

# Response to the Report of the International Financial Institution Advisory Commission

This response to the Report of the International Financial Institution Advisory Commission (the Commission) has been prepared pursuant to section 603(i)(1) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1999, found in Public Law 105-277. Section 603(i)(1) provides that the Secretary of the Treasury shall, within three months of receipt of the Commission report, “report to the appropriate committees on the desirability and feasibility of implementing the recommendations contained in the report [of the Commission]”.

The Commission was established under the legislation authorizing U.S. participation in the most recent quota increase of the International Monetary Fund (IMF) and the establishment of the New Arrangements to Borrow. Congress mandated the Commission to report on the future role and responsibilities of international institutions including the IMF, World Bank, the African, Asian and Inter-American Development Banks, the European Bank for Reconstruction and Development, the Bank for International Settlements and the World Trade Organization. In March 2000, the Commission released its report, including a set of recommendations supported by the majority, and three dissenting statements.

The work of the Commission took place in the context of intense public discussion on the role of the international financial institutions (IFIs). A number of reports with alternative programs for reform have been published recently by the Council on Foreign Relations, the CATO Institute, the Carnegie Endowment for International Peace, and the Overseas Development Council, among others. The Commission’s recommendations are appropriately considered against the background of these reform proposals, the range of Congressional mandates for IFI reform, and recent U.S. and multilateral efforts to reform the international financial architecture.

**June 8, 2000**

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## **Principal Conclusions**

The IFIs are among the most effective and cost-efficient means available to advance U.S. policy priorities worldwide. Since their inception, they have been central to addressing the major economic and development challenges of our time. They have promoted growth, stability, open markets and democratic institutions, resulting in more exports and jobs in the United States, while advancing our fundamental values throughout the world.

The Commission affirms the importance of the IFIs in today's more integrated world. We share this conviction and many of the underlying objectives of the Commission's report. We also share with the Commission the belief that the IFIs need to reform in important ways to confront the new challenges of today's global economy. The Administration, working closely with the Congress, has pressed for and achieved significant changes in the institutions. And more needs to be done. The second part of our response details reform achievements to date, and our agenda for further change.

At the same time, and despite our shared objectives, it is fair to say that we disagree in fundamental respects with the bulk of the Commission's reform prescriptions. After careful consideration of each of the recommendations in the report, we believe that, taken together, the recommendations of the majority, if implemented, would profoundly undermine the capacity of the IMF and the multilateral development banks (MDBs) to perform their core functions of responding effectively to financial crises and promoting durable growth and market-oriented reforms in developing countries – and would thus weaken the IFIs' capacity to promote central U.S. interests.

### **Shared Objectives**

The Commission recognizes a continuing and essential role for the IFIs.

The majority report concludes appropriately that the IMF should continue to have an important role in crisis prevention, and that a strong capacity to respond to financial crises will be crucial to the global economy going forward.

The majority report also concludes that the MDBs have a critically important mission in promoting long-term development and reform in the developing countries, and that more resources need to be made available to support these efforts in the poorest countries.

These are welcome conclusions, which the Administration shares.

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The Commission also outlines a number of reform objectives that have commanded broad bipartisan support in recent years – objectives that have formed the basis for achieving substantial change in the nature and focus of these institutions. These objectives include:

- A sea change in the transparency of these institutions' operations and that of member countries.

*As a result of consistent U.S. pressure, the IMF and the MDBs now systematically disclose to the public a broad range of key documents on their lending operations – including Letters of Intent and Press Information Notices. For example, program documents for nearly 90 percent of the IMF arrangements discussed by the IMF Executive Board since June 1999 have been publicly released. And the creation and expansion of the Special Data Dissemination Standard (SDDS) have set a new benchmark for IMF members to meet in providing accurate and timely financial and economic information to markets and the public at large.*

- The development of new mechanisms for strengthening incentives for countries to reduce their vulnerability to crises.

*The U.S. has strongly promoted a more comprehensive international effort to reduce the risk of financial crises, especially in the wake of recent crises in Asia and elsewhere: this has borne fruit in the development of a common set of best practices and financial standards; a systematically greater focus within the IFIs on national financial vulnerabilities, including excessive leverage or unsustainable exchange rate regimes; and the development of the IMF's new Contingent Credit Line (CCL), conditioned on strong, ex-ante reforms in these and other key areas.*

- A new focus within the IFIs on the importance of strong, open financial systems, better debt management policies, and appropriate exchange rate regimes.

*Because national policy failures in these areas have played a significant role in recent crises, the IMF and the World Bank have now adopted, or are in the process of adopting, a number of new initiatives to help improve the quality of the policy advice that they provide to governments, to help them design stronger financial systems, debt structures that are less vulnerable to various risks, and more resilient exchange rate regimes.*

- Fundamental reform of the framework for the provision of IMF and World Bank lending to the poorest countries, centered on greater selectivity and with a greater focus on poverty reduction and growth.

*Consistent pressure from the Administration and from Congress has helped to achieve much greater selectivity in the allocation of MDB assistance – with greater support for stronger performance and reduced support for repeated non-performance. We have also helped to refocus the IFIs' attention on key priorities such as investment in basic education and health care and combating corruption. The IMF's new Poverty Reduction and Growth Facility (PRGF) puts core social investments and poverty reduction at the heart of the country's economic program. And the World Bank has developed a range of tools to address*

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*corruption more effectively: for example, in the technical assistance it has provided for civil service reform.*

We have been working to build consensus in Congress and among other IFI shareholders on the importance of other broad objectives that are also highlighted in the Commission Report. Most notably:

- A substantial increase in debt relief and concessional financial assistance targeted to the poorest developing countries.

*The new international debt initiative launched in 1999 will grant substantial debt reduction to a number of highly indebted poor developing countries that commit to a credible program of economic reform. Five countries have already qualified for this enhanced relief, worth a total of \$13-14 billion, but the United States must play its part to ensure that the initiative is adequately funded. In addition to its financing request for this initiative, the Administration has proposed targeted increases in development assistance to combat infectious diseases, including HIV/AIDS, and to promote primary education, poverty reduction and other objectives, to complement existing bilateral and multilateral assistance programs.*

- A stronger role for the MDBs in international efforts to provide global public goods.

*The World Bank, with our encouragement, is intensifying its support for international efforts to promote environmental sustainability, reduce threats to biodiversity, combat infectious diseases, and encourage the adoption of development best practices. As part of this effort the President has called for the MDBs to dedicate a further \$400 million to \$900 million of their lending to the poorest countries each year for basic health care to immunize, prevent and treat infectious diseases.*

- And the need for a clearer delineation of the respective roles of the multilateral development banks and the IMF.

*We are working to develop a more focussed role for the IMF, centered on crisis prevention and response in the emerging economies and macroeconomic stability in the poorest economies, and for the MDBs, which should address the longer-term challenges to development and reform in the developing and emerging economies.*

The reforms that have been implemented in the international financial institutions and the important further steps that are underway will make a significant contribution to the IFIs' capacity to address the diverse and complex array of risks and challenges that the global economy now presents. Many of these reforms have been initiated by the United States, and they largely reflect the directions that the Congress outlined in the legislation establishing the Commission. But America's ability to promote further change in the future will depend centrally on our capacity to build broader support for our proposals among the shareholders of the institutions.

## **Commission Recommendations**

Despite the broad objectives that we have in common, we find ourselves in fundamental disagreement with the Report's core recommendations for further reform.

The critical test in evaluating the desirability of alternative reform proposals should be an assessment of whether they would strengthen or weaken the capacity of the institutions to address economic challenges that are critical to U.S. interests. In our view, the core recommendations of the majority, taken together, would substantially harm the economic and broader national strategic interests of the United States, by reducing dramatically the capacity of the IMF and the MDBs to respond to financial crises, and by depriving them of effective instruments to promote international financial stability and market-oriented economic reform and development.

The reforms proposed by the majority do not offer a realistic prospect of preventing future financial crises and, by effectively terminating the lending programs of the IMF and the MDBs in a broad range of emerging market economies, could significantly undermine our capacity to promote changes that would reduce the vulnerability of these economies, and as a consequence the vulnerability of the U.S. economy, to future financial crises.

Specifically, if the Commission's majority reform proposals had been in place in 1997 and 1998, neither the IMF nor the World Bank would have been able to respond to the acute financial crisis that spread across emerging markets during that period. As a result, the crisis would have been deeper and more protracted, with more devastating impact on the affected economies and potentially much more severe consequences for U.S. farmers, workers, and businesses.

By essentially taking the World Bank out of the development finance business, the Commission's reforms would eliminate the most cost-efficient and effective of the international development institutions, and the one with the greatest concentration of development experience and expertise. The result would be to impose a much greater burden on bilateral resources to meet development objectives that are so important to the U.S. interest. This would also reduce the effectiveness of development assistance provided by the United States and other nations.

The reform proposals of the majority, had they been in place at the start of the 1990s, also would have precluded the MDBs from supporting economic restructuring and private sector development in Eastern Europe and the former Soviet Union, and across Asia and Latin America in a period of historic opportunities for positive reform. The MDBs would have been unable to promote financial sector reform and capital market development in the emerging market economies that now have the bulk of the world's population and a substantial share of world output. And there would have been significantly reduced support for trade liberalization, privatization, agricultural reform, and other steps that have provided significant economic benefits for many of the largest, most important emerging economies that have also been rapidly growing trading partners of the United States.

In a world where the fortunes of U.S. workers and farmers, business and financial institutions are increasingly tied to the overall strength of the world economy, we have a compelling interest in working to build stronger, more effective global institutions that are able to address new

challenges to growth and financial stability. In short, by weakening the institutions, we believe that the recommendations of the Commission would leave the United States and many of our closest allies and economic partners more vulnerable to the risks that a more integrated world presents.

