (1) international monetary and financial cooperation, (2) agent and trustee activities, and (3) financial assistance to central banks.

International Monetary and Financial Cooperation

The BIS plays a unique role in fostering international cooperation among central bankers and in setting financial standards through the facilities the BIS provides for various committees. Both standing and *ad hoc* committees meet "to promote stability and mutual understanding." [27] The BIS acts as secretariat for several committees, including the Basel Committee on Banking Supervision. These committees propose international standards and offer guidance on so-called "best practices." Other committees include the Committee on Global Financial Systems---a new name for the former Euro-currency Standing Committee---and the Committee on Payment and Settlement Systems. The three committees participate in the newly created Financial Stability Forum.

Except in a few instances, BIS officials are not active members of the Committee. The membership usually consists of national technical experts. The BIS staff performs secretarial functions and helps with organization.

In 1988, the Basel Committee on Banking Supervision issued minimum capital requirements (the Capital Accord). These are now under revision. The Capital Accord marked the first decisive step in the BIS's participation in setting minimum capital standards for international banks. Eventually more than 100 countries adopted the standards, not only for internationally active banks, but also for domestic banks.

The Accord called for linking capital requirements to a crude measure of the banks' risk by assigning different risk weights for different categories of bank assets or commitments. The quality of the standards set by the Accord has been criticized for years for its crudeness, lack of effectiveness in promoting the maintenance of adequate capital (as illustrated by Japan's recent banking collapse), and for politicization. Some critics also question whether establishing a "level playing field" for capital standards will promote fairer competition among banks, given that capital is only one dimension of bank regulation.

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[27] See The Bank for International Settlements, "Profile of an International Organization," a presentation available at the bank's Web site.

A new capital adequacy framework was first circulated in June 1999, as a draft to obtain comments by the industry and academics. A final document is expected by the end of 2000. The tentative plan calls for implementing the new standards around the end of 2001. The new approach is expected to give banks more choice in assessing credit risk by allowing them to adopt an internal rating system for setting capital requirements and by linking required capital, where possible, to credit-rating agencies' ratings of bank borrowers. The new proposals, like the preexisting standards, have received substantial criticism.[28] Despite the flaws in current and proposed capital standards, the Basel Committee's work has undoubtedly helped to advance the discussion of how to achieve more effective prudential regulation of banking.

A central concern of the BIS and the Basel Committee has been finding ways to limit systemic risk in international banking. In 1997, the Basel Committee on Banking Supervision issued 25 core principles for Effective Banking Supervision, applicable to all countries. The principles cover conditions for supervision, licensing, and structure of the banking system, prudential regulation, methods of ongoing supervision, information gathering and use, powers of supervisors and cross-border banking. G-10 central bank governors and G-7 finance ministers endorsed the document.

The BIS has created a very useful forum for central bankers and regulators of financial institutions by hosting frequent meetings for a common core of participants.[29] Once a month the governors of member countries' central banks meet. The central bankers discuss common problems and exchange information about economic events in their countries. The stability of the international monetary and financial systems is a continuing concern at these meetings.

Agent and Trustee

The BIS acted as an agent (1986 to 1999) for the private clearing and settlement system of the European Currency Unit when the European Monetary Union was first established. The BIS also acts as an agent for some international loan issues and as the trustee, holding the collateral, for some international bond issues. The BIS served as agent in the rescheduling of the Brazilian external debt in 1993, and played a similar role for Peru in 1997 and Cote d'Ivoire in 1998.

Acting as agent, the bank arranges bridge loans for member states and emerging market countries. At various times since the early 1980s, the BIS has provided transitional or bridge funds to countries to which the IMF or World

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[28] For a review of criticisms of the Basel Standards, and suggestions for reform, see *Reforming Bank Capital Regulation*, U.S. Shadow Financial Regulatory Committee, Washington AEI Press, 2000.

[29] See Michele Fratianni and John Pattison, Oct. 31 draft of "An Assessment of the Bank for International Settlements." The paper is available at http: phantom-x.gsia.cmu.edu/IFIAC.

Bank has agreed to lend. These loans speed countries' access to IMF or World Bank credits. In addition, in late 1998, the BIS arranged a $13.28 billion credit facility for Brazil as part of a financial support program.

Financial Assistance to Central Banks

The BIS acts as a bank for central banks, assisting them in the management of their reserves. The banks' assets are invested in international bank deposits, securities, and government Treasury bills. BIS purchases and sales for central banks are confidential and are kept secret. Currently about 120 central banks and international financial institutions use the BIS as a bank. The total deposits placed with the BIS reached $112 billion on March 31, 1999, representing about 7 percent of world foreign-exchange reserves.

Two recent initiatives augment the mission and the global reach of the BIS. One, the Financial Stability Institute, provides a venue for international seminar-type discussions among senior financial sector officials to promote better and more independent banking, capital markets, and insurance supervision based on the implementation of core principles for financial-sector supervision.

The second is the Financial Stability Forum, a G-7 initiative. Andrew Crockett, General Manager of the BIS serves in his personal capacity as Chairman. The Financial Stability forum reaches countries not previously involved in the BIS or its various committees.

The BIS staff numbers 485 and is drawn from 32 countries.

Challenges and Recommendations

During its 70-year history the BIS has adapted well to large changes in the financial industry and central banking practices. Its ability to adapt was due largely to its limited and homogeneous membership. An example of such adaptation is the way the BIS quickly rose to the challenge of meeting regulatory deficiencies at the international level. The BIS has also demonstrated its ability to convince the most financially important countries to adopt its standards.

The Commission recommends that the BIS remain a financial standard setter. Implementation of standards, and decisions to adopt them, should be left to domestic regulators or legislatures. The Basel Committee on Bank Supervision should align its risk measures more closely with credit and market risk. Current practice encourages misallocation of lending.

The monthly meetings of central bankers are held behind closed doors. This is widely regarded as an advantage. It facilitates discussion and comments within the group. The BIS keeps a low profile and is not well-

known outside the circles of central bankers. Its accounting---using the arcane "gold franc" as a unit of account---and its loosely defined strategies and objectives also limit transparency. The BIS would improve external understanding of the bank if it expanded the quantity and quality of information about its activities.

The BIS might benefit from significant restructuring.[30] The bank currently consists of a wide array of committees that report to different bodies, with different memberships and different sponsors. This structure creates confusion about the allocation of responsibilities and the particular missions of each committee or group within the BIS. It contributes, also, to the lack of transparency noted above. While it is difficult for the Commission to make specific recommendations about how to restructure the BIS, it is our sense that **some streamlining of the BIS organizational structure would be desirable.**

The BIS's success as a meeting ground for central bankers has been facilitated by its small, homogeneous and cohesive membership. For that reason, membership expansion through the Financial Stability Forum, or other means---while potentially useful as a way of facilitating communication across more countries---is a potentially disruptive development for the BIS, and should be undertaken cautiously. The risk is that inclusion may come at the expense of efficacy.[31] The Commission recommends that **any expansion of membership in the BIS or its committees or groups be undertaken gradually and deliberately to avoid disruption of the information exchange that central bankers find valuable.**

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[30] See testimony of John Pattison, Nov. 16, 1999 on the Commission's web site.
[31] See the testimony of Michele Fratianni, Nov. 16, 1999 on the Commission's web site.

Chapter 5
The World Trade Organization

At the end of World War II, officials in many countries shared two perceptions about tariffs and trade. Most considered that high average duties mandated in the U.S. Smoot-Hawley Tariff Act contributed to the depth and severity of the Great Depression. They believed, also, that countries would not reduce tariffs or trade restrictions unilaterally. Experience with most-favored-nation clauses in the 1930s showed, however, that countries could reach bilateral agreements that extended benefits to others based on the most favored nation clause.

From 1949 to 1995, GATT, the General Agreement on Tariff and Trade, was the institutional embodiment of this consensus. The GATT was an interim agreement, not a treaty. In the United States, its legal standing was based on the President's authority to negotiate reciprocal trade agreements. Congress retained the right to approve the agreements as Executive Agreements, not treaties, so they were approved by majority vote in both branches of Congress, rather than by a 2/3 vote of the Senate.

The GATT had two principal activities. Under its umbrella, a growing group of countries reached agreements on nondiscriminatory reductions in tariff duties, quotas and other quantitative restrictions on trade in goods. Also, it managed dispute settlement procedures arising under the agreements. In its later years, the GATT worked to reduce barriers to international trade in services and nontariff barriers to trade in both goods and services. These new activities raised more complex issues than the earlier negotiations limited to tariffs and other quantitative restrictions.

Despite the absence of a formal treaty structure, GATT played a very useful role in the world economy. By creating and, to a degree, enforcing rules for trade, it encouraged trade expansion. Countries that adopted a strategy of export-led growth looked for their comparative advantage, and adopted new technologies to develop or enhance their competitive edge, thereby encouraging practices that increased living standards.

Postwar recovery in Europe and growth in Asia owe much to the gains from specialization and trade. Countries receiving exports from emerging economies gained from the spur of increased competition in their markets, from lower import prices, and from the expanding world market for their exports.

Governments in some countries, particularly Latin American countries, chose a different strategy, known as import substitution. Instead of seeking competitive advantage in global markets, these countries restricted imports in the interest of developing home production. For a time Latin American countries grew about as fast as the developing Asian countries, in part because they invested in new industries to replace imports.

By the 1970s, growth in the more open Asian countries surpassed growth rates in the import-substituting Latin American countries. A main reason was the competitive test that trade imposed on Asian countries. Their capital was more productive, their production more efficient.

Start of the WTO

Under GATT, nations reduced tariffs on goods to very low levels. Nontariff barriers, quotas, and restrictions on trade in services became the frontier for further relaxation of barriers to trade. After almost a decade of negotiation, GATT members agreed to increase the role, expand the scope, formalize the constitution, and change the name of the trade organization. On January 1, 1995, the World Trade Organization (WTO) replaced GATT.

The WTO agreement incorporated and extended earlier GATT agreements. It made two important additions: the General Agreement on Trade in Services and the Dispute Settlement Understanding. Also, it reached agreement on trade related aspects of international property rights.

The WTO makes special provision for developing least-developed and transitional economies. These include technical assistance and training to enable these members to participate more fully in the work of the WTO. Here its role overlaps slightly with that of the development banks and to some extent that of the International Monetary Fund as it presently operates.

Structure of the WTO

The headquarters of the WTO is in Geneva, Switzerland. As of November 13, 1999, there were 135 members (states or, in exceptional cases customs territories like the European Union, Hong Kong, or Macao.) All of the large trading nations, except Taiwan, are members or have applied for membership. Some thirty applications for membership are pending.

The WTO is a relatively small organization. The Secretariat staff of around five hundred is responsible to the director-general, currently Mike Moore of New Zealand. Its 1999 budget was about 122 million Swiss francs, approximately $75 million. Unlike other international bureaucracies, the Secretariat has no decision-making role. It provides technical and legal support and a public voice for its activities. Top-level decisions are taken at Ministerial Conferences, held at least every two years, and other decisions are made by the General Council, three subsidiary councils that report to the General Council, and numerous specialized committees, working groups, and working parties.

Powers of the WTO

Trade in Services

The General Agreement on Trade in Services (GATS) took effect in 1995 covering areas such as banking, insurance, telecommunications, tourism, hotels, and transport. States that are signatories to GATS commit themselves to provide access to their markets in these services. GATS also contains lists showing where signatories are temporarily not applying the "most-favored-nation" principle of nondiscrimination. A full new round of negotiations will seek to extend the scope of these agreements no later than 2000.

The fifth protocol of GATS concerns financial services. This protocol seeks to eliminate or relax limitations on foreign ownership of local financial institutions in banking, securities, and insurance, limitations on the juridical form of commercial presence, and limitations on the expansion of existing operations. As of September 30, 1999, sixty-one signatories to GATS had accepted the protocol and ten had not.

Allowing foreign participation in the financial services sector improves the operation of local financial markets, lowers the costs of these services and reduces risk. Presence of competing foreign banks and financial institutions works to reduce corruption and favorable treatment of politically connected borrowers. Further, many economies are too small to diversify production over a wide range of activities. If domestic banks are limited to financing local industry, and foreign competition is prohibited, the portfolios of banks and financial institutions have too little diversification. There is too much risk that a decline in a major local industry, or other disruption, would weaken local financial institutions, increasing failures and capital flight, followed by a banking and exchange-rate crisis. Part of this risk would be avoided by opening local markets to foreign competitors.

International banks diversify their assets and liabilities by lending to a wider range of industries and countries and taking deposits in many places. This enables them to reduce risk. Further, diversified banks can absorb local losses. Defaults in one country are balanced by profitability elsewhere.

In Chapter 2, the Commission recommended that the IMF require countries to open their financial markets as a precondition for IMF assistance in a crisis. This would both prevent the IMF from lending to countries with weak financial systems and encourage countries to reduce risk. Thus it serves the interest of developing countries and the world economy to encourage governments to accept the fifth GATS protocol.

Foreign competition not only improves the variety and quality of financial services while making them available at lower prices, it also increases the productivity of nonfinancial enterprises by increasing access to credit markets and tailoring the types of lending more closely to the borrowers' requirements. Thus the WTO's program of

opening up financial services to foreign competition contributes to the growth of international trade and investment, world output and living standards, and economic stability.

Employment Effects of Trade Agreements

Critics of trade liberalization often argue that the adjustment to more liberal trading rules imposes a heavy burden on workers and firms that face increased competition from imports. By concentrating on firms and workers that are displaced, and neglecting consumers and those who gain, critics appear to deny that there are net benefits to a country from opening markets.

A common complaint is that the United States has lost manufacturing jobs. Chart 5-1 shows that the share of manufacturing workers as a percentage of the nonfarm labor force has, indeed, declined in the postwar years. In nearly fifty years, the share of manufacturing jobs has fallen from 35% to less than 15%. In the same period, the share of manufacturing output in total output declined much less. Manufacturing productivity increased: more manufacturing output is produced with fewer labor inputs.

[Insert Chart 5-1 here]

The trend rate of decline in the share of manufacturing jobs is close to constant for the last fifty years. There is no indication that successive multilateral trade agreements, or passage of NAFTA, had any effect on the trend, contrary to frequent claims about job loss from this agreement. In fact, since the passage of NAFTA, the actual share of manufacturing jobs has been above trend. This is partly the result of the strong economy.