### **Commission Recommendations for the International Monetary Fund**

*The majority report outlines a set of recommendations for reform of the IMF that would fundamentally change the nature of the institution. The main objective of the Commission’s proposals is to limit IMF lending to very short-term, essentially unconditional liquidity support for a limited number of relatively strong emerging market economies that would pre-qualify for IMF assistance.*

We do not believe this approach is either desirable or feasible.

- By restricting the IMF’s capacity to lend only to emerging market countries that pre-qualify for assistance, the Commission’s recommendations would preclude the IMF from being able to respond to financial emergencies in a potentially large number of its member countries.
  - Even with a long phase-in period, many countries of potentially systemic importance to global financial stability could be deemed ineligible for assistance, depriving us of the capacity to help contain and resolve crises through the IMF. The majority acknowledges in the executive summary of the report a possible need for an exception to the prequalification requirements “where the crisis poses a threat to the global economy”, but this proposal is inconsistent with the overall thrust of the report and is not discussed or developed in the report itself.
  - The Commission’s limited criteria for prequalification, by focusing on the financial sector, might not significantly reduce countries’ vulnerability to financial crisis, even where they have met all the relevant conditions. Experience suggests that these conditions would not prevent governments from making a wide range of policy mistakes that could contribute to a financial crisis, nor would they significantly insulate countries from crises that arise outside the financial sector.
- By precluding the IMF from applying policy conditions to its loans, outside of a very limited set of prior conditions related to financial sector soundness, disclosure, and a general requirement for fiscal soundness, the majority proposals would deprive the IMF of the capacity to promote the policy reforms that are likely to be fundamental to restoring confidence and economic recovery in such cases. The result would be to increase substantially the risk that the financial assistance provided would be ineffective.
- By limiting IMF assistance to very short-term loans (four to eight-month maturity) at very high interest rates, the majority proposals would render IMF assistance ineffective in promoting recovery even in those countries that prequalified. Experience suggests that these terms would force repayment prematurely. Even in the most successful cases of recovery, it has taken longer than eight months to restore substantial access to private finance. Premature repayment and high interest rates that undermine the financial position of the government would in turn undermine confidence among domestic and foreign investors, and could thereby prolong and exacerbate the crisis itself.

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- For all of these reasons we believe that implementing these proposals would substantially reduce the IMF’s capacity to restore lasting financial stability in crisis economies. However, to the extent that such a system would commit the IMF to providing very large-scale assistance, with very limited conditions, it would also risk a substantial increase in moral hazard in the international financial system. Investors would be encouraged before a crisis to lend excessively to prequalified countries in the expectation of being repaid from IMF assistance. And governments would have an incentive to take risks in policy areas not constrained by the eligibility criteria, in the expectation they would be insulated by the IMF from the costs of failure. The result, in many ways, would be the worst of all worlds: over-confidence in a system that would prove ineffective for preventing and responding to crises.
- By eliminating the IMF’s concessional lending capacity in the poorest developing countries, the majority proposals would undermine the capacity of the IFIs to promote in these countries the types of macroeconomic policy reforms that are critical to economic growth and long-term development, and would thereby undercut the effectiveness of substantial amounts of bilateral and multilateral development assistance.

While we have serious reservations about the wholesale adoption of prequalification for IMF programs that the Commission proposes, we would note, once again, that we share the Commission’s desire to find new ways to encourage countries to reduce their vulnerability before crisis strikes. In this context, we agree with the report that it is critical for countries to strengthen the financial sector, improve the quality of disclosure, and reinforce the resilience of the exchange rate regime. With the objective of trying to design more powerful incentives for policy changes before crisis strikes, and with our active encouragement, the IMF has established a new facility, the CCL, that would be available to countries that met a range of conditions. We are now in the process of identifying modifications to this facility to try to make it more effective. We believe this is a promising direction for reform going forward as a complement to the IMF’s core lending instruments.

### Commission Recommendations for the Multilateral Development Banks

*The Commission proposes a comprehensive set of changes for the multilateral development banks that would substantially modify the way they provide financial assistance in support of development. The majority proposals would essentially foreclose MDB lending to a broad range of emerging market economies, focus the efforts of the MDBs on grants and “institutional reform loans” for the poorest developing countries, transfer the World Bank’s lending role to the regional development banks, and close down the private sector financial operations of the institutions.*

We do not believe this approach is either desirable or feasible.

- By eliminating MDB assistance for countries with a per capita income above \$4,000 or an investment grade credit rating, the majority proposals would eliminate the capacity of these institutions to promote economic reform and development in countries that account for a substantial share of the world’s population and continue to face formidable development challenges. Because access to private capital for many of these countries is fragile and extremely limited, denying these countries access to multilateral lending would directly

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reduce their potential resources for meeting crucial development needs. Graduation policies designed with a fixed and excessively low threshold risk worsening economic outcomes in these countries, and increase the likelihood of future crises. This could undercut or prolong the path to sustainable market access, and ultimately delay the time when these governments will grow out of the need for official support.

- By eliminating the private sector financial operations of the MDBs (including closing the IFC and MIGA), the majority proposals would eliminate an important part of the MDBs' capacity to promote private enterprise, privatization of state-owned firms, and the development of domestic capital markets, all of which are critical to successful development strategies.
- By eliminating the World Bank's financial role in providing development assistance and by transferring financial capacity to the Inter-American, Asian and, over time, the African Development Banks, we believe the majority proposals would undermine the effectiveness of the overall development effort. It would be counterproductive to limit to an advisory capacity the institution that is the strongest, most experienced, and most competent in the MDB system, and has the most advanced agenda for implementing reforms supported by the U.S. Congress over the decades. Although the regional development banks have many strengths and in many cases play a useful complementary role to the World Bank, they do not have the capacity to match the strengths of the World Bank in most areas of development policy. Nor do we believe that they should seek to do so, at a time when there is broad agreement on focusing the missions of such institutions where they have comparative advantage.
- By eliminating the capacity of the MDBs to provide emergency lending at times of financial crisis, the majority proposals would make crisis response by the IMF less effective. In those exceptional circumstances where crisis lending is appropriate, the emergency lending capacity of the MDBs can be essential to support an appropriate level of fiscal expenditures in such a crisis, to design and finance financial sector restructuring programs, and to further targeted assistance for critical social programs, such as education and healthcare.
- By transforming the adjustment and project finance capacity of the institutions into a system of grants largely channeled directly to service providers, bypassing governments, and with a new financial instrument for institutional reforms, the majority recommendations embrace a number of desirable objectives without identifying proposals that have a realistic prospect of improving the overall effectiveness of development assistance. If implemented as proposed, these measures would limit the overall availability of financial assistance to the poorest by eliminating the financial leverage provided by the MDBs' hard-loan operations and the resources generated from reflows on concessional loans. Instead, the recommendations emphasize a financing instrument that is unlikely to be effective or attractive to borrowers compared to existing instruments for promoting critical improvements in the policy framework and overall institutions of government.

As noted above, we share the Commission's view on the importance of focusing assistance on the countries that need it most, and agree that substantial further reforms are necessary to operationalize fully in the MDBs the lessons of recent experience with regard to the design and financing of more effective development strategies. We will continue to explore a broad range of proposals for how to best achieve these objectives. Our reform agenda is discussed in more detail in the next section. A detailed response to the Commission's recommendations follows.



## **U.S. Reform Agenda in the IMF and the Multilateral Development Banks**

The Administration has worked to bring about substantial reforms in the international financial institutions over the past several years. These efforts have been framed to a significant degree by the objectives set out in U.S. legislation, including the 1998 legislation authorizing U.S. participation in increasing the IMF's financial resources. The most recent Congressional efforts to advance reform in the IMF and the MDBs focused on improving transparency and accountability across the institutions; changing the terms of IMF assistance to reduce the risk of moral hazard; refocusing the policy conditionality to promote market oriented reform, environmental sustainability, and mitigating the social impact of economic change; and encouraging greater selectivity in providing development finance. Some examples of recent progress in these areas and others are detailed in the boxes that follow at the end of this part.

Although these changes are highly significant, we do not believe they sufficiently address our concerns about the capacity of the institutions to confront effectively the new and complex challenges of the world economy. Further reform is needed – on many fronts over a period of several years.

To this end, the Administration has outlined a broad framework for additional reforms that we believe should guide the evolution of the institutions in the years ahead. Many of these changes are founded on objectives similar to those that motivated the Commission's recommendations. In general, however, we believe that we have identified a more promising set of reforms, that match more closely our interests as a nation, have more practical value in addressing the complexity of these problems, and are more likely to gain the broad international support necessary to any successful program of change in international institutions.

The policy issues involved in designing more effective ways to promote financial stability and successful economic development are many and complicated. The Congress and the Administration share an interest in preserving the ability to adapt our approach to reflect past experience and the evolution of informed opinion. And because of the high stakes involved in making the right decisions about the appropriate direction of the institutions, we need to have a substantial degree of confidence that the reforms we pursue will demonstrably improve and not impair the effectiveness of the institutions. These considerations have shaped the approach for reform outlined by the Administration.

Over the past several months we have begun to build consensus for these changes. We have found considerable support for the broad direction of our proposals, and have already seen some concrete changes in the institutions. This part of the report outlines the Administration's proposals for reform, identifies specific measures that we believe would be most effective in operationalizing these changes, and briefly reviews recent changes in the institutions resulting from our initiatives.