Trade liberalization does not affect the level of employment -- it does not create or destroy jobs in the aggregate. It affects the composition of the labor force and real wages. By making the economy more efficient, liberalization raises wages. Any resulting change in the composition of jobs is more accurately related to the ebb and flow of industry and commerce.

The Department of Commerce estimates that jobs supported by exports---jobs in trading companies and companies that export---pay 13 to 16% more than the national average of non-supervisory, production jobs. This supports the implications of the economic theory of trade: workers in the aggregate gain from trade expansion.

Dispute Settlement

Five hundred or more years ago, as trade expanded within nation states, rules for trade began to evolve. Courts developed procedures for enforcing rules and settling disputes within national boundaries. Trade agreements and enforcement encouraged the postwar expansion of trade by extending the rule of law to international disputes. With increased rules and laws, the need for interpretation, adjudication and dispute settlement encouraged the development of new institutions.

Dispute settlement activities developed slowly under GATT. Between 1947 and 1994, members brought only 300 disputes. Between 1995 and September 1999, members brought 179 cases. Three reasons explain much of the increase.

First, early GATT rules mainly regulated tariffs, so violations were more easily checked and settled. As GATT, and later WTO, expanded into nontariff barriers, beginning in the 1970s, different and more complex issues arose. Are health standards valid regulation or hidden protection? Does a restriction help mainly to preserve local culture or prevent foreign competition? Do foreign trucks meet local safety standards, or do local safety standards serve to protect local suppliers?

Second, the original GATT had 23 member states, many with broadly similar trading rules. Disputes were settled by negotiation among the contracting parties. As new countries entered after the 1960s, new problems arose. Countries had different standards of conduct and different orientations. For example, government procurement and subsidies to state-owned enterprises were much more important in some countries than in others. Some countries support or permit local cartels, and the local law may favor them. Other countries prohibit monopoly and cartelization.

Third, countries could veto adverse decisions, and they often did. Time to decision was long, procedures cumbersome, and decisions were often unenforceable.

In 1994, the Uruguay Round made major procedural and substantive changes. First, a more or less unified system replaced the fragmented system that had developed. Most disputes are now handled in a similar way, unlike the practices that developed in the 1980s. Second, an appellate body can review the legal basis for decisions made by the panels that adjudicate disputes. Third, decisions cannot be vetoed by a party to the dispute. Decisions stand unless there is a consensus of the members that the decision should not be enforced. Fourth, the length of time to settle disputes has been shortened.[32]

Recommendations

The WTO is a relatively new organization subject to change as experience with its strengths and weaknesses accumulates. The Commission had neither the time nor the expertise to evaluate all the changes that have occurred or the many proposals for future changes. It confined its recommendations to two areas: general principles of operation and the role of the WTO in promoting financial stability, safety and soundness.

Some General Principles

The WTO has two main functions. First, it administers the process by which trade rules change. Trade ministers (or their equivalent) negotiate agreements that legislative bodies can approve or reject. Second, the WTO serves as a quasi-judicial body to settle disputes. Part of this process involves the use of sanctions against countries that violate trade rules.

Quasi-judicial determination, when coupled with the imposition of sanctions, can overwhelm a country's legislative process. As WTO decisions move to the broader range of issues now within its mandate, there is some risk that WTO rulings will override national legislation in areas of health, safety, environment, and other regulatory policies. The Commission believes that quasi-judicial decisions of international organizations should not supplant legislative decisions. The system of checks and balances between legislative, executive and judicial branches must be maintained.

Rulings or decisions by the WTO, or any other multilateral entity, that extend the scope of explicit commitments under treaties or international agreements must remain subject to explicit legislative enactment

[32] The United States brought 49 of 179 disputes in the first 4-1/2 years. Twenty-two were settled in favor of the U.S., by consultation or adjudication by panels. The United States lost six cases. The rest are in process.

by the U.S. Congress and, elsewhere, by the national legislative authority. There should be no "direct effect" on U.S. (or other) law or the ability to impose fines or penalties until national legislative ratification is completed.

Enactment of this recommendation would limit the WTO's authority, and the authority of other international agencies, to impose sanctions on a country for violation of rules to which it did not agree. We recognize that this would weaken the application of the rule of law internationally. Its principal benefit is that it strengthens democratic accountability and precludes delegation and erosion of the legislative function.

If countries do not accept WTO decisions, injured parties have the right to retaliate by putting restrictions on imports from the offending country or region. The injured country then suffers twice---once from the restrictions on its exports, imposed by foreign governments, and again when tariffs or duties raise the domestic cost of the foreign goods selected for retaliation. To compensate for the injury done by others, we impose costs on ourselves as well as them.

The Commission proposes that, instead of retaliation, **countries guilty of illegal trade practices should pay an annual fine equal to the value of the damages assessed by the panel or provide equivalent trade liberalization.**

Retaliation is contrary to the spirit of the WTO. Sanctions increase restrictions on trade and create or expand groups interested in maintaining the restrictions. Domestic bargaining over who will benefit from protection weakens support for open trading arrangements.[33]

Rules for Financial Stability

The Commission recommends rules to enhance financial stability. Such rules can reduce risk, spread best managerial practices, increase competition, and reduce the role of government in the allocation of bank loans. The Commission recommends that explicit minimum financial standards be phased in as a condition for assistance from the IMF in a financial crisis. Chapter 2 discusses these preconditions. Enforcement of the preconditions should remain the IMF's responsibility.

We believe that proposals and recommendations to improve financial standards should be the responsibility of the groups on banking and financial standards associated with the BIS. Chapter 4 discusses the groups responsible for these proposals and recommendations. These responsibilities should remain with the Basel-based organizations, such as the Basel Committee on Banking Supervision.

The WTO is an adjudicative organization that has proved effective in settling disputes about tariffs and quantitative trade restrictions. **The WTO should not extend its procedures to set domestic policies and regulations,**

[33] A very useful discussion of these and related issues is in Claude Barfield, "More Than You Can Chew? The New Dispute Settlement System in the World Trade Organization," available from the Commission's web site, http://phantom-x.gsia.cmu.edu/IFIAC.

including regulation of banking services, accounting practices, or financial standards. These should remain the responsibility of specialized agencies.

Supporting and Dissenting Statements

Dr. Lee Hoskins

I wish to express my appreciation to Allan Meltzer for his unfailing integrity, fairness and hard work as Chairman. Without his firm leadership, this Commission still could be wandering in a swamp of details, data and conflicting ideology. I fully support the recommendations included in the report for, if enacted, they would significantly improve the operations of the international financial institutions evaluated in the report. However, several of these recommendations I regard as "second best" solutions.

The best solution to international financial crisis is to allow markets to work their will. Intervention by the IMF or other crisis manager creates moral hazard, leads to less efficient financial markets and supports the continuation of bad economic policies in many countries around the world. A true world liquidity crisis, were it to occur, can only be dealt with by central banks since they are the source of base money. In short, I believe the United States and the world would be better off without the IMF.

Restricting the lending by development banks and focusing their efforts on the alleviation of poverty would be a significant improvement compared to current operations but why allow any lending at all. If a country can borrow in the market let it do so. If it cannot, then it is either too poor or too limited institutionally to qualify. Such a country does not need a loan, it needs direct aid or institution building. Eliminating all development bank lending would keep these banks from being distracted from their main mission, the alleviation of poverty.

I appreciate the opportunity to work with all those associated with this commission. I hope Congress gives this report the careful consideration it deserves.

Congressman Tom Campbell

"I commend my colleagues for an excellent report. I ask for my separate views to be noted in one regard. Whereas the Commission believes a limited role continues to exist for the IMF, as a 'quasi lender of last resort to emerging economies,' I remain concerned that fulfilling that role might actually deter the development of those institutions within the recipient countries that would make the IMF role unnecessary. Eventually, it is the commercial market that will determine credit-worthiness of enterprises within countries. The availability of a lender of last resort outside that commercial market may soften the drive toward the integration of the recipient country into the regime of international commercial lending. My concern in this regard has been accommodated somewhat by the phrase in the Commission's recommendation that the lender of last resort function is to be accomplished "under a system that would

not retard the development of those institutions within the recipient country that would lead to the country attracting capital from commercial sources." It is fair to observe that I believe such conditions upon an IMF role would be very unlikely to be achieved, and hence, I believe the lender of last resort function should not be pursued."

DISSENTING STATEMENT

There are numerous constructive proposals in the report. We agree that reform is needed at the international financial institutions (IFIs) and support a number the report's most important recommendations: to clearly delineate the responsibilities of the International Monetary Fund and the World Bank, to promote stronger banking systems in emerging market economies, to publish the IMF's annual appraisals of its member countries, to avoid any use of the IMF as a "political slush fund" by its donor members, to fully write off the debt of the highly indebted poor countries (HIPCs) to the IFIs, to increasingly redirect World Bank support to the poorest countries and to the "production of global public goods," and to provide that assistance on grant rather than loan terms.

But some of the central proposals in the report are fundamentally flawed and/or unsubstantiated. They rest on misinterpretations of history and faulty analysis. They would greatly increase the risk of global instability. They would be inimical to the interests of the United States. We reject them totally and unequivocally.

Misreading History

Most importantly, the report presents a misleading impression of the impact of the IFIs over the past fifty years. A visitor from Mars, reading the report, could be excused for concluding that the world economy must be in sorry shape. But we all know that the postwar period has been an era of unprecedented prosperity and alleviation of poverty throughout the world. The bottom line of the "era of the IFIs," despite obvious shortcomings, has been an unambiguous success of historic proportions in both economic and social terms. The United States has benefited enormously as a result.

Even a somewhat narrower "bottom line" evaluation would be much more favorable to the IFIs than is the report. Almost all of the crisis countries of the past few years, ranging from Mexico through East Asia to Brazil, have experienced rapid "V-shaped" recoveries. All of the East Asians except Indonesia, for example, have already regained output levels higher than they enjoyed before the crisis. Even Indonesia and Russia, the two laggards with deep political problems, are now growing again. The world economy as a whole rebounded quickly and

smoothly from what President Clinton called "the greatest financial challenge facing the world in the last half century." Whatever the difficulties along the way, the IMF strategy has clearly produced positive results.

The history of successful development over the postwar period is even more dramatic. Never in human history have so many people advanced so rapidly out of abject poverty. The World Bank and the regional development banks contributed significantly to those outcomes. The report itself notes, at the outset of Chapter 1, that "in more than fifty postwar years, more people in more countries have experienced greater improvements in living standards than at any previous time." It ignores that reality for the remainder of the text, however, and the tone throughout is so critical as to convey the message that very little progress has occurred.

The other great success story of the postwar period is democratization. More than half of the world's population now lives under democratic governments—a dramatic shift over the past decade or so. Yet the report repeatedly argues that the IFIs undermine democracy by somehow precluding local governments from pursuing autonomous economic policies. The report is particularly critical of the Fund's role in Latin America, where virtually every country has become democratic during the very period when the IMF has been most active there. IMF conditionality is obviously not a roadblock to democracy. The allegations of the report simply fail to square with the facts of history.

Promoting Financial Instability

Turning to the specific recommendations, the most damaging relate to the central responsibility of the International Monetary Fund for preventing and responding to international monetary crises. The report would limit the Fund to supporting countries that prequalified for its assistance by meeting a series of criteria related to the stability of their domestic financial systems. This approach has two fatal flaws.

First, the majority would have the IMF totally ignore the macroeconomic policy stance of the crisis country—"the IMF would not be authorized to negotiate policy reform." Hence they would sanction Fund support for countries with runaway budget deficits and profligate monetary policies. This would virtually eliminate any prospect of overcoming the crisis; it would instead enable the country to perpetuate the very policies that likely triggered the crisis in the first place and thus greatly increase the risk of global instability. It would also provide international public resources for countries whose own policies were likely to squander them in short order, without any assurance of their even being able to repay the Fund. No reputable international institution would adopt such an approach.

The proposal for adding an undefined "proper fiscal requirement" to the prequalification list smacks of an international equivalent to the Maastricht criteria, which have been extremely difficult to apply in the relatively homogenous European Union and would be totally

unrealistic at the global level. If the "fiscal requirement" were left open as to content, it would require Fund negotiation ("conditionality") of precisely the type that the major rejects—as well as the strong likelihood of periodic dequalifications and requalifications of countries that would be immensely destabilizing. Hence the prequalification list would in practice be limited to financial sector considerations, as clearly intended by the majority in any event, and fiscal as well as monetary policy would be completely ignored.

Second, limiting Fund activity to any set of prequalifying criteria would almost certainly preclude its supporting countries of great systemic importance and thereby substantially increase the risk of global economic disorder. Whatever criteria might be selected, it is totally unrealistic to think that all systemically important countries will fulfill them even after a generous transition period. The Fund would then be barred from helping such countries and financial crises in them would carry a much greater risk of producing a severe adverse impact on the world economy. No reform of the Fund should block it from fulfilling its central responsibility as the defender of global financial stability through providing emergency support for all countries which could generate systemic threats. (The Executive Summary suggests a takeout from these requirements "in unusual circumstances, where the crisis poses a threat to the global economy" but Chapter 2 on the IMF calls only for "extraordinary events" to be handled by "vehicles other than the IMF.")

These proposals apparently derive from five faulty lines of analysis in the report:

- that the overwhelming systemic problem that needs to be addressed is moral hazard, despite a dearth of empirical evidence that this phenomenon had much to do with any of the three sets of crises in the 1990s (except for Russia, where the market's "moral hazard play" was related primarily to that country's being "too nuclear to fail" rather than to its economy or to prior IMF policies);

- that countries will be deterred from getting into crises, and hence having to borrow from the Fund, by according senior status to the IMF's claims on the country and by charging them "penalty interest rates"; the Fund already has *de facto* senior status and has already sharply increased its lending rates, however, and a crisis country in any event is motivated primarily by acquiring additional liquidity rather than by the terms thereof;

- that the IMF fails to require banking reform in borrowing countries, whereas it has done so in every crisis case in recent years;

- a misrepresentation of the extensive literature that assesses IMF conditionality, which reaches agnostic conclusions concerning its effectiveness rather than the negative verdict claimed in the report; and, closely related,

- a failure to compare actual outcomes in crisis countries with what would have happened in the absence of IMF programs; crisis countries obviously experience losses of output and other negative developments but the issue is whether they would have fared even worse without IMF help and the report, while noting the need to consider the "counterfactual," does not even attempt to address that central issue.

Much more desirable proposals for reforming the International Monetary Fund can be found in the recent report *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* by an Independent Task Force sponsored by the Council on Foreign Relations. That group, unlike the current Commission, reached unanimous agreement. Its members included Paul Volcker, George Soros, several corporate CEOs, former Secretaries of Labor and Defense, former members of Congress Lee Hamilton and Vin Weber, President Reagan's former Chief of Staff Kenneth Duberstein, and top economists including Martin Feldstein and Paul Krugman.

For example, the Independent Task Force suggested that the IMF should offer <u>better terms</u> on its credits to countries that have adopted the Basel Core Principles to strengthen their domestic banking systems in order to provide incentives for such constructive steps; this is far superior to the report's all-or-nothing approach, which would have the deleterious effects outlined above. That group also offers constructive and realistic reform proposals on how to alter the IMF's lending policies so as to reduce moral hazard without jeopardizing global financial stability, through better burden sharing with private creditors, and on how to shift the composition of international capital flows in longer-term and therefore less crisis-prone directions.

<u>Undercutting the Fight Against Poverty</u>

The second major problem with the report is that <u>its recommendations might well undercut the fight against global poverty</u>, despite its stated intention to push the world in the opposite direction. In particular, its proposal to eliminate the nonconcessional lending program of the World Bank represents another reckless idea based on faulty analysis.

First, <u>the report would totally shut down two major sources of funding for the poor</u>—the World Bank's nonconcessional lending program and the IMF's Poverty Reduction and Growth Facility. These programs help hundreds of millions of the world's poorest people,

many of whom live in the poorest countries but many of whom also live in countries (e.g., Brazil and Mexico) whose average per capita income now exceeds the global poverty line.

The report would in fact return substantial amounts of World Bank capital and more than $5 billion of IFC capital to the donor countries. This proposal would amount to massive "reverse aid" to the richest people in the world! It would be financed through sizable repayments of prior World Bank loans, draining real resources from some of the poorest people in the world (e.g., in Africa and India). The proposal belies the avowed intent of the report to improve the lot of the poor.

Second, the report would bar World Bank lending even to the poorest countries if those countries had obtained access to the private capital markets. Why penalize countries like China and Thailand for doing precisely what the majority says it wants them to do—qualify for market credits?! This proposal would create negative incentives for a large number of key developing countries.

Third, and most critically, the report would rely wholly on appropriated grant funds from rich-country governments for future assistance to the poor. Callable capital that was no longer needed at the World Bank because of the shutdown in its lending programs could not simply be given to IDA; an entirely new authorization and appropriation process would be required in our own Congress and other legislatures around the world. Indeed, IDA would lose the funds now transferred to it from World Bank profits (and, under another of the report's proposals, the repayments of earlier IDA credits as well). This proposal comes at a time when Official Development Assistance, as measured annually by the OECD, has declined enormously—especially, as a share of total income, in the United States. Even if the report's proposals were to promote dramatic improvements in aid effectiveness, the results would take many years to show up and it takes a great leap of faith to believe that donor governments would provide substantially increased funds even then—let alone in the longish transition period when the changes were being implemented.

Fourth, the report wants the more advanced developing countries to henceforth rely wholly on the private capital markets for external finance. But those markets are enormously volatile as we have seen in the crises of both the 1980s and 1990s; the private money can flow back out, deepening crisis conditions, even faster than it came in. Moreover, the markets do not care if their funds are used for developmental purposes, especially poverty alleviation.

Unsubstantiated Proposals

The third major problem with the report is its cavalier recommendations for several sweeping institutional changes without any analytical foundation at all. While there may be legitimate reasons for some of these proposals, the rationale for pursuing them has not been established:

- elimination of the World Bank's Multilateral Investment Guarantee Agency on the basis of three lines of assertions;
- elimination of the International Finance Corporation, one of the most successful components of the World Bank family, and the parallel entities at the regional development banks, without a shred of evidence that such actions would be desirable (and without acknowledging that such a step, along with the elimination of MIGA, would undercut the report's stated goal of increasing the flow of private sector resources to the poor countries);
- a shift of funding for all country and regional programs for Latin America and Asia from the World Bank to the Inter-American and Asian Development Banks, respectively, solely on the basis of cryptic assertions that the latter would do a superior job—which run counter to the judgments of most observers.

The fourth major problem is the chapter on the World Trade Organization. The global trading system, and US policy toward it, is an enormously complex and important issue at this point in time. The Congress will indeed shortly be considering a vote on whether the United States should maintain its membership in the WTO. The chapter is totally inadequate and indeed full of errors in dealing with the issue, understandably so because the Commission members were not chosen for their expertise on trade topics.

For example, the chapter suggests that "there is considerable risk that WTO rulings will override national legislation" when there is no such risk. It believes that WTO rulings "should not supplant legislative decisions" when there is no risk of their doing so. It recommends that "WTO rulings…should (have) no direct effect on US law" when they neither do so now nor ever could do so. The group's title is the International Financial Institutions Advisory Commission and the report admits that "the Commission had neither the time nor the expertise to evaluate all the changes that have occurred or the many proposals for future changes."

Additional Problems

There are numerous other flaws in the report:

- there is no reason to preclude the IMF from future assistance to high-income countries, which might need its help in future crises if global consequences are to be minimized;

- there is no reason to bar it from pushing member countries to adopt more stable exchange rate systems;

- there is no reason to propose a new set of ideas for strengthening banking systems in emerging market economies when the Basel Core Principles have already been agreed and the correct priority is to promote their adoption and effective implementation;

- it ignores the fact that the dozen countries which receive the bulk of the World Bank's loans also have the bulk of the world's population, and hence deserve substantial official funding;
- it ignores the valuable role of the Bank in strengthening the hand of reformers in developing countries and thereby tilting national policies in constructive directions; and

- it ignores central issues such as sustainable development and core labor standards that must be addressed by all of the IFIs.

The report also fails to address some of the central issues that must be part of any serious reform of the IMF. It should advocate, for example, much more effective "early warning" and "early action" systems to head off future crises. It should offer a formula for "private sector involvement" in crisis support operations, to assure sharing their financial burden between private creditors and official leaders (including the IMF), rather than simply "leaving that issue for participants." It should address the cardinal practical issue of <u>how</u> emerging market economies will manage their floating exchange rates, rather than simply reiterating that these countries should either fix rigidly or float freely—which very few now or ever will do. It should promote more stable exchange-rate arrangements among the major industrial countries, which are crucial for global stability and without which the emerging markets will continue to have severe problems whatever their own policies.

To conclude where we started: reform is needed at the IFIs and there are a number of constructive proposals in the report. But its recommendations on some of the most critical issues would heighten global instability, intensify rather than alleviate poverty throughout the world, and thereby surely undermine the national interests of the United States. These recommendations must be rejected and their presence requires us to dissent from the report in the strongest possible terms.

C. Fred Bergsten, Director, Institute for International Economics

Richard Huber, Former Chairman, President and CEO, Aetna, Inc.

Jerome Levinson, Former General Counsel, Inter-American Development Bank

Esteban Edward Torres, US House of Representatives, 1983-99

SEPARATE DISSENTING STATEMENT OF

JEROME I. LEVINSON

I. SUMMARY

I join with Commissioner Bergsten in his statement and recommendations with respect to a revised role for the IMF and the World Bank. The majority proposal (Hereafter Majority), in contrast, effectively eviscerates the IMF, the World Bank, IDB and the ADB; it does not discuss, much less make recommendations, as to whether core worker rights (and environmental protection) ought to be incorporated into the main body of the WTO agreement, despite the fact that extensive testimony was taken on this issue.

This separate dissent to the Majority is to (i) elaborate in greater detail the implausibility of the Majority proposal for the IMF and World Bank (ii) register my disagreement with the Bretton Woods institutions one-sided labor market intervention policies; and (ii) propose the need for core worker rights and environmental protection to be incorporated into the main body of the WTO agreement.

I make four specific recommendations for consideration by the Congress:

RECOMMENDATION #1:

CONTINUED U.S. SUPPORT FOR THE BRETTON WOODS
INSTITUTIONS SHOULD DEPEND UPON:

(A) THE U.S. EXECUTIVE DIRECTORS IN THESE INSTITUTIONS VOTING AGAINST FINANCING PROPOSALS FOR COUNTRIES THAT ARE EGREGIOUS ABUSERS OF CORE WORKER RIGHTS;

(B) A STATED POLICY BY THE USED'S IN THESE INSTITUTIONS THAT CREDITORS AND INVESTORS MUST MAKE A SUBSTANTIAL CONTRIBUTION BEFORE PUBLIC MONEYS ARE DISBURSED IN ANY FUTURE BAILOUT;

(C) A FORMAL STATEMENT BY THE USED'S IN THE BOARD OF EXECUTIVE DIRECTORS OF THE WORLD BANK AND THE IMF THAT THE U.S. CONSIDERS SETTLED THE RIGHT OF WORKERS TO FREEDOM OF ASSOCIATION AND COLLECTIVE BARGAINING AND THAT THESE RIGHTS ARE NOT OPEN TO FURTHER STUDY.

RECOMMENDATION #2:

AMEND THE WTO AGREEMENT TO INCLUDE A CORE WORKER RIGHTS PROVISION;

RECOMMENDATION #3:

AMEND THE WTO AGREEMENT TO CREATE A NEW CHAPTER IN THE MAIN BODY OF THE AGREEMENT INCORPORATING THE PROVISIONS OF ARTICLES XX (b) AND (g), THE "HEALTH AND SAFETY" AND "ENDANGERED SPECIES" PROVISIONS OF THE EXCEPTIONS CLAUSE OF THE WTO.

RECOMMENDATION #4:

ALLOW UNCONDITIONAL DEBT RELIEF FOR THE HIPC COUNTRIES, ALLOWING THEM A FRESH START: FUTURE ASSISTANCE CAN BE ASSESSED IN LIGHT OF HOW WELL THEY USE THAT FRESH START

II. THE IMF, THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS A. THE IMF

(Chapter 2)

The Majority recommendations are based upon two propositions, both of which are of dubious validity: (a) the 1995 Mexican bailout circumvented the Congress and encouraged "moral hazard", leading directly to the 1997 East Asian financial crisis;[34] (b) access to IMF resources is too attractive and easily available for member countries. Based upon these two propositions, the Majority conclude that the IMF should continue to exist, but only with a much reduced mandate: that of a quasi-lender of last resort for countries that are pre-qualified and can therefore automatically draw upon IMF resources for short- term financing by paying a "penalty" rate of interest and providing collateral for the resources drawn.

The IMF would be divested of discretionary judgment; it would be barred from imposing conditions on its financing designed to address the balance of payments problems which occasioned the need for IMF financing. Article IV consultations with member countries, by which the IMF informs itself and advises member countries as to economic issues relating to the balance of payments, would continue but not as a basis for "conditions" related to IMF financing.

1. The Mexican Bailout: Circumventing the Congress?

The Administration, initially, sought a $20 billion authorization of funds from the Congress to fund the Mexican bailout so as to avoid that crisis spreading to other emerging market economies. The Congressional Leadership of both political parties supported the proposal, but when it became evident that the funds would be used primarily to payoff the investors, including wealthy Mexicans, in short-term Mexican bonds-- tesobonos-- the Congress balked. Then U.S. Secretary of the Treasury, Robert E. Rubin, resorted to the Exchange Stabilization Fund (ESF) and requested the assistance of the IMF. (Sanger).

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[34] References are to chapters but as this was written, page references were not settled.

After an initial burst of Congressional criticism, that criticism dissolved. Constituents had invested in the emerging market funds that had promised a higher rate of return than they could then realize on more conventional U.S. investments. As Congresspersons began to hear from these constituents, a tacit bargain emerged: the Congress would mute its criticism of the Administration's actions and the Administration would ask nothing specific of the Congress. The bailout would go ahead but without explicit Congressional authorization. Investment by ordinary American citizens in emerging market funds had transformed the domestic politics of international finance.

The tesobono investors were overwhelmingly American investors. European Central Bank officials were openly skeptical of the contagion effect of the Mexican crisis, but they agreed to participate in an international effort which eventually amounted to $50 billion. The United States no longer had at its disposition a ready source of foreign aid funds as it did in the decade of the 60s; nor was there the urgency of the Cold War with the former Soviet Union to scare Congress into action. The Treasury, and the other Finance Ministers of industrialized countries, "raided" the IMF and World Bank funds for the Mexican, East Asian, and Brazilian 1990s bailouts because that's where they could find easily accessible money and there was no chance that the U.S. Congress and Parliaments of other countries would appropriate money for these purposes.

In an ideal world, such a raid on the funds of the IFIs for the purpose of bailing out imprudent lenders and investors, would not have been necessary. But we do not live in such a world. The Administration did not circumvent the Congress; on the contrary, it did the responsible thing in first seeking direct Congressional funding of the bailout. Both the Administration and the Congress understood the political reality that such funding was not going to happen. The raid on the funds of the IFIs reflected that reality.

2. Moral Hazard:Mexico Leads to East Asia?

Nor is the accusation of increasing moral hazard any better founded. In contrast to the tesobono investments, the East Asian commercial bank lenders were primarily Japanese and European banks, not American. It stretches credulity to believe that the Japanese and European banks engaged in their East Asian lending in expectation that, on the basis of the Mexican tesobono experience, if those loans turned sour, a similar bailout would be organized on their behalf. They must have been well aware that their own government authorities were the ones most skeptical of the claim that the fear of contagion justified intervention in the

Mexican case. There is no smoking gun memo from within any of the banks which as yet has surfaced, one which states, in effect, that, based upon the Mexican experience, if the borrowers cannot repay, the banks can count on an IMF led bail out similar to what occurred with Mexico.