## **Agenda for Further Reform of the International Monetary Fund**

The central objective of reform in the IMF in this world of more integrated global capital markets should be to reduce the incidence and severity of financial crises, particularly in emerging market economies, and, more broadly, to foster growth in the context of a more stable international financial system, including strong macroeconomic policies to spur growth in the poorest countries. We believe the most promising proposals for advancing these objectives lie in the following areas:

### Greater focus on promoting the flow of information from governments to markets and investors

IMF surveillance should shift from a focus on collecting and sharing information within the club of nations to promoting the collection and dissemination of information for investors and the public, and assigning high priority not only to the quantity but also to the quality of information disseminated.

- To reinforce the Special Data Dissemination Standard as the international standard for disclosure of national economic data, we support a new quarterly publication highlighting country adherence and compliance with the SDDS, and encouraging more countries to subscribe and comply.
- The SDDS should be further strengthened with better data on countries' external debt and, in due course, financial sector indicators.
- Publication of IMF Reports on the Observance of Standards and Codes (ROSCs) on country observance of the range of codes and standards to help strengthen financial systems should be routine, with countries allowed to disclose their IMF Financial Sector Assessments if they choose.

### Greater attention to financial vulnerabilities and steps to reduce countries' vulnerability to crisis

This would entail, in particular, greater focus on the strength of national balance sheet and liquidity indicators, with a more fully integrated assessment incorporated into regular IMF surveillance. In this context, the IMF should highlight more clearly the risks of unsustainable exchange rate regimes.

- Indicators of financial vulnerability, liquidity and balance sheet risks should be developed and systematically incorporated into the Fund surveillance process, both bilateral and multilateral, and published regularly.
- Debt management guidelines, based on the recent work by the IMF, the World Bank and the Financial Stability Forum, should be developed by the IMF to guide countries to limit their risks, make best use of today's markets, and disclose their debt and reserve management policies.

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### A more strategic financing role focused on crisis prevention and emergency situations in emerging economies, and on supporting macroeconomic stability and growth in the poorest countries

The IMF has already begun to streamline its financing instruments and a major review of its facilities is underway, as called for by the United States and the G-7 countries earlier this year. Going forward, we believe the IMF should focus primarily on forestalling contagion and providing appropriately priced and conditioned financing for balance of payments emergencies in emerging market economies, and on providing the macroeconomic framework for growth and financial stability in the poorest, in the context of World Bank-led poverty reduction programs.

- The IMF's CCL should be recast to make it a more effective crisis prevention tool, with greater clarity about the conditions for its use and a more attractive pricing structure relative to the IMF's other crisis financing instruments.
- Terms of non-concessional IMF loans should be changed, with graduated charges to promote early repayments, to limit excessive use of large-scale IMF financing and to reduce unduly prolonged reliance on IMF financing. Use of the Fund's Extended Financing Facility (EFF) to address longer-term structural balance of payments problems should be limited.
- The new Poverty Reduction and Growth Facility should provide IMF advice and financing for the poorest in support of strong macroeconomic policies to combat capital flight and promote the financial stability and growth needed for effective poverty reduction.

### Greater emphasis on catalyzing market-based solutions to crises

The IMF should continue to develop ways of catalyzing market-based approaches to resolving crises, particularly where the private sector is involved, with carefully designed approaches to achieve the right balance between maximizing prospects for an early recovery from the crises and the need to lessen the risk of moral hazard.

- IMF lending should catalyze private market financing on appropriate terms and promote a return to normal market access.
- In cases where debt restructuring is needed, the Fund should provide a medium-term framework for the debt negotiation.
- The Fund should be prepared to lend into arrears if a country is seeking to work cooperatively and in good faith with its private creditors and is meeting other program requirements.

### Modernizing the IMF

As the IMF adapts to changes in the international financial system, it is important that it also modernize as an institution, improving its evaluation system, enhancing dialogue with the private sector, and updating its existing governance structure.

- The IMF should quickly establish the recently agreed upon permanent independent evaluation office, ensuring that the office's structure, terms of reference and operating procedures allow it to be fully independent, transparent and open to external consultations.
- The Fund should formally establish a liaison group consisting of private financial market participants to deepen the Fund's understanding of global market trends.
- Changes in the international monetary system, including countries' relative economic and financial strength, should be more fully reflected in the IMF's governance structure.

### **Agenda for Further Reform of the Multilateral Development Banks**

The overriding objective of reform of the multilateral development banks in a world where the humanitarian and economic challenges facing developing and emerging economies are still formidable should be to put into place more effective ways of promoting poverty reduction, market-oriented economic reform, increased resources in support of programs with high development returns, such as health care and basic education, the successful graduation of emerging and transition economies to the point where they can rely on private finance, and global public goods, such as environmental sustainability and programs to combat infectious diseases. We believe the most promising proposals for advancing these objectives lie in the following areas:

#### Improved performance and impact

The MDBs should rely on a smaller number of clear and measurable performance targets that are set more realistically and are more vigorously adhered to.

- Performance-based lending guidelines should apply to all soft loan windows and assistance should be more focused on countries that are performing well, with less assistance to poor performers -- and essentially withheld where governance is especially weak.
- More effective mechanisms are needed within a number of the MDBs to evaluate when targets and intermediate benchmarks have been met, along with a stronger commitment to disburse in stages and to review more frequently.

### Emphasis on economic growth and poverty reduction

The MDBs need to focus an even higher level of assistance in areas that have the highest development returns, and particularly on investments in access to health care, clean water, and basic education.

- Ex-ante social and poverty assessments done by the World Bank should be prerequisites to all Country Assistance Strategies (CASs) and adjustment operations, and such assessments should be more explicitly linked to the sequencing and pace of reforms in IMF PRGF programs.
- Public Expenditure Reviews should be precursors to CASs to identify and remedy poor composition and efficiency of spending.
- Lending to social sectors and other poverty reduction priorities should be further increased.

### Focused lending to emerging economies

We believe that the MDBs need to explore more innovative ways to catalyze private capital flows to countries, within strict and clear guidelines that safeguard the financial position of the institutions.

- MDBs should establish a more selective lending framework that facilitates graduation.
- MDB lending should decline in volume over time in countries that are expanding their capacity to attract private finance.
- Capital increases for the MDB hard windows are not anticipated and future donor contributions should be directed exclusively to the soft windows. Along these lines, the MDBs should re-examine their current hard window pricing policies with a view toward stronger sustainability of the institutions' balance sheets and building a greater financial capacity to contribute to overall development efforts.

### Transparency

There needs to be a higher degree of transparency, with a stronger presumption for publication of key loan documents, and transparency in the relevant operations at the national level, so that the domestic population, outside investors and donors can more easily track results.

- All CASs and Poverty Reduction Strategy Papers (PRSPs) should be released to the public.
- All reports of MDB evaluation units should be public.
- The quality and comprehensiveness of public participation in review of Bank policies, projects, CASs and PRSPs should be strengthened.

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### Global public goods

As integration proceeds, the world is confronting a broad range of problems that cross international borders and defy solution by individual governments and markets. The World Bank and other development institutions have an enormous contribution to make in helping advance international efforts to provide global solutions in the form of public goods, especially those which benefit developing countries.

- There should be even greater focus on solutions to the problems of infectious diseases and degradation of the global environment.
- Information technology can be used better to create and disseminate medical knowledge and global environmental expertise.

### Improved collaboration and selectivity

Institutional collaboration and definition of tasks need to be further improved, not only between the IMF and the World Bank, but also between the World Bank and the regional development banks.

- MDBs should reduce MDB overlap and inconsistencies, speak more clearly on priorities, and share lessons of experience.
- Regional development banks should follow the example of the World Bank/African Development Bank Memorandum of Understanding (MOU) to develop agreements between each of the remaining regional banks and the World Bank.
- MDBs should work to reduce the administrative burden on developing countries that stems from negotiating multiple development and economic priorities with multiple donors and international institutions.

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### International Monetary Fund: Selected Reforms Achieved to Date

<b>Transparency and Accountability</b>	<ul style="list-style-type: none"><li>• Since June 1999, there has been a presumption of public release of program documents detailing policy commitments countries have agreed to as a condition for IMF support; documents have been released in 50 of 58 cases since then.</li><li>• Release of “Public Information Notices” (PINs) following Executive Board discussions of Article IV consultations is becoming routine: 113 of 139 (81%) were released in 1999. PINs are also published on a broad range of policy issues, e.g., private sector involvement, safeguarding IMF resources, IMF work program.</li><li>• There is agreement to publish the IMF’s Financial Transactions Plan quarterly with a one-quarter lag beginning in August 2000. Information about the IMF’s financial position is available on the IMF’s internet web site.</li></ul>
<b>Crisis Prevention and Resolution</b>	<ul style="list-style-type: none"><li>• The SDDS is now fully operational, providing potential investors with better information about financial conditions in member countries; 24 countries now comply with SDDS.</li><li>• The IMF is moving to address vulnerabilities, including national balance sheet and liquidity risks, as part of surveillance. A growing number of Article IV staff reports make use of key vulnerability indicators.</li><li>• The CCL offers incentives for countries to take early steps to reduce vulnerability to crisis. The Supplementary Reserve Facility (SRF) charges premium interest rates to encourage an early return to private markets, while providing exceptional financing to countries of systemic importance.</li><li>• The IMF has begun to make use of guidelines developed by the G-7 to catalyze private sector involvement.</li></ul>
<b>Strengthened Financial Systems</b>	<ul style="list-style-type: none"><li>• The IMF helps to disseminate and encourage implementation of the Basle Core Principles.</li><li>• Under the Financial Sector Assessment Program (FSAP) launched in 1999, the IMF and World Bank jointly conduct in-depth assessments of countries’ financial systems; five countries have undergone assessments with seven more to be completed by July 2000.</li><li>• As of September 30, 1999, the IMF had completed assessments (ROSCs) of countries’ adherence to internationally-accepted standards for 13 countries, 10 of which agreed to publication. Twenty-four countries are participating in a third phase to be completed in September 2000. Information on ROSCs is available on the IMF web site.</li></ul>
<b>Exchange Rate Regimes</b>	<ul style="list-style-type: none"><li>• The United States and other G-7 nations have agreed that the IMF, in its surveillance, should increase attention to exchange rate sustainability.</li><li>• The G-7 have agreed that the IMF should not provide significant official financing to a country whose government is intervening heavily to support a particular exchange rate level, except where that level is judged sustainable and certain conditions have been met, including supporting institutional arrangements and maintaining consistent domestic policies.</li></ul>
<b>Labor Issues</b>	<ul style="list-style-type: none"><li>• Labor standards issues have been raised in recent important IMF programs (e.g., Korea, Indonesia, Brazil and Mexico), as well as in Article IV consultations and program reviews (e.g., Indonesia, Thailand and Korea).</li><li>• The ILO has been granted ongoing observer status in the IMF’s International Monetary and Financial Committee.</li><li>• The IMF, with the World Bank and the AFL-CIO, sponsored a seminar on Labor Standards and the New International Economy during the 1999 Annual Meetings of the IMF and World Bank.</li></ul>
<b>Trade Liberalization</b>	<ul style="list-style-type: none"><li>• In 1998, 24 IMF members moved to a more open trade regime, 17 in the context of Fund-supported programs.</li><li>• In 1999-2000, trade liberalization was an element in IMF programs in Indonesia, Nigeria, Zambia, Guyana, South Korea, Jordan, Colombia and Uganda.</li></ul>
<b>Good Governance and Combating Corruption</b>	<ul style="list-style-type: none"><li>• A new safeguards framework to guard against misuse of IMF resources requires the publication of annual audited central bank financial statements and new assessments of internal controls.</li><li>• The IMF now routinely encourages countries to maintain strong internal financial controls and tighten supervision and regulation of domestic financial institutions, including measures to deter money laundering.</li><li>• Governance/corruption measures were an integral part of Fund programs in the Ivory Coast, Indonesia, Ukraine, Russia, Uganda and Kenya.</li></ul>

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### Multilateral Development Banks – Selected Reforms Achieved to Date

<b>Transparency and Accountability</b>	<ul style="list-style-type: none"><li>• The MDBs now have formal disclosure policies based on a presumption of disclosure.</li><li>• MDB CASs increasingly address fiscal transparency and sound budget choices, including military spending, and public expenditure reviews are conducted prior to many adjustment loans and CASs.</li><li>• Most MDBs have installed independent inspection panels to investigate public allegations of non-compliance with MDB policies. Compliance advisers have been established in the IFC and MIGA to address public complaints.</li><li>• Public participation in the design of MDB policies, projects and country strategies has increased significantly. Public participation in the design of PRSPs is mandatory.</li></ul>
<b>Poverty Reduction</b>	<ul style="list-style-type: none"><li>• Heavily Indebted Poor Country debt reduction is a major new component of the international response to poverty reduction, under which PRSPs are being used to direct resources freed from debt relief to social investments.</li><li>• Comprehensive poverty assessments done by the World Bank have started to feed into the design of macroeconomic and structural reforms in lending programs for the poorest countries.</li><li>• World Bank lending is shifting from traditional infrastructure projects toward institutional and policy reforms designed to build an enabling environment for human development and private sector development</li></ul>
<b>Effective, Selective and Performance-Based Lending</b>	<ul style="list-style-type: none"><li>• Lending effectiveness and project quality are enhanced through: annual assessments by evaluation units in each MDB; the introduction of mandatory project performance and monitoring indicators; and the addition of outcome indicators in CASs.</li><li>• Selectivity and comparative advantage have been encouraged through the adoption of an MOU between the World Bank and AfDB, and the creation of the Evaluation Cooperation Group – composed of the heads of evaluation units of each of the MDBs – to establish a common project rating methodology to facilitate identification of MDB comparative advantage.</li><li>• The World Bank and the AfDB have policies to link concessional lending levels to country performance by evaluating public sector performance/governance, macro and structural policies, and poverty reduction strategies. Good IDA performers now receive five times the allocation of poor performers.</li></ul>
<b>Governance and Anti-corruption</b>	<ul style="list-style-type: none"><li>• Comprehensive governance strategies covering accountability, transparency, corruption, participation and legal/judicial frameworks are in place or under preparation in every MDB.</li><li>• The World Bank now prepares governance assessments for all countries; in cases where indicators suggest severe governance problems, lending is reduced or suspended.</li><li>• MDBs have upgraded attention to fiduciary policies, including anti-corruption measures and improved procurement guidelines to safeguard the use of Bank resources.</li></ul>
<b>Labor and Environment</b>	<ul style="list-style-type: none"><li>• An increasing number of MDB lending facilities include safeguards for core labor standards. Additionally, MDB planning instruments and guidelines increasingly include references and/or provisions for key labor issues and core labor practices.</li><li>• Publicly available Environmental Impact Assessments are required for all investment projects and sector adjustment loans with potentially significant environmental consequences.</li><li>• There is now a much greater focus on environmental sustainability in MDB projects.</li></ul>
<b>Structural Change for More Resilient Financial Systems</b>	<ul style="list-style-type: none"><li>• In response to the onset of crisis in East Asia, the World Bank established a unit of financial experts to provide comprehensive, rapid-response, financial-sector advice to affected countries.</li><li>• Under the FSAP, the World Bank and IMF jointly carry out assessments of selected countries' vulnerabilities</li><li>• The World Bank and IMF have been developing jointly debt management guidelines to inform countries on how to limit risks associated with sovereign debt and make best use of today's markets.</li></ul>
<b>Trade</b>	<ul style="list-style-type: none"><li>• MDBs have committed to better integrate trade into CASs in order to improve trade-related infrastructure and institutions, and to foster trade liberalization and participation in the international trading system.</li></ul>



## **Response to the Recommendations on Reform of the International Monetary Fund**

### **Restrict IMF lending to countries that meet prequalification criteria**

*The Commission recommends that the IMF be restructured as a smaller institution (a “quasi-lender of last resort”) that focuses on providing short-term liquidity assistance to solvent emerging economies meeting a set of prequalification eligibility criteria.*

We share a number of the objectives that apparently underlie this recommendation – notably the importance of creating strong, open financial systems; the role that greater transparency and market forces can play in strengthening financial systems and reducing their vulnerability to crisis; and the importance of sharpening incentives for countries to rely on private capital markets and avoid undue recourse to IMF financing. However, we believe that this recommendation would be neither desirable nor feasible.

To be eligible for IMF financing, a member country would have to meet three conditions primarily: (1) permit freedom of entry and operation for foreign financial institutions; (2) establish market-based disciplines in the domestic financial sector and ensure that commercial banks are adequately capitalized (e.g., by a significant equity capital base or by the issuance of uninsured subordinated debt to non-governmental and unaffiliated entities); and (3) publish regularly the maturity structure of its outstanding sovereign and guaranteed debt and off-balance-sheet liabilities in a timely manner. The Commission notes that this system would be phased in over a period of several years and refers to the possibility of lending to countries that do not prequalify in circumstances where a crisis poses a threat to the global economy. This exception is not discussed in the report.

Our concern with the proposal centers on three points. First, implementing this recommendation would preclude the IMF from being able to respond to financial emergencies and support recovery in the vast majority of its members, possibly including all of the emerging market countries affected by the financial crisis of 1997 and 1998. The exclusive focus on relatively strong emerging economies would leave out most of the Fund’s membership, notably all lower income countries and many transition economies.

Second, the proposed eligibility criteria are too narrow. Even where they were met, they would be unlikely to protect economies from the broad range of potential causes of crisis. The criteria focus on the financial sector, and yet even problems that surface in the financial sector often have their roots in deeper economic and structural weaknesses. One simply cannot predict with confidence what the next generation of crisis will be and therefore we need to preserve the IMF’s ability to respond flexibly to changing circumstances.

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Third, the eligibility criteria as designed could increase moral hazard risks in the system. The Commission's approach would provide an assurance of substantial financing, available immediately and automatically without conditions, to countries that have met the eligibility criteria but may still have fundamental macroeconomic weaknesses or structural problems in areas other than the financial sector. In our view, this approach risks creating incentives for countries to maintain inappropriate policies (other than those directly covered by the eligibility criteria) in the expectation that unconditional funds would protect them from the adverse consequences of their actions or inaction – as well as incentives for investors to lend to countries with substantial underlying vulnerabilities in the expectation that the IMF will bail them out.

Despite our concerns with this proposal, we think it is important to strengthen incentives for countries to take early steps to reduce their vulnerability to crisis. This should include steps to strengthen macroeconomic frameworks; address macro-related structural weaknesses (including though not limited to the financial sector), adhere to relevant international standards and codes, and increase transparency. It was in large part with these objectives in mind that the IMF created the Contingent Credit Line (CCL) in April 1999. The CCL offers the possibility of substantial financing to countries fulfilling a number of eligibility criteria (implementing strong macro policies; adhering to internationally accepted standards; maintaining constructive relations with private creditors; ready to adjust their economic and financial programs as needed). The CCL, therefore, incorporates a number of elements from the Commission's prequalification proposal. However, the prequalification approach of the CCL, important as it is in setting a precautionary line of defense against financial crisis and contagion, should be seen as a complement to (not a replacement for) the IMF's other financing facilities.

### **Unconditional Lending**

*The Commission recommends that the IMF be precluded from conditioning its financial support to member countries on the achievement of economic reforms, other than reforms required to meet prequalification conditions.*

We do not believe that this recommendation is desirable or feasible.