The Chairman states that, in 1997, the Thai finance Minister, knowing that he lacked sufficient funds to support the value of the currency, nevertheless, committed himself to do so; he must have expected, like the Mexicans, that Thailand would also be bailed out by the IMF. (Meltzer Tr. Feb 2, pp.135-139). But this is speculation; no evidence is cited in support of the Chairman's statement. If the banks in Thailand expected to be bailed out, why did they pull their loans as rapidly as they did when the crisis commenced? (Council on Foreign Relations Task Force (hereafter CFR), p. 9). It is not unprecedented for finance ministers to hope that the mere statement that they will not devalue their currency will be sufficient to stop a run on the currency. That is what the Mexican Finance Minister did in December 1994, knowing full well, like the Thai Minister, that his country was hemorrhaging reserves. The result was equally futile.

After first detailing the efforts of U.S. officials to pry open Asian capital markets for the benefit of American firms, Kristof and Sanger summarize the responsibility for the East Asia short-term banking fiasco:

> "Responsibility can be assigned all around: not only to Washington policymakers, but also to the officials and bankers in emerging market countries who created the mess; to Western bankers and investors who blindly handed them money; to Western officials who hailed free capital flows and neglected to make them safer; to Western scholars and journalists who wrote paeans to emerging markets and the Asian century." (Kristof with Sanger).

Stanley Fischer, Deputy Managing Director of the IMF, candidly noted: "I see very little sign that the capital flows to East Asia bore any relationship to what happened in Mexico....nobody, including me, believed that those [the East Asian] countries, which had been growing at 8 to 10 percent, were structurally weak." (Fischer, Tr. p. 218).

Unable to establish with any degree of certainty that the Mexican bailout led to the East Asian crisis, the Majority assert that in Mexico, Asia and Russia, the IMF "did little to end the use of the banking and financial systems to finance government favored projects, eliminate so-called "crony capitalism" and corruption , or promote safer and sounder banking and financial systems." But, until the 1997 crisis, South Korea had "graduated" from IMF and World Bank funding; the World Bank <u>East Asia Miracle</u> report had praised the Korean credit system; Korea had followed a development model based upon the Japanese experience of directed

credit by the government to foster specific industries. "Crony capitalism" only made its appearance as an explanation of the Korean problems in the aftermath of the 1997 crisis.

It is true that the Russian and Mexican banking sectors represent two of the greatest asset steals of the century:

> " In his bid to increase capital inflows, [Mexican President Carlos] Salinas [de Gortari] has put state banks on the block at three times their book value and often more...But in exchange for high prices, Salinas offered their buyers sweet regulatory deals and long term promises of fabulous riches through Nafta, which would soon allow some of the new owners to sell their monopolies corporations at record profits...Through a policy of "directed" or selected liberalization, Salinas paved the way for the formation of more than a dozen monopolies that would control industries such as copper mining and telecommunications. (Oppenheimer, p. 91).

John Lloyd describes a privatization process in Russia similar to what occurred in Mexico (Lloyd, p. 35). To attribute to the IMF responsibility for the corruption and favoritism that characterized the banking scandals in Mexico and Russia is either naive or cynical. The distribution of banking assets to favored players was an integral part of the political power system in both countries. The IMF could no more stop that process than King Canute could part the waters. What it is fair to say is that uncritical praise for Mexico's reforms and Russia's progress in achieving a "market" economy provided a mantle of legitimacy for a thoroughly corrupt process in both countries of privatization of state assets, but the IMF was hardly alone in its failure to blow the whistle: virtually all of the industrialized country officials looked the other way. The geo-political stakes in both cases were simply too great. To blame the IMF alone in both Mexico and Russia for the outcome is wrong. It is a reflection of the schizophrenic approach of the Majority to the IMF: it is either too interventionist or did not intervene effectively enough.

3. The IMF: Too Easy?

Equally implausible is the Majority assumption that countries are tempted to resort to the IMF for financing because such resort has been made too attractive for them. This assertion is as plausible as asserting that someone goes to the dentist to have root canal work done on his mouth because he enjoys it. Countries, more often than not, resort to the IMF too late because they fear that IMF conditions will be too burdensome.

4. IMF Conditions

The Chairman set forth the central belief of the Majority that the conditions imposed by the IMF do not advance democratic governance:

> “ We believe that the interests of developing democratic government abroad, that the first step in that procedure must be to get the country to take responsibility for doing things that are in its own best interest. And that those can’t be imposed from abroad and shouldn’t be imposed by any international institution, even though we recognize that there’s a useful role for advice.” (Meltzer, Tr. Feb 2, pp. 200-1).

The Chairman is certainly right that if conditions are perceived in a country to have been imposed from without, they are unlikely to be effectively implemented. But the conditions that accompany IMF financing must be agreed with the country. It is the country that submits a letter of intent to the IMF, stating the country’s proposed program. In practice, the content of the program incorporated in the letter of intent is negotiated with the IMF staff before it is formally submitted to the IMF. It is also true that countries, particularly small countries, desperate for assistance, may too easily agree with IMF staff suggestions. If that program departs too radically from what the political traffic in the country will bear, the program will certainly fail. The fact that a program is agreed with the IMF does not, by itself, undermine democratic government.

It is not unreasonable for the international financial community, in providing financing for a country with balance of payments difficulties, to want some assurance that the conditions that led to the need for such financing will be addressed. It is the content of the program that more often than not is the subject of dispute: is there an accurate diagnosis of the source of the problem? Is the burden of adjustment equitably shared within the society and between external creditors and the debtor country? These are contentious, but inevitable issues that accompany IMF assistance.

Mr Fischer was asked to speculate as to what would have happened had the IMF not intervened in 1997/8 in the East Asia:

> “ I believe that the crises would have been bigger, not smaller. That is, each country, at the moment the crisis broke out, would not have had the external financing available...would have had to stop external payments. I do not believe that could have been done in an orderly way.. And I think you’d have turned off financing for developing countries all over the world...In addition, I believe that without the international assistance effort, the policymaking solutions, responses, in those countries would have been much weaker....” (Fischer, Tr. p. 217).

There is plenty of room to differ as to whether the IMF analysis as to the source of the problem in the East Asian countries was mistaken (Fischer, LA; Sachs, American Prospect); and whether the burden of adjustment was equitably distributed among creditor banks, debtor countries, and within both debtor and creditor

countries. Rather than confront these issues in the future, the Majority has opted for an impractical and implausible solution.

5. IMPLAUSIBLE AND IMPRACTICAL

(a) Who Certifies as to Pre-qualification?

The Majority does not identify who is to certify that a country has met the pre-qualification criteria. The Majority do not wish to entrust this responsibility to the IMF staff; there is no indication that the Bank for International Settlements (BIS) has the capability or the desire to assume this task. Nor is it likely that an international consulting firm could perform this function. Countries are unlikely to accept a foreign firm, with other international clients, having access to sensitive national financial data.

(b) Opening to Foreign Banks

The Majority states that, among other criteria, a borrowing member country of the IMF would have to agree to open its banking system to foreign banks: "eligible member countries must permit freedom of entry and operation for foreign financial institutions in a phased manner over a period of years." Fernao Brasher, a former Brazilian central bank president who now heads a Sao Paulo bank with Austrian shareholders, though majority owned by Brazilians, urges the Brazilian government to limit the entry into Brazil of foreign financial institutions: " The richest countries of the world are wise enough to realize that national interests coincide with a strong, domestically led financial system...Why should Brazil, a developing country, be run rough-shod over?." Domestically owned Brazilian banks,

> " tend, in some instances, to support the stability of the financial system in times of crisis. For instance, in the tumult that followed the devaluation of the currency nearly a year ago, some foreign banks counseled their clients to avoid purchasing Brazilian government bonds and other securities, citing the risk of default." (Romero,a).

Despite Brazil having a strong domestic banking sector, if it were to impose limitations upon foreign ownership of domestic banks, under the Majority criteria, Brazil would be ineligible for future IMF funding. It is a technocratic approach. There is no room for national interests.

(c) Countries Most in Need Ineligible for IMF Assistance

If only countries that are pre-qualified are eligible for IMF funding, the Majority would cut off those countries that are probably most in need of such funding. Often, the crisis itself is what precipitates needed

reform. Yet, the Majority would bar the IMF from conditioning its funding upon the implementation of a program designed to address the conditions that led to the crisis.

(d) Short Term Finance

The Majority assumes that a country which has resorted to IMF financing will quickly (weeks or months) regain voluntary access to the financial markets. (Majority, Ch. 2 p. 18). But what if it does not? What if the measures necessary to restore credibility in the market require legislative action, a time consuming and difficult process? The Majority assumes an almost automatic restoration of credit access in the private markets, but for countries for whom such access is, to begin with, already fragile, such an assumption might not be warranted.

Divested of any discretionary judgment, the IMF doesn't need a prestigious Managing Director, but a high level clerk, a couple of disbursing officers and a few lawyers to draw up the necessary legal documentation.

B. THE WORLD BANK AND THE REGIONAL DEVELOPMENT BANKS

(1) The Financing Scheme in Detail (Chapter 3).

With respect to the World Bank, and the regional development banks, the Majority concludes that development financing displaces private market financing and, consequently, should be substantially curtailed. The World Bank would convert itself primarily into a non-financial development agency, with two tasks: (a) coordinating donor aid by individual countries and non-governmental agencies; (b) addressing issues not now being adequately addressed by any of the international agencies in the United Nations complex and without, finding innovative solutions for seemingly intractable problems.

The Majority recommends that poverty reduction programs and infrastructure projects be financed exclusively with grant funds. The grantee would not receive or administer the funds; the development banks would disburse directly to a vendor selected by the grantee. Loan funding would be confined to structural adjustment lending. In order to create an incentive for implementing agreed reforms, repayment of principal, under a structural adjustment loan, can be deferred for as much as ten years, provided that an independent third party certifies that the reforms have been implemented in a satisfactory manner, or, are still in place. If such a certification is not forthcoming, repayment of principal recommences.

The World Bank would cease operations (lending or grant) in its borrowing member countries in Latin America or Asia; that responsibility would be delegated to the IDB and ADB:

> "The World Bank should become the principal source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World bank would also be the development agency responsible for the few remaining poor countries in Europe and the Middle East."

However, the IDB and ADB would only be able to extend assistance (structural adjustment loans or grants) to countries without capital market access (as denoted by an investment grade international bond rating), or with a per capita income less than $4,000; starting at $2,500 levels, official assistance would be limited.

It proposes that, the "World Bank's role as lender would be significantly reduced." Repayments on the World Bank's existing IBRD portfolio will amount to $57 billion (49 % of loans outstanding) over the next 5 years and $102 billion (87 % of loans outstanding) over the next ten years." In vague terms, it proposes, "[s]ome of the callable capital should be reallocated to regional development banks, and some should be reduced in line with a declining loan portfolio." In other words, it should be returned to the shareholders; in the case of the U.S., it would be returned to the Treasury and would require Congressional appropriation for other uses.

Since the Majority recommends discontinuing World Bank lending in Latin America and Asia, the bulk of the repayments from borrowing member countries of the Bank in these regions will not be compensated by new loans from the World Bank; it is highly unlikely that the regional development banks will realize a commensurate increase in resources to be able to make-up for the loss of World Bank resources. There is likely to be a net loss of development resources for these countries. For five major borrowers of the World Bank--Argentina, Brazil, Mexico India and Indonesia--net repayments (that is amortization and interest less World Bank disbursements) over a five year period will be an estimated amount slightly in excess of $20 billion. (Salop/Levinson). Under such circumstances, repayment by borrowing member countries of the World Bank is almost certain to meet domestic political resistance. It is not in the interest of the United States to force a confrontation with major World Bank borrower countries in Asia and Latin America, many of whom have deep internal social unresolved problems.

<u>(1) Displacement of Private Financing</u>

The charge that the World Bank financing is concentrated in countries that have been market eligible and displaces private market financing is misleading. The Majority lumps all forms of foreign capital together, but Ernest Stern notes,

> " a very large part of private flows is directed to foreign investment, which is very important but serves a somewhat different function. A substantial portion of the rest is trade...and short term bank credits...You have a third element...which is portfolio equity investment and finally you have...long term debt financing...and it's only that part you can reasonably compare with the flows of the World Bank, because that's the same objective, sovereign Government borrowing on medium term." (Stern, Tr. pp. 111-112).

It is true that World Bank financing (and IDB lending) has been concentrated in the larger countries, many of which, at various times have been able to directly access the international financial markets. Those markets, however, have been highly volatile. Between 1983 and 1989, countries in the Western Hemisphere borrowing member countries of the World Bank experienced a cumulative net outflow of $ 116 billion. (Folkerts-Llandau and Ito, p. 2). Only after the March 1989 Brady debt reduction initiative, did capital in significant amounts return to Latin America. In the period 1990 to 1994, Western Hemisphere countries received a net inflow of $200 billion albeit in a form different than syndicated bank loans: On average since 1990, 41 percent of capital inflows to all developing countries has been in the form of portfolio investment in tradeable bonds and equity shares, and 37 percent has been FDI. (Folkerts-Landau and Ito, p. 2).

The portfolio investments have, during the decade of the 90's, been particularly unstable, reversing course at the first sign of trouble. Over $220 billion of public resources in the decade of the 90's has had to be mobilized to bailout imprudent investors and lenders. A significant part of those resources has come from the development banks. The Majority, as does the CFR, rightly questions the desirability of use of the resources of the development banks for bailout purposes. But, given the fact that those resources were mobilized for this purpose, it is not surprising that, for the past two decades, the lending portfolio of the World Bank and the IDB, in particular, have tended to concentrate in their larger borrowing member countries. (That concentration is also a consequence of the limited implementation capacity of the smaller countries).

The displacement argument also misconceives the nature of development finance. President James Wolfensohn of the World Bank testified from his own personal experience as to the difference between commercial or investment banking and development financing:

> " I used to raise money for lots of countries...And I can tell you that I never had a discussion with them about their social policies or their economic policies...When we go in from the [World] Bank we go in on the basis of trying to look at what's happening to the country and what's happening to the people in the country and what's happening to social stability and what's happening on issues like governance, on openness of financial systems...Can you imagine the head of Goldman Sachs or Merrill competing for business, going in and talking to them about whether they should have a bigger education program?" (Wolfensohn, Tr. pp. 240-1).