In making this recommendation, the Commission argues that IMF conditionality is generally ineffective, that it allows the IMF to wield too much power over the economic policies of borrowing countries, that it strengthens the executive branch of borrowing nations at the expense of their legislatures, and that the IMF often fails to enforce its conditions. The only apparent exception to the general prohibition on conditionality is that the IMF should establish "a proper fiscal requirement to assure that IMF resources would not be used to sustain irresponsible budget policies."

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In our view, the practice of providing phased financial support conditioned on progress in implementing economic reforms is central to the effectiveness of financial assistance. Conditionality is no guarantee of success – ultimately, sovereign governments are responsible for the decisions that shape the performance of their economies – but it is central to several fundamental objectives:

- **Encouraging countries to address the macroeconomic imbalances and structural weaknesses, which gave rise to the need for external financing.** This is critical to stemming financial crisis, promoting recovery and growth, and reducing the risk of future crisis. The Commission acknowledges the importance of a sound fiscal policy but makes no accommodation for conditions on the monetary policy framework, the exchange rate regime, the scope for exchange rate intervention, central bank support to financial institutions or other actions that are likely to be critical to restoring confidence and promoting recovery. Indeed, this has long been a core objective of Fund activity. And there is substantial evidence that linking IMF financing to steps to, for example, improve a country's tax collection system, strengthen the financial sector, reduce government subsidies, in fact strengthens the hand of national authorities committed to reform.
- **Helping to ensure, along with other measures, that IMF financing is used for the purposes for which it is intended.** Policy conditionality, in combination with safeguards in the form of transparency, financial controls and auditing requirements, are important to reduce the risk of misuse of IMF resources.
- **Helping to ensure that the borrowing country has the capacity to repay the IMF on time.** Without the capacity to apply conditions to its loans, the IMF would have virtually no means to promote the economic changes necessary to improve the countries' ability to repay.

Of course the conditions on which the IMF provides financing need to be carefully designed to fit the particular economic circumstances of the country involved.

**Maturity and Pricing of Loans**

*The Commission recommends that IMF loans should have a short maturity (e.g., a maximum of 120 days, with only one allowable rollover), and should be provided at a penalty interest rate (i.e., a premium over the sovereign yield paid by the member country one week prior to applying for an IMF loan).*

In our view, these recommendations are not desirable. The proposed 120-day lending window (even with one rollover) is an unrealistically short repayment period. Even in the successful recent cases, countries needed substantially more than four months (120 days) to be in a position to repay the loans extended by the official sector. Providing IMF assistance with such short maturities could undermine, rather than support, prospects for repayment and recovery.

The Commission’s recommendation of a penalty rate calculated on the basis of sovereign yields one week before the member country applies for an IMF loan would also be counterproductive. This would entail in most cases interest rates so high (see Graph 1) that these loans would worsen the underlying financial position of the borrowing country.

While we find the Commission’s specific recommendations on maturity and pricing to be undesirable, we do believe that it is important for the IMF to carefully structure the terms of its financing in such a way that reduces moral hazard risks, discourages excessively frequent or prolonged recourse to IMF resources, and encourages an early return to the private markets, especially in cases where exceptional amounts of IMF assistance are provided. With these objectives in mind, the United States led an important innovation in this area with the creation in December 1997 of a new IMF facility: the Supplemental Reserve Facility (SRF). This marked a fundamental change in the terms and conditions of IMF lending, emphasizing financing on shorter terms at premium rates of interest. Since the creation of this new facility, a substantial portion of IMF lending in large programs has been provided on so-called SRF terms – interest rates that are at least three percentage points above short-term market rates, and maturities of two years or less. Experience with this facility has been very positive, both in supporting economic recovery and encouraging realistically early repayment.

**Graph 1: Timeline of the Recent Financial Crises, 1997-2000**  
*Timeline of country crises vs. JP Morgan Emerging Bond Market Index (EMBI Brady Bond and EMBI Global spreads over U.S. Treasuries, in bp)*



*Source: JPMorgan (Bloomberg). The EMBI Sovereign series is available from 1991 onward; however, it covers the spreads of Brady Bonds over U.S. Treasuries. The EMBI Global series was created in 1998 as a broader measure.*

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More recently, we have sought in the IMF to win support for our view that all non-concessional Fund lending should in future be based on the principle that charges should escalate the longer countries have Fund money outstanding and, above certain thresholds, the larger the scale of financing. We are also seeking changes that would encourage more limited and effective use of the Fund's vehicle for medium/longer term lending, the Extended Financing Facility (EFF). In our view, the utility of this facility is in supporting those few, carefully targeted cases where bold structural reforms are needed to secure stabilization and where the balance-of-payments benefits of structural reforms may require a long time to appear and where countries have limited capital market access.

### Credit Limits

*The Commission recommends that the IMF have the capacity to lend on a substantial scale to countries that have met its prequalification criteria, with restrictions on the amounts available in order to reflect the borrowing government's capacity to repay.*

We share the view that the IMF should have the capacity to respond to crises in member countries on a scale consistent with the scale of the crisis. However, we do not think that the Commission offers a feasible approach to establishing appropriate credit limits.

The IMF currently has in place access limits that govern the amount of financing available to member countries under its programs. These existing IMF limits allow countries to borrow 100% of their IMF quota per year, with a cumulative limit of 300% of quota under normal IMF Stand-By or Extended arrangements. (The level of a country's quota is broadly determined by its economic position relative to other members. Economic factors considered include members' GDP, current account transactions, and official reserves.) In exceptional cases, the IMF may approve arrangements exceeding these limits, but most programs are financed at a level well below the access limits. There are also provisions in the IMF for exceptional access to resources in cases of systemic crisis – through the Contingent Credit Line and the Supplemental Reserve Facility. Under the CCL, access is expected to be within a range of 300-500 percent of quota. Under the Supplemental Reserve Facility, access is determined based on considerations including a member's financing need, its capacity to repay, the strength of its reform program, and its record of cooperation with the Fund in the past.

We think that the Fund's current access limits provide the appropriate basis for guiding IMF lending to member countries. Strict controls are needed on IMF lending to mitigate moral hazard, preserve the Fund's catalytic role, and provide the incentives for countries to undertake strong reform efforts, which are essential for ensuring that drawings from the IMF are repaid.

It is unrealistic and undesirable to hold out the prospect of IMF lending at a level equivalent, for example, to one year of a member government's tax revenues. Such a credit limit would dramatically increase the level of Fund financing to qualifying countries, resulting in very large bailout packages that would surpass the financial capacity of the IMF and increase moral hazard. For instance, Brazil's annual tax revenue is approximately \$139 billion, many times the amount of its quota in the IMF (\$4.5 billion) as well as its most recent Fund program (\$14.5 billion).

### **Elimination of IMF Concessional Lending**

*The Commission recommends that the IMF's concessional lending instrument, the Poverty Reduction and Growth Facility (PRGF), be closed. Further, the Commission suggests that long-term assistance to foster development and encourage sound economic policies should be the responsibility of the reconstructed World Bank or the regional development banks.*

In our view, this recommendation is neither desirable nor feasible. The recommendation rests on the premise that the IMF is not well-suited to carry out a concessional lending role, has not done so effectively, and that the multilateral development banks (MDBs), in particular the regional development banks, would do a better job. This premise and the Commission's recommendation are not well-grounded, on several counts.

First, one of the clearest lessons of development experience is that economic growth is critical to poverty reduction, and that sound macroeconomic policies are critical to growth. Growth is the necessary basis for generating resources for investment in primary education, health care, rural infrastructure, and other areas critical to poverty reduction. A strong macroeconomic policy environment – one that, for example, supports currency stability and keeps inflation in check – is essential if a country is to avoid capital flight, make effective use of development assistance, and lay a durable foundation for broad-based growth and poverty reduction. Helping countries set up appropriate macroeconomic frameworks is the IMF's particular expertise and is not an area of competence or experience for the MDBs. While the IMF is by no means infallible, there is simply no other institution with the technical expertise to design the essential and highly specialized policy conditions that the Fund provides in this area.

Second, the Commission's suggestion that the Fund could be effective in providing macroeconomic advice through its Article IV consultations, but no financing to accompany such advice is, in our view, wholly unrealistic. Development experience suggests that, while financing is no guarantee of success, countries needing to take challenging, sometimes politically difficult measures are unlikely to show the same degree of attention and receptivity if IMF policy advice comes without any financial underpinnings.

Third, it is important to recognize that the IMF's concessional lending activities are financed by bilateral contributions of member countries in addition to and separate from contributions in the form of IMF quotas. Those activities are largely financed by other member countries, and they will have a proportionately greater voice in deciding how these resources are used. Currently, there is a strong consensus among the Fund's membership that concessional lending should continue, partly for the reasons noted above, but also based on the view that IMF financing should be available to all its members, and that the Fund's poorest members cannot afford financing on non-concessional terms.

All of this said, we do believe that the IMF's role in this area needs to change significantly. The recently created PRGF, the successor to the IMF's Enhanced Structural Adjustment Facility (ESAF), represents an important shift in Fund operations in poor countries. Under this approach, there is to be a clearer division of labor between the World Bank and the IMF, with the Bank taking the lead in providing advice on the design of growth-enhancing national poverty reduction

strategies and structural reforms, while the Fund will focus on promoting sound macroeconomic policy and structural reforms in related areas, such as tax policy and fiscal management. This division of labor should be accompanied by a streamlining of conditionality to avoid overlap and promote coherence. It is expected that both institutions will focus on a smaller number of clear performance targets that are aimed at maximum poverty impact, are set realistically, and are then more rigorously adhered to.