In order for advice to be credible to the country authorities, it must be coupled with financing. (Wolfensohn Tr. p. 241; Stern, Tr. pp. 94/95). That dialogue between the Borrower and the development bank depends upon a relationship of trust and confidence, which is expected to continue over an extended period of time. The Majority proposed disbursement scheme, in which the borrower is divested of responsibility for administering the financing evidences a distrust of public sector officials that is not compatible with that relationship. It also largely defeats the purpose of development financing: that financing is not only concerned with achieving physical targets; equally, if not more importantly, it is concerned with policy and leaving the borrower institutionally stronger when the relationship ends. Not trusting the borrower with administration of the financing undermines this objective. (That distrust does not reflect my own experience, over a thirty year period, in dealing with high level officials throughout the Latin American region).

The private markets are not a dependable source of development finance. The development banks, in contrast, provide such a source of long-term finance for high value human capital investments. However, it is also true that for many of the more advanced middle income countries, it is time for the World Bank (and regional development banks) to begin, with them, to plan for reduced access to development bank resources, but that planning must be coordinated with market access experience over the next decade and take into account the financial consequences for both countries and institutions.

<u>(2) Structural Adjustment financing</u>

With respect to structural adjustment financing, the Majority rightly observes that reform is most effective when the country has made the political decision to undertake such reforms; it cannot be bribed from outside, or forced by "conditionality", to do it. And yet, the Majority proposes to do just that with a financing scheme that is both impractical and unwise. It is proposed that the borrower be given an "incentive" to carry out its obligations under an agreed structural adjustment program: deferral of repayment of principal for as much as ten years, provided that an independent third party, on an annual basis, certifies that the reform program is being implemented, or is still in place.

If reform lags, or backslides, then, repayment resumes. Again, discretion is vested in an "independent" third party that would have the responsibility to determine whether the government is complying with its reform obligations, and enjoy the financial advantages of deferral of repayments, or must resume such payments. As with the IMF, the World Bank and the regional development banks, are divested of discretionary judgment for determining compliance.

Who are the 'independent" third parties that are vested with such extraordinary powers? Foreign accounting, consulting firms, academics? What borrowing member country of the World Bank is going to cede such discretionary power to foreign consultants or academics? The proposal is justified on the basis of creating an" incentive" for the country to comply with its reform commitments. It is conditionality by another name, but it is not even necessary. The incentive for the borrower complying with its commitments, as the Majority originally wisely said, is its decision that the reform is in its own interest, and the prospect of future funding from the IFIs.

(3) A World Development Association?

The World Bank changes its name to the World Development Association, a symbol of the diminished role of development financing. It may be true that not enough is being done in areas of public goods identified by the Majority, but it is hard to see why the new Association, largely divested of its financing function, should be any more effective as a coordinator of aid than the UN Development Agency. Or, why, for example, it should be more effective in addressing tropical disease research than the World Health Organization

(4) Relationship to Regional Development Banks

The Majority is preoccupied with duplication between the functions of the World Bank and the regional development banks. Undoubtedly, there is some overlap, but each of the development banks arose out of a specific history, often, as was the case with the IDB, in reaction to the priorities of the World Bank. That conflict has largely dissipated, but it is undesirable, as the IDB itself recognizes, to return to a situation where only one institution is the basis for assured long term development financing. Such monopoly breeds arrogance. The institutions do a pretty good job of working out priorities among themselves. The Majority's preoccupation with duplication is exaggerated. (Stern, Tr. pp. 102-3).

(5) Repayments and Grant Financing

The World Bank (and the IDB) are now, in their ordinary operations, on a self sustaining basis, that is present levels of lending for the foreseeable future, can be financed out of earnings and loan repayments by their

borrowers. The proposal to return World Bank loan repayments to the shareholders, and to substitute grant financing for this self sustaining revolving loan fund, is a reckless gamble. The majority members of the Commission are not naive. President Wolfensohn testified as to the historic difficulty in obtaining Congressional appropriations for IDA financing (Wolfensohn, Tr. p. 234). The Clinton Administration abandoned any attempt to obtain from the Congress modest amounts of funds for the IDB soft loan fund. To return World Bank loan repayments to the shareholders and expect some substantial part of those repayments to reemerge from the domestic legislative processes as grant financing for the development banks is not credible. Whether intended or not, the return of capital to the shareholders can have only one result: undermine, discredit and ultimately terminate the World Bank, the IDB and the ADB. The Congress should reject the Majority proposal.

C. AN ALTERNATIVE

1 THE IMF-A MORE LIMITED ROLE

And yet, the Majority has a point. Like an archeological dig, layer upon layer of often competing and conflicting policy mandates have been imposed upon the Bretton Woods institutions: from limited and well defined functions in the first three decades of their existence, they have been: (i) entrusted with overseeing the debt workout of the 80s; (ii), the arbiters of internal structural reform within their borrowing member countries; (iii) the front line agencies of the international financial community in combating world poverty; (iv) entrusted with the responsibility for guiding into market economies the former Soviet Union and Eastern European countries ; (v), the lead agencies, particularly the IMF, in the decade of the 90s, in dousing the successive financial crises that appeared to threaten the stability of the international financial system.

They are, to a very great extent, the victims of their own success for, they are perceived by their major shareholders to be the only international institutions competent enough to be entrusted with these tasks. It makes sense to reconsider these multiple, and too often, conflicting mandates.

The first issue with respect to the IMF is should it continue to be a financial crisis manager, or should future crises be resolved by the market? Eichengreen and Portes are candid as to the risks involved in a market strategy:

> “ Clearly life would go on in the absence of the IMF (or with a greatly reduced role for IMF lending). Lenders would still lend; borrowers would still borrow. But to say debt problems would be resolved by the consenting adults involved without additional costs being imposed on the principals and innocent bystanders is a leap of faith...without other institutional innovations that reduce the pain...” (Eichengreen and Portes pp. 15-16).

Eichengreen and Portes are equally candid in their paper as to the difficulties involved in accomplishing the institutional innovations to which they refer. A continued crisis managing role for the Fund is the most likely outcome, but that role has to change.

Secretary Summers states , " The basic principle is clear: programs must be focused on the necessary and sufficient conditions for restoring stability and growth. Intrusion in areas that are not related to that goal carries costs that exceed the benefits." (Summers, 1999). The CFR notes that the IMF "is still needed to see that balance of payments problems, be they under fixed or flexible exchange rates, are resolved in ways that do not rely on excessive deflation, competitive devaluations , and imposition of trade restrictions, and to respond to liquidity crises when neither private capital markets nor national governments can handle those problems well on their own." (CFR p. 115). And it is still more specific as to the limits of IMF conditionality: " The IMF should limit the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies." (CFR p. 116).

This more limited mission is contrary to the expansive terms in which the IMF has conceived its mission. In addition to the traditional concern with fiscal, monetary and exchange rate policy, the IMF also reviews,

> "the growth and welfare implications of a country's macroeconomic and structural policies have increasingly been taken into account, since they may strongly affect the credibility and sustain-ability of a country's overall macroeconomic policy. In addition, social, industrial, labor market, and environmental issues have increasingly been taken into account if these have significant implications for macroeconomic policies and performance."(IMF Survey, 1995).

It is difficult to see what element of domestic policy would not be a proper subject of IMF conditionality. The difference between the more limited role outlined by the Secretary and the CFR and the expansive mandate conceived by the IMF is the difference between night and day. It is reasonable to require of the IMF that as it assesses a country's proposed program, it make a judgment as to whether the program allocates the burden of economic adjustment equitably, and, if not, to negotiate for changes in the program. In more recent years, that is what the IMF has been doing. But it is unreasonable to expect the IMF, on a continuous basis, to be actively engaged in poverty reduction programs. It is not consistent with the more limited role envisioned for the institution by the Secretary. The IMF should continue to defer to the World Bank and the regional development banks with respect to poverty reduction programs.

2. THE WORLD BANK (AND THE REGIONAL DEVELOPMENT BANKS)

. With respect to the World Bank, the CFR recommends: “The Bank should concentrate on the longer-term structural and social aspects of economic development. It should expand its work on social safety nets. But it should not be involved in crisis management, in emergency lending, or in macro-economic policy advice.” (CFR p. 116). These are sensible general principles, but it is unlikely they can withstand the heat of actual crises such as the successive ones that occurred in the decade of the 90's. Absent an identified alternative source of public financing, which does not now seem to be on the horizon, the temptation will remain to do what every U.S. Treasury Secretary (and his counterparts in the other industrialized nations) has done since the 1982 Mexican default: resort to the Bretton Woods institutions as sources of funds and as crisis managers.

The issue, then, is how can these institutions carry out this function in a more equitable way than has been the case to date? In 1998, the IDB, as part of the Brazil bailout package, loaned Brazil $4.5 billion, one half of the IDB $9 billion annual lending program. The IDB coupled its financing with a commitment from the Brazilian government to maintain an agreed level of funding for human capital development in education and health. The linking of the IDB financing with the Brazilian Government’s financial commitment for these two sectors was a way for the international financial community to say that the economic adjustment program that it supported should not sacrifice investment in the human capital of the country.

3. DISTORTED PRIORITIES: ONE-SIDED LABOR MARKET INTERVENTION

(a) The Successive Financial Crises

Like the movie Ground-Hog Day, the essential elements of the successive crises of the past twenty five years repeat themselves so that we seem to be reliving the same experience again and again. The syndicated bank lending of the decade of the 70's, the tesobono and East Asian financing fiascos, all have common characteristics: in each instance, banks and investors, awash with liquidity, seek a higher financial return than they can obtain in their home bases; without “due diligence”, they invest (tesobonos), or loan (East Asia, 1970's, syndicated bank loans) to governments or banks and corporations in the developing countries; much of the resources are not used for productive investments; a combination of external and internal shocks leads to an international financial crisis, which is perceived to put at risk the international financial system.

The IMF and the World Bank are charged with overseeing the workout; the financial institutions, who were equally responsible for the crisis by their imprudent lending or investing, are bailed-out and rewarded: they are enabled to buy into local banks and financial institutions at bargain basement prices (Mexico and East Asia); the debtor countries are counseled to export their way out of the crisis, which, in practice, means flooding the U.S. market with goods and services because that is the only market that is effectively open to them; and, in order to make their goods more internationally competitive, the IMF and World Bank require governments in the debtor countries to adopt labor market flexibility measures--making it easier for companies to fire workers without significant severance payments, weakening the capacity of unions to negotiate on behalf of their members, all for the purpose of driving down labor costs and benefits.

Workers in both the industrialized and developing countries, particularly in the unionized part of the labor market, bear a disproportionate part of the burden of adjustment. (U.S. workers may, as consumers, have benefitted from lower prices as a consequence of lower cost imports, but that benefit is likely to be ephemeral; the increasing U.S. trade deficit, as both former Secretary of the Treasury, Rubin and Secretary Summers have repeatedly said, is not, economically, or politically, sustainable; manufacturing jobs lost to imports or FDI, are not likely to return).

Professor Joseph Stiglitz, former Chief Economist at the World Bank, observes:

> "[e] ven when labor market problems are not the core of the problem facing the country, all too often workers are asked to bear the brunt of the costs of adjustment. In East Asia, it was reckless lending by international banks and other financial institutions combined with reckless borrowing by domestic financial institutions–combined with fickle investor expectations–which may have precipitated the crisis; but the costs in terms of soaring unemployment and plummeting wages were borne by workers." (Stiglitz).

Professor Stiglitz's comment is an apt summary of not only the East Asia crisis but of each of the successive financial crises of the past twenty five years.

It should be a requirement in the future that before public funds are disbursed, the financial institutions involved in such crises must make a substantial commitment to the resolution of the crisis. Bondholders are not accustomed to such a requirement and, in contrast to the syndicated bank lending of the decade of the 70's, there are legal and practical problems in obtaining such a commitment. (Bucheit, Tr. pp. 460-74). But it is also true that a stated policy by the Bretton Woods institutions would put such bondholders on notice that in the future they cannot assume that they will be bailed out by the official financial community. The fear that such a requirement will retard market access for developing countries is exaggerated. The story of the past twenty five years is that, in the financial

markets, greed trumps all other considerations. Indeed, the Latin American debtor countries only regained substantial voluntary access to the financial markets after the markets perceived a greater credit worthiness on their part after the Brady debt reduction initiative of March 1989.

(b) Labor Market Intervention

Joanne Salop, Vice President, Operations Policy and Strategy, World Bank, explains that, "with respect to freedom of association and the right to collective bargaining, the Bank is in the process of analyzing the economic effects in order to form an informed opinion." (Salop/Levinson). Robert Holzmann, Director, Social Protection, the World Bank, in a seminar jointly sponsored by the IMF and the AFL-CIO, elaborates on the Bank's reservations with respect to core worker rights, particularly the right of freedom of association:

> " And on both accounts we have a problem with some of the core labor standards, in particular, one which deals with freedom of association which concerns an important human right which has economic dimensions, but most importantly , also has a political dimension. This political dimension, which prevents us from simply using it as an instrument during our programs and to impose it on countries, because this would be considered as a breach of our rules."(Holzmann).

The "political" argument invoked by Mr Holzmann is a bogus argument: it is based on the idea that World Bank intervention for the purpose of addressing abuses of the right of freedom of association contravenes the provision of the Articles of Agreement that prohibits taking into account "political considerations" in the Bank's decisions". (Article IV, Section 10 of the IBRD Articles of Agreement).

To claim that result is required by Article IV, Section 10 of the Articles of Agreement, is a blatant distortion of the intent of the authors of the Charter, John Maynard (Lord) Keynes and Harry Dexter White. (Levinson). The Bank feels no such inhibition with respect to intervention in a country's labor market to condition its financing upon a member country taking measures–labor market flexibility-- that make it easier for firms to fire workers, weaken the capacity of unions to negotiate on behalf of their members and drive down urban unionized wages. Nothing is more politically charged than such a one-sided labor market intervention that so blatantly favors the interests of employers.

Holzmann continues:

> "The second one has to do with the economics of core labor standards, in particular again, the freedom of association, because while there are studies out–and we agree with them that trade union movements may have a strong and good role in economic development–there are studies out that also show that this depends. So the freedom by itself does not guarantee that the positive effects are achieved." (Holzmann).