### **No Future Quota Increases; Private Market Borrowing in a Crisis**

*The Commission recommends against further quota increases for the foreseeable future, and that, in the event of a crisis, the Fund should borrow as needed either from the private sector or from credit lines of member countries.*

While it is difficult to predict the future with confidence, we agree that the IMF's liquidity position is comfortable currently, and we do not see a need for a quota increase in the near future. As of March 2000, the IMF had \$289 billion in total resources, of which \$138 billion was usable. (The remaining \$161 billion is currently in the form of existing loans and currency holdings of countries with weak currencies.) In light of the Fund's comfortable liquidity position, we consider the first part of this recommendation, counseling against a quota increase for the foreseeable future, to be both desirable and feasible.

We agree that the Fund should be able to borrow from credit lines of member countries in appropriate circumstances. This possibility is already provided for by the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). The GAB and the NAB are arrangements between the IMF and a number of member countries and institutions under which supplementary resources can be provided to the IMF. Eleven industrial countries participate in the GAB, which was created in 1962. Twenty-five countries and institutions participate in the NAB, created in 1998. The total amount of resources available to the IMF under the NAB and GAB combined is SDR 34 billion, about \$46 billion.

While the Fund under its Articles of Agreement has the authority to borrow from private markets, the IMF's membership has not taken advantage of this authority for two principal reasons. First, it is not clear that the IMF could raise substantial amounts of money from the markets without compromising its members' financial claims on the institution. For the IMF to borrow at AAA rates, its members may have to back such borrowings with their currency subscriptions, similar to the way that callable capital of World Bank members backs up borrowings by the Bank. This would involve a fundamental change in the IMF's financial relationship with its members. (To the extent that borrowings need to be backed by currency subscriptions, those subscriptions would be impaired.)

Second, we think that it is necessary and appropriate for members to exercise close oversight over the financial resources and operations of the Fund. The quota increase mechanism provides an effective means for such oversight.

### **Article IV Consultations**

*The Commission recommends that OECD members be allowed to opt out of Article IV consultations, though all other IMF members would be required to participate. The Commission further recommends that all Article IV reports be published promptly.*

We agree that Article IV reports should be published promptly and have actively advocated this position in the Fund as part of our broader efforts to increase transparency. Towards this end, the United States led the effort to set up a pilot program for the publication of countries' Article IV staff reports. Under this program, 29 countries, including the United States, have now made public the staff reports prepared as part of the Article IV surveillance process. Nearly 20 additional countries have agreed to release their staff reports in the future.

We do not think it is desirable, however, to allow OECD countries to opt out of the Article IV process. Their participation underscores the reality that all IMF members play a part in the international monetary system, and reinforces the universal nature of the Fund. The health of industrialized country economies in particular is critical to the system. The United States sees the Article IV process as an important vehicle for encouraging needed adjustment and reform in industrialized countries no less than in emerging market economies or developing countries. A number of OECD countries (e.g., Mexico, Korea and Turkey) are emerging market economies whose health is important to regional/international stability, and are, in some cases, users of IMF resources. Allowing them to opt out of the Article IV process would undermine the important ongoing efforts to make the process a more effective vehicle for avoiding financial crises, and would put the Fund in the imprudent position of providing financing to countries that are not part of its surveillance activities.

### **Transparency in IMF Accounting**

*The Commission recommends a variety of steps to improve transparency in IMF accounting – broadly that the IMF's accounting system be simplified and reformed to mimic standard accounting procedures for representing assets and liabilities and income and expenses. The Commission also suggests that the IMF's SDR accounts be incorporated into the IMF's overall accounts so as to obtain "an accurate view of net providers and users of subsidized funding."*

We believe that the recommendation to improve transparency in IMF accounting is desirable and feasible. We agree that the IMF accounts should be as transparent and understandable as possible and that there is scope for progress in this area, while bearing in mind that the accounts reflect complexities in the nature of the Fund's financing and operations.



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Although there is more to be done in this area, a number of steps have been taken with the strong backing of the United States to enhance information available about the IMF's financial position.

- Most recently, a decision was taken to publish quarterly details on the financing of the Fund's operations by members – the “Financial Transactions Plan” (formerly known as the operational budget). The Financial Transactions Plan will provide information about the IMF's holdings of individual countries' currencies considered useful as a funding resource (i.e., those members considered financially strong enough to support the extension of Fund credits).
- The Fund already posts a wide range of financial information on its web site. This includes: a weekly update of its financial activities, monthly information on its liquidity position and the resources available for lending, up-to-date information about Fund credit outstanding, and extensive country-specific data on transactions with its members, including loans, loan disbursements and repayments. The aggregate amount of Fund lending is already clearly labeled as financial assistance in the “IMF Financial Activities” report, which is updated weekly. The list of individual loans outstanding indicates the date the arrangement was approved and the date it expires.<sup>1</sup>
- Annual audited financial statements which have traditionally been included in IMF Annual Reports are now also published on the Fund's website along with quarterly financial statements. Financial statements are prepared in accordance with generally accepted accounting principles and are accompanied by detailed explanatory footnotes. For the first time this year, the Fund's financial statements for the latest financial year (May 1, 1999 to April 30, 2000) will be prepared in accordance with internationally accepted accounting standards; they will also be published (per established practice) in the IMF's annual report and on the public web site.

Regarding the recommendation to incorporate the SDR accounts into the Fund's general accounts, given the very different nature and purposes of the Fund's general resources (i.e., quota-based) and SDR resources, we think there is merit in having distinct accounts for the two, and note that a change to this practice would require an amendment to the IMF Articles of Agreement. We are prepared, though, to explore whether there is some presentational advantage in showing a country's net use of SDRs.<sup>2</sup> Indeed, it is our understanding that the new financial statements noted above are expected to specifically identify net use and holdings of SDRs, as well as credit outstanding, usable and non-usable currency assets, liquid claims on the Fund, and a cash flow statement.

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<sup>1</sup> All Stand-by Arrangements must be repaid within 5 years of the date of expiration; Extended Arrangements must be repaid within 10 years; and ESAF/PRGF arrangements must be repaid within 10 years.

<sup>2</sup> The IMF publication International Financial Statistics includes a table providing data on each member country's position (and the membership as a whole) with respect to use of IMF credit and SDRs. What is not provided is a separate column showing a country's net use of SDRs, though this can easily be derived from the data provided by subtracting a country's net cumulative allocation of SDRs from current holdings of SDRs.

**Repayment Obligations: IMF Priority; Negative Pledge;  
Ineligibility in the Event of Default**

*The Commission recommends that the IMF be given priority over all other creditors, that members exempt the IMF from application of negative pledge clauses, and that member countries that default on IMF debts not be eligible for financing from other multilateral agencies or member countries.*

These recommendations are already largely reflected in the way that IMF financing is provided. At present, the IMF, as a *de facto* preferred creditor, already enjoys priority status with regard to other creditors. As for exempting the IMF from negative pledge clauses, the Commission itself notes that the IMF is frequently exempted from the operation of such clauses and that other approaches are available, even absent an explicit exemption, to permit the IMF to enforce its repayment rights.

Regarding the proposal to suspend eligibility for other IFI financing if a country is in arrears to the IMF, generally this is already the case. However, we recognize that there may be cases requiring special consideration, such as during workouts, humanitarian crises, or certain post-conflict situations where lending would clearly advance our national interests.

## **Response to the Recommendations on Reform of the Multilateral Development Banks**

### **Limits on MDB assistance**

*The Commission recommends phasing out MDB lending to countries with annual per capita incomes above \$4,000 or an investment grade international bond rating and sharply limiting assistance to countries with annual per capita incomes above \$2,500.*

We do not support a rigid eligibility cutoff based solely on these criteria, as it is neither desirable nor feasible.

The Commission's recommendation rests on the assumption that a country's potential access to private markets at some level automatically translates into an availability of private finance at the rates, maturities and volumes appropriate for the full range of purposes necessary to lay the basis for sustained growth and poverty reduction. This is clearly not the case. Even relatively productive emerging markets face severe limitations in the volume of private capital that is reliably available for long-term development investments with the medium to longer-term maturities that are necessary. Moreover, the private capital that is available comes with interest rates that are prohibitive for development programs. These market limitations are of particular importance with respect to the availability of support for development programs such as policy-based sector reforms.

If the Commission's recommendations were applied as written, countries as diverse as Brazil, Indonesia, Turkey, and South Africa – where important, long-term U.S. strategic and economic interests are clearly at stake -- would be denied access to MDB assistance. If these recommendations were applied today, the World Bank and regional development banks would be effectively precluded from lending of any kind, in any circumstances. These countries currently absorb fully one-third of U.S. exports, a share that has risen markedly over the past decade. Moreover, they are home to a substantial share of the world's poor. For example, more than 36 percent of the population of Latin America lives on less than \$2 per day. Graduation policies designed with a fixed and excessively low threshold risk worsening economic outcomes in these countries and increasing the risk of future crises. This could undercut or prolong the path to sustainable market access, and ultimately delay the time when these governments will grow out of the need for official support.

We believe MDB support for emerging market economies needs to be more selective and focused on areas where it can increase their overall capacity to access private capital resources on a more durable basis. MDBs should emphasize lending to:

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- promote key public investments, particularly for the public goods that will not be adequately supplied by private markets;
- attract additional private capital flows, by among other things, reducing obstacles to private investment; and
- counteract temporary disruptions in access to private external capital.

Accordingly, we believe that the MDBs should:

- have a strong presumption against lending where private finance is available on appropriate terms;
- reduce the share and volume of their lending to emerging economies over time, with complete graduation as a clear objective; and
- use their loan pricing flexibility more systematically to encourage graduation.