The Bank appears to be reopening in the year 2000, the debate, which we thought had been settled in the 1930s, about the desirability of allowing workers the right to form unions of their own choosing as a means of equalizing bargaining power between the individual worker and the enterprise.

Professor Stiglitz summarizes his experience with the labor issue in the World Bank:

> "I am just completing serving three years as Chief Economist of the World Bank. During that time, labor market issues did arise, but all too frequently, mainly from a narrow economics focus, and even then, looked at even more narrowly through the lens of neo-classical economics; a standard message was to increase labor market flexibility–the not so subtle sub-text was to lower wages and lay off unneeded workers." (Stiglitz).

We would not accept as a basis for domestic labor policy in our own society, at least the great majority of Democrats would not, the "narrow neo-classic economic lens" to which Professor Stiglitz refers. We should not accept it within the World Bank. The U.S. Executive Director (USED) should have read a clear and forceful statement in the Board of Executive Directors of that institution stating that the United States considers settled the right of workers to freedom of association and collective bargaining. (In the protocol of these institutions, reading a written statement signals that it carries the imprimatur of the Treasury, not just the USEd).

Mr Fischer denies that the IMF is one-sided in its labor market intervention. In Indonesia, in 1998, after the fall of the Suharto Government, Fischer observes, the IMF intervened with the new government to press for adoption of core worker rights, including the right of freedom of association and collective bargaining; Nazi Germany would not, he notes, on political grounds be eligible for IMF assistance. (Fischer, Tr. p 189). (The IMF Charter does not have a "political" clause, but the IMF has previously invoked, by means of a legal opinion, the same inhibitions as are asserted for the World Bank).

Mr Fischer's assertion of IMF intervention to assure freedom of association in Indonesia, and candid acknowledgment that there are limits to political tolerance, is a welcome departure from the continued invocation of the political section of its charter by the World Bank as a basis for failing to address labor market abuses; but there was also a disturbing aspect of Mr Fischer's testimony: he was relieved that the De La Rua government, elected in Argentina in 1999, has submitted its own labor flexibility measure legislation and therefore, a potential conflict with the IMF had been avoided.

The IMF intervention with respect to the Argentine labor market is, according to the IMF, a consequence of the Argentine currency regime that prevents the Country from using the exchange rate as a means of adjusting

relative international prices. (IMF Submission, p. 21). The IMF--- and successive Argentine Governments--- seek to make Argentine goods more competitive in international markets by lowering labor costs. Achieving that objective, requires diminishing the social and economic gains of workers, and that requires weakening the unions that won those gains for their members.

The labor relations system in a country like Argentina is more than a question of optimum economic efficiency considerations: the union movement in that country is a result of a long history of social conflict; it is an essential component of the social compact of Argentine society. Any change in that compact ought to be negotiated within Argentine society free of pressure by the IMF or the World Bank. It should be no part of the "conditionality" of either institution in Argentina, or anywhere else in the world. It is not in the national interest of the United States to be associated with a policy that involves such a one-sided labor market intervention on behalf of employers. It is creating an increasingly alienated and embittered urban working class in both Argentina and other countries.

C. Does Growing Income Inequality Matter?

Income inequality in Latin America, already the worst in the world, increased in the past two decades, the period in which the Latin American countries embraced the market liberalization strategy. (Birdsall). A number of members of the Commission believe that growing income inequality is not important.

Commissioner Calomiris:

> "What I care about is poverty and, as Mr Huber mentioned, exiting from poverty, and I don't care very much about inequality. I don't think it's part of our objective as a Commission to be talking much about inequality" (Calomiris, Tr. Jan. 4, 2000, p. 78).

But the issue will not disappear:

> "In Latin America today, all countries except President Fidel Castro's Cuba are free of military rule, but polls show that only two nations, Uruguay and Costa Rica, indicate a rate of satisfaction with democracy of over 50 percent. Although massive government corruption has prompted much disillusionment, analysts say it also stems from the fact that the benefits of the new free market have gone disproportionately into the hands of the rich." (Faiola).

Reporting on the prolonged strike at the National University in Mexico City, Julia Preston observes:

> " But the student strikers were also a product of globalization...The government has stimulated growth by restraining inflation, mainly by depressing workers' wages. Official figures show that the minimum wage today buys 48 percent of what it did in 1982. So, while export enclaves have thrived, workers have been

drawn into a spiral of downward mobility...[I] n today's increasingly impoverished urban working class, even small tuition costs can break a family."

Ms Preston concludes with a caution: "The damage to education and the division among Mexicans could serve as a cautionary tale to anyone who thinks the changes that globalization brings will only reinforce democratic institutions." (Preston). A far sighted leadership in the World Bank and IMF would have realized that market liberalization and privatization of state owned assets, required strong institutional counterweights. A strong labor movement, at its best, has been in the forefront of the fight for social justice; it might have provided such an institutional balance. (Stiglitz). But that is not the view that has prevailed in the Bretton Woods institutions.

4. The HIPC Initiative

The Majority observes that the debt of heavily indebted poor countries (HIPC) "cannot be repaid under any foreseeable future developments." (Majority, Ch. 2). Yet, they condition forgiving such debt on "debtor countries "implementing institutional reforms and an effective development strategy". The HIPC's are then the only ones, under the Majority proposal, that are subject to IMF conditionality. It makes more sense to accept the implications of the Majority observation that the debt cannot be repaid; unconditionally forgive the HIPC debt, and let the debtor countries start over with a clean slate. Future resources can be determined on the basis of an assessment of whether they have used well the opportunity gained by unconditional debt relief.

II. THE WTO

A. CORE WORKER RIGHTS

The Commission heard extensive testimony, including that of John Sweeney, President of the AFL-CIO, with respect to whether core worker rights should be incorporated into the main body of the WTO agreement and the role of labor flexibility in the Bretton Woods institutions. Yet, there is no discussion of the testimony or the issues in the Majority Report. (Majority, Ch. 5). The Commission colloquy with the witnesses is both provocative and illuminating. It is too important an issue to be ignored.

1. THE NORTH AMERICAN AGREEMENT ON LABOR COOPERATION AS PRECURSOR TO CORE WORKER RIGHTS AND THE WTO

The demand that core worker rights be integrated into the WTO agreement must be understood in light of the experience with the North American Agreement on Labor Cooperation (NAALC), the labor side agreement to the Nafta. The Nafta, like the WTO, is misnamed; both agreements are trade and investment agreements. Chapter 11 of

the Nafta, designated the INVESTMENT chapter, prevents a party to the Nafta, read Mexico, from imposing restrictions on FDI. Both the Nafta and the WTO contain provisions dealing with intellectual property protection. The WTO, additionally, includes trade related investment measures (TRIMs) and a separate protocol in which countries agree to open their financial services market to foreign capital. Dispute settlement provisions in both agreements are detailed and allow for either trade sanctions or monetary penalties for violations of provisions assuring corporate property rights.

First, we ought to be clear about what we mean by core worker rights. Ms Thea Lee of the AFL-CIO, in her testimony of December 14, 1999, emphasized the qualitative nature of these rights: " The prohibitions, the three prohibitions on child labor, forced labor and discrimination and then the two affirmative standards that affirm the right to collective bargaining and the right to freedom of association. These standards do not in any way place quantitative restrictions on countries. They do not require that countries set minimum wages or hours limitations or anything of that nature." (Lee, pp.7-8).

Mexico has based its development strategy on attracting FDI. (Lustig). The Salinas de Gortari administration (1988-1994) evidenced its determination that it would brook no interference by Mexican workers in creating a climate conducive to attracting that investment. When a labor leader, a member of the governing political party, in Matamoros, in Mexico, which is across the border from Brownsville, Texas, tried to negotiate aggressively with largely U.S. owned maquiladora plants, he was arrested by Federal Police, bundled on a plane to Mexico City where he was held incommunicado for weeks. The companies then imposed their own contracts upon the leaderless workers. (Cody). In order to prepare the ground for privatization of the Cananea copper mining and smelting company, historically viewed in Mexico as the birthplace of Mexican trade-unionism, the government crushed the union by declaring the enterprise bankrupt, abrogating the collective bargaining contract with the union, and sending in the army to subdue worker protests. (Foreign Labor Trends, 1989-90).

In 1992, Volkswagen (VW), anticipating the enactment of the Nafta, determined that in order to be competitive it needed to lower wages and revise work rules, which it proceeded to unilaterally impose. The VW union, affiliated with the Confederation of Mexican Workers (CTM), closely allied with the governing party, approved without any consultation with the membership, the company's actions. The workers reacted with work stoppages and demands for the creation of a union not affiliated with the CTM:

> "After weeks of a bitter strike, Salinas gave VW permission to rip up the union contract. The company promptly fired 14,000 workers and rehired all of them, minus some 300 dissidents, under a new contract. Within days, VW revamped its entire Mexico operations–the German car maker's first such experiment anywhere." (Business Week, a). .

By sending in the army to intimidate the workers at Cananea, symbolically so important in Mexico's union history, intimidating the too aggressive union leader in Matamoros, and allowing VW to unilaterally recast its operations, the message to Mexican workers was clear: don't get in the way of the government's determination to attract FDI, or you will be crushed.

Candidate Bill Clinton in 1992 understood that if these abusive practices continued at the same time that the Nafta dismantled the barriers to FDI , the temptation for American companies to relocate production to Mexico could be irresistible:

> " For a high wage country like ours, the blessings of more trade can be offset at least in part by the loss of income and jobs as more and more multi-national corporations take advantage of their ability to move money, management, and production away from a high wage country to a low wage country. We can also lose incomes because those companies who stay at home can use the threat of moving to depress wages, as many do today." (Clinton).

Candidate Clinton conditioned his approval of the Nafta upon complementary agreements that would assure that each party to the Nafta would effectively enforce its own labor and environmental laws. The NAALC contained no enforcement provisions for a violation of the core worker rights of free association and collective bargaining. Nor is there any legal bridge between the NAALC and the Nafta, so that violation of the NAALC brings no trade sanction or financial penalty under the dispute settlement provisions of the Nafta..(The WTO contains a provision on prison labor, but no other provision relating to core worker rights).

In summing up the results of the first proceeding alleging denial by the government of Mexico of the right of free association, the U.S. National Administrative Office (USNAO), which administers the NAALC on behalf of the U.S., observed:

> :"...Despite pursuing every legal means of redress, the attempts to register an independent union failed......interested workers who signed the original petition were subsequently dismissed from their employment and remain unemployed to date...It appears that such dismissals were intended as punishment and a warning to other Sony workers... (USNAO, 1995).

Three years later, in another maquiladora case (Han Young), involving the right of freedom of association, the USNAO concluded:

> "[t] he placement by the Tijuana CAB [a form of labor court in Mexico] of obstacles to the ability of workers to exercise the right of free association... is not consistent with Mexico's obligation to effectively enforce its labor laws on freedom of association in accordance with Article 3 of the NAALC...not one independent union had been registered or had obtained collective bargaining rights in Tijuana and only one other exists in the entire maquiladora sector." (USNAO, 1998).

The risk that candidate Clinton foresaw has materialized: American manufacturers increasingly seek to take advantage of the low wage business climate enforced by the Mexican government:

> "Mexico is now home to more than 3,000 export-processing plants, or maquiladoras, which produce everything from cars to pharmaceuticals to electronics. And new ones are sprouting up each day....Foreign direct investment, which averaged $5 billion a year under former President Salinas, has jumped to more than $10 billion a year under Zedillo." (Business Week, b, pp. 61-2).

Tens of thousands of auto parts manufacturing jobs have gone to Mexico. (Bradsher).

The General Electric Company has undertaken a new "super aggressive round of cost cutting"; in order to meet the stiff goals, "several of GE's business units–including aircraft engines, power systems, and industrial systems–have been prodding suppliers to move to Mexico...Migrate or be out of business; not a matter of if, just when. This is not a seminar just to provide information. We expect you to move and move quickly. " (Business Week, b, p. 74).

The NAALC and the Nafta were submitted to the Congress as a single package; the demand that core worker rights be included as a part of the WTO does no more than build on the experience of the NAALC. Based upon what we have learned in the NAALC, instead of ineffectual side agreements, those core worker rights must now be incorporated into the main body of any trade agreement.

2. OBJECTIONS

(a) Imposition from without

Chairman Meltzer observes that he is only opposed to imposing such rights from without (Meltzer Tr. Dec 14, p. 36). It is difficult to see why incorporating such worker rights into the WTO is any different than any other requirement that countries must adhere to as the price of admission to the WTO. Countries must accept national treatment of imported goods and services and an agreed intellectual property standard. Witnesses Daniel Tarullo and Professor Jagdish Bhagwati, strong supporters of globalization, both candidly admit that there is no basis for distinguishing core worker rights from an intellectual property standard in the WTO. (Tarullo, Tr. p. 188; Bhagwati, Tr. p. 26).

(b) The ILO Alternative

The Chairman and Commissioner Johnson both refer to a "strengthened" ILO as a substitute for including core worker rights in the WTO. (Meltzer Tr. Dec. 14, p. 65; Johnson, Tr. Dec 14, p. 87); but the ILO has no enforcement power. Neither the Chairman nor Commissioner Johnson make a concrete proposal as to how the ILO should be strengthened.

(c) Union Self Interest

Throughout the Commission Hearing on worker rights there is a suggestion by some members of the Commission that the advocacy by American labor leaders on behalf of workers is tainted by self interest. (Meltzer-Sweeney Tr. Oct 20 p. 29; Sachs Tr. Dec. 14, p. 116). That self interest, however, may also be a powerful force in initiating change which benefits the disadvantaged worker. A worker in Mexico, Salvador, Indonesia, or wherever, who can exercise the right of freedom of association and collective bargaining as a consequence of advocacy of these rights by American and European unions, is not less advantaged because these unions acted, in part, out of self interest. There are very few saints in the world. The fact that there is a coincidence of interests between American unions and workers abroad, denied their core worker rights, does not invalidate the efforts to assure such rights to all workers.

In the words of Gibson Sibanda, president of the Zimbabwe Congress of Trade Unions, "They tell us that African trade unions will be used by the trade unions of the industrialized countries to undermine the comparative advantages of African workers. It is vital that we insist that this is a question of fundamental human rights, and has nothing to do with protectionism." (ICFTU, November 1999).

(d) Protectionism: The "Bloody Shirt"

When the issue of core worker rights is raised by its proponents, the almost invariable response is that it is merely a disguised form of protectionism. The cry of protectionism has become the "bloody shirt" of trade politics. In the decades immediately after the conclusion of the Civil War in the United States, rather than debate pressing social questions arising out of the post-civil war industrialization, Republican politicians would resurrect against their Democratic opponents, who had been divided on the war, Civil War issues: was the opponent for or against the Union? This tactic was known as waving the "bloody shirt". In contemporary trade politics, rather than discuss a

distorted international trade, finance and investment regime, and its social consequences, the defenders of the status quo wave the contemporary "bloody shirt" of protectionism.

In 1998, in Geneva, Switzerland, the ILO adopted a Declaration on Fundamental Principles and Rights at Work. The Declaration was initially opposed by the employer group in the ILO and most of the same nations that oppose incorporating core worker rights in the WTO. They contended that the Declaration would be used for protectionist purposes. Replying on behalf of both workers in the developing and industrial countries, the vice-chairperson of the Workers' delegation stated:

> "The Workers' group is quite clear that to ask to belong to a trade union and for it to bargain on your behalf is not protectionism; to seek an end to child labor is not protectionism; to wish to eradicate discrimination in the workplace is not protectionism; to call for an end to slavery or forced labor is not protectionism; but to deny those rights to workers in the name of comparative advantage–that is truly protectionism." (United Nations Association p. 57).

(e) Death in Africa and Responsibility for Poverty

In an exchange with Ms. Lee, Commissioner Sachs states,

> " I ...agree with you that international trade costs jobs in textiles and apparels. ...and that is what should happen in the kind of economy the U.S. has...I also see it as a huge benefit for the rest of the world to be able to produce textiles and apparel and sell them to the U.S. market...I will use the word nothing less than immoral how the textile lobby fought liberalization of apparel from Africa. Because their people are dying for lack of access to the markets." (Sachs, Tr. Dec 14, p. 105).

Commissioner Calomiris framed the issue in blunt terms:

> " ... [i]s it true that core worker standards would help very poor people? Just to remind you, we're not dealing with the overfed teamsters here..I think that is a big problem and I really don't care very much , to be honest, compared to that problem whether employees in the United States have wages that go up or down by five or ten percent or whether anyone in the United States has wages or incomes that go up or down by five percent compared to that problem." (Calomiris, Tr. Dec. 14, p. 131).

For both Commissioners Sachs and Calomiris, the villains in the piece are the American workers, who stubbornly refuse to immolate themselves in the cause of poverty alleviation in the poorer countries, but this charge is a vast oversimplification. The Commission heard extensive testimony from Professor Ayyiteh on the endemic corruption and mismanagement in African countries.(Ayyiteh, Tr,. Sept. 28, 1999). (Commissioner Sachs did not identify specific African countries but painted with a broad bush.). Africa is afflicted with an AIDs problem of epic proportions. Until very recently, commodity prices for major exports from the African countries have been severely depressed. Many African countries had preferential access to the European market through the Lome Convention

with the European Community, but that access did not result in a vigorous textile trade. To place the onus for "people dying" in Africa on the American textile worker is disproportionate to the facts.

Commissioner Calomiris elaborates:

> There simply is no basis aside from gross violations of human rights for a country to be told that it cannot participate as a trading partner with the rest of the world... denial of freedom of association and collective bargaining are not such gross violations: they don't come close". (Calomiris, Tr. Dec 14, p. 135).

According to the International Confederation of Trade Unions, 123 workers who tried to exercise these rights were murdered in 1998, 1,650 were attacked or injured, and 3, 660 were arrested. (ICFTU, January, 2000). Governments may not have been directly responsible for all of these abuses, but too many have been indifferent, amounting to complicity, in such abuses. We ought not to be equally indifferent, for we too then become accomplices.

(f) Jobs Lost: A Wash For the Economy as a Whole

In his dialogue with President Sweeney, the Chairman noted that if 500,000 jobs, as alleged by Mr Sweeney, had been lost in manufacturing, they had been more than made up for in other parts of the economy; Mr Sweeney was seeking to defend unionized jobs, but from the point of view of the economy as a whole, it was a wash. (Meltzer-Sweeney. Tr. Oct. 20, 1999, pp. 26-27; Majority, Ch. 5). But not all jobs are equal: " You keep referring to our members. I'm not talking about our members. I'm talking about the difference between good jobs and bad jobs. I'm talking about the high road versus the low road, and 500,000 manufactured jobs, organized, unorganized, whatever they are, are the issue here." (Sweeney Tr. Oct 20, 1999, p. 29).

The Majority state that the Department of Commerce estimates that jobs supported by exports pay 13 to 16 percent more than the national average of non-supervisory, production jobs. (Ch. 5, p.5). Other studies note that, "[i]n reality, imports are doing more damage to wages than exports are doing to raise them. At the economy's margins, where current rather than past trade is having its largest impact, imports have been destroying better- than-average jobs". (Economic Policy Institute, p.2). Even if one assumes, as does the Majority, that employment levels are controlled by macroeconomic factors (such as the intervention of the Federal Reserve), the effect of large chronic trade deficits "will present itself in the shifting composition of jobs (i.e, a shift from manufacturing to service sector jobs) and in deteriorating job quality (i.e falling wages for large segments of the workforce)" (Id at p. 5).

(h) Technology

The conventional wisdom is that technology accounts for whatever changes have taken place in the workplace that disadvantage workers. But there have always been technology innovations and there is no reason to think that contemporary technological change is any more disruptive than in the past: " Technology historians remain skeptical that the Internet age can match the period from about the 1880s to 1910 in terms of its impact on peoples lives. Inventions and new products from that period of technological dynamism included Bessemer steel making, refrigeration, the light bulb, the phonograph, the telephone, the radio, the automobile and the airplane." (Lohr).

(I) Not a Panacea

International worker rights is not a panacea. Where land tenure arrangements are as distorted as in Brazil, or, where, as in Mexico, the government encourages large land holdings for efficiency reasons, migration from rural areas to the great urban metropolitan centers will continue to put downward pressure on urban unionized wages. But such rights would eliminate, or, at least mitigate, the most egregious abuse in the international economic system: the deliberate use of the coercive power of the state to deny workers the most basic worker rights in order to gain a competitive advantage in attracting FDI.

B. THE ENVIRONMENT

There are two relevant provisions relating to (a) " measures necessary to protect human, animal or plant life or health" and (b) "to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption" Both provisions are contained in Article XX, (b) and (g), the General Exceptions clause of the WTO. Both provisions are carried over from the GATT, drafted over fifty years ago.

Under the dispute settlement provisions of the WTO , panels are established whose members are drawn from a WTO roster of trade experts. A permanent Appeals Body is also established to oversee the panels. The United States has invoked Article XX (b) and (g) as a defense for measures it has taken to protect exhaustible natural resources-- Dolphins, Sea Turtles and clean air. In all three cases, the invocation of the exceptions provisions under Article XX have been rejected. In each of the three cases the U.S. position was weakened because it could not demonstrate to the satisfaction of either the panels or the Appellate Body that it had made a serious attempt to reach an agreement with the other parties. It can, hence, be argued that to the extent the decisions encourage negotiation before resorting to the exception provisions of Article XX, they are not unreasonable.

A close reading of the cases, however, leads to the conclusion that it will be virtually impossible for any party invoking Articles (b) and (g) to ever prevail. Article XX has been given a narrow reading:

> "The Panel observed that Article XX provides for an exception to obligations under the General Agreement. The long-standing practice of panels has accordingly been to interpret this provision narrowly, in a manner that preserves the basic objectives and principles of the General Agreement. " (Tuna/Dolphin, June 16, 1994, p. 59).

More recently, the Appellate Body has confirmed this restrictive interpretation: "..[.t]he negotiating history of Article XX set forth limited and conditional exceptions from the obligations of the substantive provisions of the GATT." (Shrimp/Sea Turtle, p. 61).

Under these restrictive interpretations the environmental considerations are considered subordinate to the trade objectives. Yet, the Appellate Body in the Shrimp/Sea Turtle case notes:

> " While Article XX was not modified in the Uruguay round, the preamble attached to the WTO Agreement shows that the signatories to that Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy. The preamble of the WTO Agreement–which informs not only the GATT 1994, but also the other covered agreements–explicitly acknowledges "the objective of sustainable development". (Shrimp/Sea Turtle p. 48).

In the Decision of Ministers at Marrakesh to establish a permanent Committee on Trade and Environment, the Ministers expressed their view that,

> "there should not be, nor need be, any policy contradiction between upholding and safeguarding an open, non-discriminatory and equitable multilateral trading system on the one hand, and acting for the protection of the environment, and the promotion of sustainable development on the other..." (Shrimp-Sea Turtle, p. 58).

There is an evident tension between these expressions of the need for a balanced approach between trade, environment and sustainable development considerations and the continued highly restrictive interpretation given to the exceptions provisions of Article XX. That tension should be resolved by amending the WTO Agreement to transfer Articles XX (b) and (g) from the exceptions clause to a new chapter in the main body of the Agreement.

Without a change in the expertise of the roster from which panel members are selected however, neither a core worker rights or environmental amendment to the WTO can be effective. The roster from which experts are drawn for dispute settlement panels should be expanded to include individuals expert in environmental and labor matters.

This statement has not attempted to address the more profound issues of national sovereignty involved in decisions of the WTO. I would only note that any international agreement involves some limitation on national sovereignty. But the WTO does not have the legal authority to require a country to change its laws; as the frontier between more traditional cross border trade violations and policies previously considered internal to a country becomes increasingly blurred, this issue will certainly become more acute. I interpret the Majority's cautions in Chapter 5 of the Majority report to be a recognition of this fact.

III CONCLUDING REMARKS

If the IMF and World Bank are to play the essential role in the international economy that I believe is desirable they are going to have to accept that the high water mark of their role in overseeing structural transformation in their borrowing member countries has now passed. Professor Stiglitz reminds us that they approach issues from an "excessively economic" view, and, within an even more narrow neo-classical economic lens. That approach is singularly unsuited to the complexity of the kinds of transformations now in train in the East Asian countries as well as in Latin America. Each one of these countries is going to have to work out a new social compact within society. How they balance out economic efficiency considerations with social and political stability is for them to decide, just as it is for Argentina to determine how to revise its labor markets, an essential component of Argentina's social compact.

And a new social compact is going to have to be negotiated internationally that balances minimum standards of equity with economic efficiency criteria and national sovereignty. It is no good any longer waving the contemporary "bloody shirt" of alleged protectionism to avoid having to come to terms with the need for such a negotiation. The immediate battleground is in the IFIs. We are forced to try and persuade, or to coerce, existing institutions–the WTO, the World Bank and the IMF–to adopt minimum standards of equity for which they have little or no sympathy.

Is there any reasonable prospect that we can achieve such standards within these institutions? We cannot know the answer to this question so long as the United States sounds an uncertain trumpet. The President in Seattle, admirably, did not dissemble as to the United States objective with respect to the WTO: inclusion in the main body of the agreement of a core worker rights clause. His Trade Representative undermined this position, assuring other governments that the U. S. objective is limited to the establishment of a working group. (Dugger).

In the Bretton Woods institutions, despite the Congressional mandate included in the legislation establishing this Commission, to use the voice and vote of the United States in support of core worker rights, the USEDs' in these institutions have never voted against a financing for a government which is a notorious and egregious abuser of such rights. Countries opposed to core worker rights and environmental protection might well be excused for thinking that the U.S. commitment to these values is suspect.

It may be that the resistance in these institutions to such minimum standards is so great that no policy, no matter how consistent, will make a difference. In that case, the trade, investment and finance system, as now constituted, does not deserve further support. That is not blanket opposition to trade, development finance, or even globalization. It is opposition to a system that is now so profoundly inequitable that it is a travesty of what it ought to be.

A brief note on process

The Chairman refused to appoint, as is the custom in a bi-partisan commission, a deputy chairman from among the minority appointees. I believe this was a mistake. The Chairman was receptive to suggestions for witnesses and, even where it was evident that he did not agree, to subject matter. The Chairman briefed individual members of Congress; he was accompanied by staff, but there were no memoranda of conversation circulated to other members of the Commission. Nor was there any verbal briefing. As is evident from my own, and other, separate statements, there are strong disagreements, not necessarily along partisan lines, on substance among the members of the Commission. I would not have wanted my views represented to others by the Chairman. A Vice-Chairman would, I believe, have forced a more baloanced consultation and communication process. For future reference, I would suggest that the Congress, in authorizing such Commissions, specify that a vice-chairman be appointed from among the minority appointees.

Unfortunately, neither the Majority, nor my own statement can do justice to the testimony of all of the witnesses who testified before the Commission; for those who wish to take the time to peruse the record, it is rich, if often contentious, as it should have been, in substantive discussion. I believe it initiated the beginnings of a constructive debate as to the future shape of the architecture of an international finance, trade and investment regime that can assure self sustaining growth with a greater degree of equity in distribution of the fruits of that growth than is now the case.

I would like to thank Gerald O'Driscoll, staff Director, and his assistant, Ferdinand Von Stade, for their invariable courtesy and helpfulness.

ADDITIONAL VIEWS OF RICHARD HUBER

I have signed both the majority report and the dissenting statement with Messrs. Bergsten, Levinson and Torres.

I agree with the basic thrust of the report that there is a need to recast the relative roles of the IMF and the World Bank. At the same time, I agree with the dissenters that the report is too negative in its appraisal of those institutions and that some of its recommendations might not work to benefit either the world economy or the national interest of the United States.

While I fully support the core recommendations of the report, I feel compelled to point to several areas where I am less than totally comfortable. To begin, I agree with the dissenters that the tone of the report should be more evenhanded in describing the half-century history of the IMF and the World Bank. It is easy to point to their failures and shortcomings, but there also have been many successes and achievements. I believe that the world is a better place that it would have been had the two institutions not existed.