### Severely Curtail Direct MDB Support for the Private Sector

*The Commission recommends eliminating direct MDB loan and equity investments in the private sector, closing the IFC, and limiting future support for technical assistance and the dissemination of best practices standards. The Commission would also eliminate the Multilateral Investment Guarantee Agency, which provides political risk insurance to private investors.*

We do not support eliminating the private-sector focussed operations of the MDBs or halting MDB lending, guarantees, or insurance for private sector investors.

The Commission's recommendation is premised on a view that the public benefits (even in poor countries) resulting from official credit for private-sector entities are not necessary, and that official credits crowd out private investors. We believe this view ignores some important realities:

- capital markets are imperfect and the presence of private sector investment opportunities does not mean, *ipso facto*, that they will be financed;
- private capital does not flow to risky countries in the volume and for the purposes necessary to stimulate enduring and equitable growth;
- direct MDB engagement with the private sector has been an instrument for wider private sector development reforms; and
- limited MDB lending to the private sector has catalyzed many times its amount in new and additional private flows.

We believe that U.S. interests and the realities of developing country and emerging market finance fully justify carefully focussed MDB support for private sector operations:

- medium and long-term domestic finance is virtually unavailable for many sectors/projects in most of the world's countries;

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- private finance can be extremely susceptible to short-term disruption;
- private sector finance for properly structured enclave investments in the poorest countries can yield substantial social benefits;
- modest amounts of MDB finance can privatize state-owned enterprises, providing both social gains and new opportunities for subsequent private investment;
- despite liberalization and reform during the 1990's, emerging market risk remains unacceptably high, and project returns too low, for most private investors and lenders; and
- despite substantial progress in reforming the overall investment climate, uneven emerging market accounting practices and investment regulation still present substantial challenges to financial due diligence in these areas which further discourages long-term domestic lending.

Transactional finance from MDB private sector operations is an integral component of the MDBs' broader sector restructuring and policy reform efforts in virtually every country in which the MDBs are active. Given the real obstacles that still exist to long-term emerging market lending and investment, MDB private sector operations are making important and clear contributions to create new opportunities for investment, reduce risk and volatility, and increase access to capital. In particular, the private sector windows play the following vital roles:

- **Investment Climate Development** by promoting sound economic policies, divestiture of state-owned enterprises, capital market development, investment rules and protection, and free flow of capital;
- **Risk Mitigation** through innovative co-financing and guarantee arrangements, application of performance clauses to government partners, and early due diligence; and
- **Market Access Facilitation** by restoring investor confidence in crisis times by investing in those disrupted emerging markets with sound economic and investment climate fundamentals.

The MDB private sector windows have been instrumental in catalyzing the additional private funding, and the private sector development more broadly, which would not otherwise have occurred given the realities of developing country finance. Given the risk of crowding out private finance, direct MDB support for the private sector must be provided very selectively and with great care. There would be no compelling case for involvement by the MDBs in the private sector if all they brought to the table was cheaper finance.

### **Shift World Bank Operations to Regional Development Banks**

*The Commission recommends eliminating World Bank operations in Latin America and Asia.*

We do not support the Commission's recommendation to restrict lending in these regions to the regional development banks.

The World Bank's global focus and unparalleled cross-regional experience represent an enormously valuable asset to developing countries in all of the regions, and to the shareholder community more broadly. In an increasingly integrated world economy, we believe that the

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World Bank should be at the center of the global effort to develop and deliver core program lending and targeted project finance aimed at building and supporting the institutions of development and poverty reduction. The location, shareholding structure, and operational experience of regional banks are also important assets, but in general they are not able to match the technical resources of the World Bank. Indeed, knowledge transfer across regions is an intrinsic asset of the World Bank. We believe that our multiple interests are best served by working to ensure that each MDB brings its particular expertise, including its unique regional perspective, to bear whenever appropriate, while playing a clearly subsidiary role where others are better positioned to bring maximum value.

We fully agree that increasing cooperation among the MDBs, sharpening their areas of comparative advantage, and reducing operational overlaps would increase the system's overall development effectiveness and should be pursued as a matter of priority. It makes little sense for the regional development banks or, indeed, the World Bank, to build and maintain a capacity to undertake every kind of activity relevant to development in every country in which they could play a role. Responsibility for certain kinds of project lending should more often shift to the regional development banks, where they have proven expertise. We have been working aggressively to give these views concrete expression in the form of formal Memoranda of Understanding between the World Bank and the regional banks that articulate a division of labor reflecting comparative advantage and selectivity. In addition to these MOUs, the Country Assistance Strategies (CASs) are continuing to address the appropriate division of labor in borrowing member countries. The World Bank and IFC produce joint CASs designed to maximize Bank Group synergies in promoting private sector development.

As part of the process of improving institutional focus and specialization across the system, the World Bank will need to deliver on its commitment to accept a more coordinating or supporting role with respect to other agencies. For example, other agencies and bilateral donors that often work closely with NGOs often have a clear comparative advantage in the area of humanitarian assistance in post-conflict situations.

### **Transfer World Bank callable capital to regional development banks**

*The Commission recommends transferring a portion of the World Bank's callable capital to the regional development banks and reducing or reprogramming the remainder in line with a declining portfolio balance.*

The Commission recommends a significant reduction in World Bank non-concessional lending in order to free up callable capital that could then be reprogrammed to support Bank assistance for other purposes, or transferred to the regional development banks. We do not believe the Commission's proposals in this respect are either desirable or feasible. Specifically, we do not support the sharp reduction in World Bank lending capacity proposed by the Commission for the short-run, nor do we believe its proposals are workable legally or attainable politically.

Shareholder capital in the MDBs has two components: paid-in and callable. **Paid-in capital** is the amount of funding that countries actually transfer to the institutions to support their market-based lending operations. **Callable capital** is funding that shareholder countries have formally agreed to make available on a contingency basis in the event that the bank is not able to meet its

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liabilities. Callable capital therefore represents the contractual commitment of shareholders such as the United States. Paid-in capital is typically a fraction of the total capital of a bank. For example, for the IDB's seventh capital increase in 1995, paid-in capital represented only 2.5% of the total capital increase. The Banks issue bonds against their assets, including the paid-in capital and the callable capital of investment grade shareholders (primarily the industrialized countries) and use the proceeds to provide loans for development projects.

The Commission does not appear to have taken into account a number of major legal and financial issues that would be direct obstacles to the callable capital transfers/reassignments it is recommending. The World Bank is one of the global capital market's largest borrowers and is widely viewed as one of its strongest. The Bank currently has about \$116 billion of publicly-held bonds outstanding that have been issued against its callable capital. A transfer of this underlying asset would be fundamentally inconsistent with the terms and conditions on which these bonds were issued; there is a real risk that it could be potentially disruptive to the market, and it would clearly raise a host of highly complex legal and contractual issues. Beyond this, the World Bank's 181 member governments have specifically given callable capital commitments to specific institutions, typically through a complex legal and legislative process. Any material changes to these specific commitments would require most (perhaps all) of the shareholders to return to their own legislatures for the necessary approvals and amendments.

Apart from the major technical obstacles to a callable capital transfer of the kind recommended by the Commission, any such transfer would need to gain a level of international support that is highly unlikely. Specifically, it may require amendment of the Articles of Agreement of each of the affected institutions, which would require at least a 75 percent majority vote of the shareholders.

### **Eliminate MDB Role in Mitigating Financial Crisis**

*The Commission recommends that the MDBs should be precluded from financial crisis lending.*

We do not support precluding the development banks from financial crisis lending.

While we agree that MDB financial crisis lending should be limited to exceptional cases, we also believe that direct MDB support in crises can be critical to the success of recovery programs by helping to minimize long-term damage, sustaining and restoring development momentum, and contributing to intensified economic reform and restructuring. We view the MDBs as particularly well-positioned to provide significant value added in the effort to:

- avoid unnecessary fiscal contractions in fiscal expenditures;
- restructure banking and other financial institutions; and
- minimize the adverse impact of the crisis on the poor by, for example, strengthening social safety nets.

The upsurge in MDB "crisis" lending in the late 1990s, most of which was provided on shorter maturities and higher rates, was appropriate in the context of the acute and generalized reduction of private capital flows to emerging economies. The risks were high. However, the economic

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results that have emerged – in terms of helping to put in place fundamental reforms needed to restore private sector confidence – have been broadly positive. A large measure of economic and financial stability has been restored and economic growth prospects are now far better than would otherwise have been expected.

MDB intervention was achieved without any additional budgetary costs for MDB member governments. Moreover, it is our view that the existing capital base of the three largest MDB hard loan windows (the IBRD, IDB, and ADB) is sufficient to maintain a cushion in lending capacity that would enable these institutions to respond quickly with a substantial, but temporary, expansion of lending if justified by a future adverse shift in global financial conditions.

While MDB hard-loan lending rose sharply to help members deal with the recent financial crisis, it has now returned to levels more consistent with, and in the case of the IBRD well below, the pattern of pre-crisis lending.

The long-term pre-crisis trend shows that annual MDB hard-loan window lending has been relatively steady in both the IDB and ADB, and actually declining in the IBRD despite the addition of nineteen new member countries in Eastern European and the former Soviet Union.

### **Replace MDB Loans with Grants**

*The Commission recommends that MDB support for physical infrastructure and social service projects in the poorest countries be provided through grants rather than loans and guarantees.*

If implemented as proposed, this recommendation would limit the overall availability of financial assistance to the poorest. Moreover, we believe that moving to an all-grant system would have negative long-term financial implications for the institutions and their shareholders. Over time, the effect would be to eliminate the reflows that derive from concessional loans (mainly repayments of principal) and that currently fund a substantial portion of the institutions' new concessional loan commitments. Individual donors rely, almost invariably by law, on annual legislative allocations of funding to support MDB operations in the poorest countries (i.e., concessional loans for the most part). They cannot provide the long-term guarantee of future resources that the Commission's grant-based approach would require.