I have consistently expressed my discomfort with the debt forgiveness recommendation for HIPCs. I would have much preferred a mechanism like Chile's Chapter -- 18/19 debt-for-equity scheme of the late 1980s and early 1990s. Such mechanism would help kickstart the privatization process with the aim of prying the means of production in the HIPCs from the often larcenous hands of corrupt governments and putting them in the hands of entrepreneurs, domestic or foreign, who could operate them effectively and invest in them to create growth.

As to our proposed reforms for the IMF, I heartily endorse the narrowing of focus and the other steps in the report. Whole I also agree with the desire to make it more rules-driven, I am still concerned about making it totally mechanistic. In other words, since none of us can foresee the future, I continue to believe in giving considerable latitude to the executive board of the institution to react to future crises. I recognize that the final draft of the report remedies this in part, but I would have gone further.

I fully support leaving developmental, lending and poverty reduction grants to the World Bank (Perhaps under a new name) and the regional development banks. I also agree that these institutions should not be involved in balance-of-payment lending or financial crisis assistance. However, I do not think that the Commission had adequate time to study the various entities, especially the regional banks, well enough to support the recommendation that for Latin America and Asia the IADB and the ADB should be the sole institutions, respectively, with the World Bank keeping this responsibility for the rest of the developing world. While I certainly agree that the overlaps that exist today are wasteful and often counterproductive, I am not completely convinced that the sweeping division of the world in the report is the only or best way to achieve the goals of greater effectiveness and accountability.

When the Commission met on March 2, I mentioned my concern that any suggestion of "returning the capital" of the developmental institutions to their shareholders might not only appear unseemly, but really have a negative impact on the whole effort of poverty alleviation. It is easy to say that such withdrawals would be replaced by new monetary allocations to grant
funds; in the political reality of the legislative bodies of donor countries, however, this could be very difficult to achieve.

Finally, I share the dissenters' concern about our treatment of the WTO. I think that all (or almost all) of us agree that scrutiny of it did not fit into our mandate to review the IFIs, I concur in our single meaningful recommendation about it (that penalties and fines are much better enforcement tools than retaliation), but I am afraid that anything we say may be "used against
us" or, what is worse, be used against the WTO in the politically charged debate that will take place soon. I would prefer simply to leave out the part on the WTO with a comment as to how it did not really fall within the scope of our study and should be left for future consideration.

In closing, I want to echo the words of many of my fellow Commissioners who have complimented Allan Meltzer on his leadership and even temper throughout the long process of doing work that all of us hope will have some impact. I am proud to have been a member of the Commission.

Richard L. Huber
Hartford, Connecticut
March 3, 2000

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Table 3-1

Multilateral Development Banks
($ amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Year of Formation	1966	1959	1964	1945	---
Regional Members	41	28	53	181	---
Non-Regional Members	16	18	24	---	---
Borrowing Members	38	26	53	156	---
Total Loans & Investments Outstanding	$39.3	$39.5	$17.1	$210.4	$306.3
of which:					
government loans	$24.4	$32.3	$9.5	$117.2	$183.4
zero interest credits	$14.3	$6.9	$7.6	$83.2	$112.0
private sector	$0.6	$0.3	$0.0	$10.0	$10.9
Market Investments	$9.5	$12.7	$2.6	$50.9	$75.7
1998 Lending & Investments	$6.1	$10.1	$1.7	$32.5	$50.4
of which:					
government loans	$4.9	$8.8	$0.8	$22.2	$36.7
zero interest credits	$1.0	$0.7	$0.7	$6.8	$9.2
private sector	$0.2	$0.6	$0.2	$3.5	$4.5
Total Offices	15	29	1*	127	172
Total Employees**	2,300	2,200	1,100	11,500e	17,100
Administrative Expenses	$0.2	$0.3	$0.1	$1.6	$2.2
Debt Outstanding	$24.1	$32.9	$7.6	$131.4	$196.0
Paid-In Capital	$3.4	$4.2	$2.8	$14.0	$24.4
Concessional Capital Contributions	$20.6	$9.5	$13.1	$96.3	$139.5
Callable Capital	$45.0	$90.0	$19.6	$177.7	$332.3
Total Capital	$69.0	$103.7	$35.5	$288.0	$496.2
Retained Earnings	$8.6	$7.2	$2.0	$30.0	$47.8
Non-Borrower Member Callable Capital	$27.0	$44.6	$6.5	$103.4	$181.5
G-5 Share of Voting Rights	35%	40%	18%	38%	33%
G-5 Share of Concessional Capital Contributions	79%	63%	49%	72%	70%
G-5 Share of Non-Borrower Member Callable Capital	68%	80%	55%	66%	70%

Data for most recently available fiscal year.
* 25 offices are scheduled to open over the next 5 years.
** Including long-term consultants; World Bank employees: 10,000.

Sources: World Bank; Asian Dev. Bank; Inter-American Dev. Bank; African Dev. Bank

Table 3-2

Multilateral Development Bank Activities
(amounts in billions)

	1992	1993	1994	1995	1996	1997	1998
World Bank Group:*							
IBRD Lending	$16.9	$14.2	$16.9	$14.5	$14.5	$21.1	$22.2
IDA Credits	6.8	6.6	5.7	6.9	4.6	7.5	6.8
IFC Investments	2.1	2.5	2.9	3.2	3.3	3.4	3.5
MIGA Guarantees	0.4	0.4	0.7	0.9	0.6	0.8	1.3
Asian Development Bank							
ADB Government Lending	3.8	3.7	2.5	4.0	3.5	7.7	4.9
ADF Credits	1.2	1.3	1.2	1.5	1.7	1.6	1.0
ADB Private Sector Investments	0.1	0.2	0.1	0.2	0.2	0.1	0.2
Inter-American Development Bank							
IADB Government Lending	5.5	5.5	4.7	6.3	6.2	5.3	8.8
FSO Credits	0.5	0.4	0.5	0.8	0.4	0.3	0.7
IADB Private Sector Investments	---	---	---	0.1	0.2	0.3	0.6
African Development Bank							
AfrDB Government Lending	1.9	1.6	1.4	0.7	0.5	0.8	0.8
AfrDF Credits	1.1	0.8	---	---	0.3	1.0	0.7
AfrDB Private Sector Investments	---	---	---	---	---	---	0.2
Total	$40.2	$37.2	$36.5	$39.0	$36.2	$50.1	$51.6

*World Bank figures are for fiscal year ending June 30 of following calendar year.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Appendix B

U.S. Participation in Multilateral Development Banks

($ amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Paid-in Capital	$0.5	$1.3	$0.2	$2.6	$4.6
Callable Capital	$7.2	$27.5	$1.1	$30.0	$65.8
Concessional Capital Contributions	$2.9	$4.8	$1.6	$23.4	$32.7
Share of Voting Rights	13%	31%	6%	17%	17%
Share of Paid-In Capital	16%	31%	6%	19%	19%
Share of Concessional Capital Contributions	14%	51%	12%	24%	23%
Share of Non-Borrowing Member Callable Capital	27%	62%	17%	29%	36%

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Table 3-4

Annual Cost of Multilateral Development Banks (1)

(amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Interest Cost on Paid-in Capital	$0.24	$0.29	$0.20	$0.98	$1.71
G-5 members	0.10	0.12	0.04	0.40	0.66
Interest Cost on Concessional Capital Contributions	$1.44	$0.67	$0.92	$6.74	$9.77
G-5 members	1.13	0.42	0.45	4.82	6.82
Risk Compensation on Callable Capital (2)	$0.53	$1.32	$0.50	$4.76	$7.11
G-5 members	0.36	1.06	0.28	3.14	4.84
Interest Cost on Retained Earnings	$0.60	$0.50	$0.14	$2.10	$3.34
G-5 members	0.29	0.20	0.03	0.92	1.44
Total	$2.81	$2.78	$1.76	$14.58	$21.93
G-5 members	1.88	1.80	0.80	9.28	13.76
% Share	67%	65%	45%	64%	63%

Notes: (1) 7.00% average annual long term interest rate.
(2) Compensation for risk on callable capital equal to 1/2 of capital market premium.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Table 3-5

Annual Cost of Multilateral Development Bank Participation to United States

(amounts in billions)

	Asian Dev. Bank	Inter-American Dev. Bank	African Dev. Bank	World Bank	Total
Interest Cost on Paid-in Capital	$0.04	$0.08	$0.01	$0.17	$0.30
Interest Cost on Concessional Capital Contributions	$0.19	$0.31	$0.10	$1.52	$2.12
Risk Compensation on Callable Capital	$0.14	$0.81	$0.08	$1.39	$2.42
Interest Cost on Retained Earnings	$0.09	$0.14	$0.01	$0.37	$0.61
Total	$0.46	$1.34	$0.20	$3.45	$5.45

Notes: (1) 6.50% average annual long term interest rate.
(2) Compensation for risk on callable capital equal to 1/2 of capital market premium.

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank
Federal Reserve Board

Table 3-8

Performance of World Bank Projects

Failure Rate of Projects to Achieve Satisfactory Sustained Results

	1990-93	1994-97	1998-99	1990-99
Adjustment Lending	55%	45%	37%	47%
Investment Lending	60%	59%	56%	59%
Africa	75%	74%	68%	73%
South Asia	66%	56%	60%	61%
Latin America	51%	50%	37%	48%
East Asia	38%	36%	48%	39%
Low Income	73%	69%	66%	70%
Lower Middle Income	48%	50%	46%	49%
Upper Middle Income	45%	36%	31%	39%
High Income	27%	30%	28%	28%
Total	59%	56%	53%	57%

Source: World Bank

Table 3-9

World Bank Performance

Failure Rate of Bank Responsibilities

	1990-93	1994-97	1998-99	1990-99
Project Identification	12%	18%	22%	16%
Project Appraisal	33%	38%	38%	36%
Project Supervision	24%	28%	24%	26%
Overall	38%	44%	43%	42%

Source: World Bank

Table 3-6

Risk Evaluation by the Private Sector:

Medium-Long Term Emerging Market Bonds

Spread above U.S. Treasury Securities
July 1994 - June 1999

	Asia	Latin America	Africa	World
Average	4.34%	8.16%	10.50%	8.12%
Maximum	9.91%	17.82%	30.37%	16.62%
Minimum	1.48%	3.26%	3.94%	3.28%

Sources: Morgan Stanley Dean Witter
Salomon Smith Barney

Table 3-3

Overlap of Regional Development Bank and World Bank Lending: 1996-98

($ amounts in billions)

Asia

	ADB		IBRD	
	Amount	Share	Amount	Share
Korea	$4,015	24.6%	$7,048	27.7%
Indonesia	3,767	23.1%	4,223	16.6%
China	2,920	17.9%	6,487	25.5%
India	1,576	9.6%	2,095	8.2%
Thailand	1,510	9.2%	2,068	8.1%
Philippines	1,419	8.7%	1,141	4.5%
Total	$15,207	93.1%	$23,062	90.7%

Latin America

	IADB		IBRD	
	Amount	Share	Amount	Share
Argentina	$5,785	28.9%	$6,038	35.0%
Brazil	4,642	23.2%	4,296	24.9%
Mexico	1,829	9.1%	3,677	21.3%
Peru	1,493	7.4%	1,080	6.3%
Venezuela	1,030	5.1%	122	0.7%
Uruguay	882	4.4%	269	1.6%
Colombia	768	3.8%	302	1.8%
Total	$16,429	81.0%	$15,784	91.5%

Africa

	AfrDB		IBRD	
	Amount	Share	Amount	Share
Morocco	$611	30.4%	$748	35.2%
Algeria	580	28.9%	239	11.2%
Tunisia	414	20.6%	658	30.9%
S. Africa	154	7.7%	46	2.2%
Total	$1,759	87.6%	$1,691	79.5%

Sources: World Bank
Asian Development Bank
Inter-American Development Bank
African Development Bank

Table 3-10

Effect of Country Eligibility Phase-Out

Countries with Investment Grade Rating (9/1/99)			Countries with 1998 Per Capita Income					
			above $2,500 Begin Phase-out			above $4,000 Complete Phase-out		
Asia	Latin America	Africa	Asia	Latin America	Africa	Asia	Latin America	Africa
China	Chile	Egypt	Malaysia	Belize	Mauritius	Korea	Argentina	Gabon
Korea	Colombia	Mauritius		Colombia	S. Africa		Brazil	
Malaysia	El Salvador	S. Africa		Costa Rica			Chile	
Thailand	Uruguay	Tunisia		Panama			Mexico	
				Peru			Trinidad and Tobago	
				Venezuela			Uruguay	

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Sources: World Bank; Moody's Investors Service and Standard & Poor's

Table 3-7

Effective Subsidies on Development Bank Lending
($ amounts in billions)

	Asian Dev. Bank		Inter-American Dev. Bank		African Dev. Bank		World Bank				
	Bank	**Fund**	**Bank**	**FSO**	**Bank**	**Fund**	**Bank**	**IDA**	**Banks**	**Total Concessional**	**Combined Total**
Loans Outstanding*	$24.4	$14.3	$32.3	$6.9	$9.5	$7.6	$117.2	$83.2	$183.4	$112.0	$295.4
Average Lending Rate**	7.12%	0%	7.22%	1%***	7.37%	0%	6.87%	0%	---	---	---
Average Private Sector Cost**	10.53%	16.69%	14.35%	16.69%	16.69%	16.69%	14.31%	16.69%	---	---	---
Effective Subsidy Per Annum	3.41%	16.69%	7.13%	15.69%	9.32%	16.69%	7.44%	16.69%	---	---	---
Rate as % Private	32%	100%	50%	94%	56%	100%	52%	100%	---	---	---
Sector Cost Amount	$0.8	$2.4	$2.3	$1.1	$0.9	$1.3	$8.7	$13.9	$12.7	$18.7	$31.4
U.S. Share	$0.2	$0.3	$1.4	$0.6	$0.2	$0.2	$2.5	$3.4	$4.3	$4.5	$8.8

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*** Government lending only as of 12/31/98 for all regional banks and 6/30/99 for World Bank.**
**** July 1994-June 1999**
***** FSO charges an average interest rate of 1.80% but no administration fee.**
Other Banks charge an administration fee of 0.75-1.00%.

Sources: Morgan Stanley Dean Witter; Salomon Smith Barney; World Bank; Asian Development Bank; Inter-American Development Bank and African Development Bank.