The lending terms of all four MDB soft-loan windows are already highly concessional; e.g., IDA credits have a grant element of about 70 percent at current interest rates. The World Bank also provides selective grants for research and other global public goods, HIPC debt relief, and to spur development in post-conflict countries. The IDB also provides some targeted grant funding.

The current approach of relying largely on highly concessional credits covers the administrative costs of lending. It has two other advantages that would be lost under an all-grant approach.

- Over time, repayments on past credits play a major role in funding new credits that would have to be offset by donors to maintain the level of new commitments. For example, reflows will finance over 38 percent of IDA-12 lending – the most recent replenishment of IDA resources. This recycling of IDA repayments into new lending favors the poorest countries



in that the more advanced former and current recipients of IDA now account for roughly one-half of current reflows.

- The reality that credits must eventually be repaid helps to build financial discipline and debt management skills in borrowing countries. It also provides an added incentive to ensure that borrowed funds are used selectively and wisely.

We do believe there is scope for greater differentiation of soft-loan lending terms among the poorest countries, providing the very poorest and least creditworthy borrowers with the highest degree of concessionality. It is important to ensure that the stock of highly concessional debt is accumulated and managed in a way that minimizes the prospect of future debt servicing problems. We believe there is positive value in maintaining the lending approach of the MDBs and consequently, we do not believe it is desirable to redesignate them as “Agencies”.

### **Make Payments Directly to Service Suppliers**

*The Commission recommends that “poverty reduction grants” to eligible countries (poor countries lacking capital market access) be paid directly to service providers after there is independently verified delivery of service.*

We fully share the Commission’s underlying objective to improve the efficiency and effectiveness of development assistance, to minimize the scope for corruption, and to link MDB support systematically to solid performance by service providers. But while the specific approach proposed by the Commission might be appropriate in some individual circumstances, we do not believe it practical to institute this approach as standard practice.

Most social sector development operations have a much broader focus and scope than providing a discrete and easily quantifiable service. In fact, many require a series of concerted actions over a period of many years, and with sustained and extensive government involvement. For example, a rural school or health clinic could well (and we would argue often should) be built by an independent contractor. But the longer-term viability of the school, and therefore whether it actually delivers the development benefits that are intended, requires regular government involvement and support through the budget process.

We are also concerned that the proposal could:

- undermine the basic objective of building local capacity to implement projects effectively, including the need to improve the quality and performance of the government institutions involved, and to build transparent procurement systems;
- reduce private sector and civil society interest in bidding for selection as a service provider; the built-in payment delays specified by the Commission’s proposal would likely be a disincentive to smaller private firms and NGOs, who would need to seek interim financing that could well be in short supply; and
- increase the cost of projects, because of additional risks associated with bridge financing requirements, the additional costs of the independent verification process, and the potential additional costs of outsourcing core services.

### **Establish Institutional Reform Loans to Support Policy Reform**

*The Commission endorses direct MDB loan support for institution building and policy reform, and recommends a specific lending instrument whose terms and conditions differ substantially from existing MDB instruments designed for this purpose.*

While the Commission's proposal incorporates a number of basic principles and objectives with which we are in fundamental agreement, the specific financing instrument the Commission proposes is unlikely to be a particularly attractive device, compared to existing instruments, for encouraging good performance.

For example, the proposed "Institutional Reform" loan program would be based on full amortization of principal and an interest subsidy of between 10-90%. Terms of the loan could be adjusted over the life of the loan to reflect good or poor project execution. It could be, however, counterproductive to increase loan charges when a country is experiencing difficulty delivering on its reform program. That may be the time when it needs the most help servicing its debt.

Notwithstanding these technical difficulties, we share the Commission's basic presumptions in most significant respects. Specifically, we welcome the Commission's:

- endorsement of direct MDB assistance to help build the core public institutions and promote the basic policy reforms necessary for equitable economic growth and sustained development;
- strong agreement that objective and consistent assessments of borrower performance should directly guide MDB lending choices;
- conviction that MDB instruments and operations need to incorporate, in a more effective manner, clear and monitorable performance benchmarks and strong incentives for achieving them; and
- belief that monitoring of compliance with these conditions should be fully transparent.

These views have been the basis for much of our reform advocacy in the MDBs during the past five years, and they have directly shaped much of what has been achieved. All of the institutions are focussing both lending and analytical work much more heavily on building institutional capacity in borrowing countries, and on identifying and supporting the core policy reforms necessary to create a favorable climate for market-driven growth and development. New loans are building in more specific monitoring criteria, are being disbursed in tranches on the basis of monitorable performance on agreed conditions, and are being directed intensively toward countries that are moving demonstrably ahead with these reforms and using assistance effectively. In particular, the World Bank, African Development Bank and the Inter-American Development Bank have adopted detailed criteria for assessing performance and are allocating all new concessional lending on that basis. We are presently working toward a similar system at the Asian Development Bank. And finally, the aggressive transparency agenda we have pursued with great success in all of the institutions has opened them up to a degree of independent public scrutiny and quality control that can only improve their effectiveness.

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In our view, these steps build in much of the additional clarity, accountability and performance incentives that the Commission rightly seeks. That said, there is still room for additional progress, and we would welcome additional views on how this might be achieved most effectively.

### **The World Bank Should Concentrate on the Production of Global Public Goods**

*The Commission recommends that the World Bank concentrate on the production of global goods and serve as a centralized resource for regional banks.*

We support the Commission's desire for increased focus by the World Bank on the production of global public goods, including serving as a center for technical assistance to the regional development banks. However, we view this as complementing, rather than replacing, the Bank's other development priorities for addressing poverty reduction.

We believe that the World Bank and other development institutions have the potential to significantly expand their efforts to promote global public goods and can make an enormous contribution in helping to push the frontier of international collaborative efforts in this area. Regional MDBs should continue to emphasize regional projects that address cross-country concerns. Examples such as the Consultative Group on International Agricultural Research (CGIAR), the Green Revolution, and the onchocerciasis control program for river blindness in Africa all demonstrate that innovative collaboration among the World Bank and other official bodies delivers results. We believe that regional development banks also should continue to increase their emphasis on developing regional approaches to regional development issues.

The World Bank and the regional development banks already provide significant support for global public goods. For example, the World Bank has committed almost \$1 billion to more than 81 HIV/AIDS-related projects in 51 countries and last year created a strategy to intensify its actions in this area in collaboration with the Joint United Nations Program on HIV/AIDS, which the Bank co-sponsored. The African Development Bank and the Inter-American Development Bank are also lending for HIV/AIDS programs, but on a much smaller scale. The World Bank is also boosting its support for expanded childhood immunization and looking into new incentives to stimulate development of vaccines against key infectious killers in poor countries – AIDS, malaria, and TB. In addition, the World Bank provides annual grants (currently \$125 million) out of its regular administrative budget for its Development Grant Facility (DGF). The DGF works in partnership with other development organizations in supporting development research (e.g., CGIAR) and other priority public goods, including seed money, for innovative, high risk, high return activities for which lending is not appropriate.

### **Increased U.S. Support for Poverty Reduction Programs**

*The Commission proposes that the United States should significantly increase its support of effective programs to reduce poverty.*

We welcome the Commission's focus on the critical importance of reducing poverty and fully support this recommendation of the Commission.

The United States provides substantially less official development assistance (ODA) as a share of GNP than any other developed country. The 1998 U.S. ODA/GNP ratio of 0.10 percent was less than one-half the 0.24 percent ratio recorded by all twenty-one members of the OECD's Development Assistance Committee. The United States ranked twentieth in the level of ODA we provided by per capita (\$32.65).

The level of U.S. development assistance appropriated annually has been consistently less than the Administration's total request.

The Administration has substantially redirected the financial support we are providing to the MDBs in favor of the soft-loan windows and the highly concessional assistance they provide for the world's poorest countries. Funding for the soft-loan windows (including the Global Environment Fund) account for over 88 percent of the Administration's FY 2001 Request for the MDBs. We have also publicly stated that we do not believe it is realistic for the hard-loan windows to expect any new capital increases.

We also continue to accord priority attention to the issue of how MDB resources are deployed by working with MDB management and members to improve the MDBs' effectiveness in reducing poverty. Our efforts center on such crucial issues as: greater lending selectivity, including allocations based on borrower performance; intensified support for social sector investments and public goods; sharper focus on institutional and policy obstacles to equitable, market-based growth; increased transparency and accountability within the institutions themselves; and improved collaboration with other institutions and interested parties.

The Administration's request for almost \$920 million in support of the HIPC Initiative between FY 2000 and FY 2003 is another important demonstration of our commitment to work with our development partners to enhance our assistance to the poorest countries that are committed to sound policies in their efforts to reduce poverty. We are also seeking Congressional approval of a substantial increase in our bilateral funding to help the poorest countries deal with HIV/AIDS and other infectious diseases.

**Box 1: Assessing the Commission's Negative Assessment of MDB Successes**

*Overview of the Commission's critique of the World Bank OED Measurement of Success*

The World Bank's Operations and Evaluation Department (OED) is an independent unit of the World Bank that reports directly to the Executive Board. It uses best practice standards and is internationally respected for the quality of its work. The indicator used by the Commission is not an accurate measure of the success or failure of Bank projects, and the Commission combines categories to present an overly negative picture of the actual success rate.

The appropriate measure for the success of Bank projects is the OED outcome indicator. This reports whether Bank projects are likely to achieve both their development objectives and at least a 10% rate of return. The outcome indicator takes into consideration all available information regarding actual costs and benefits known at the time of evaluation as well as expected net benefits over the remainder of the project's intended life. By this measurement, 72% of projects completed, and 81% of the dollars lent, in FY98-99 had satisfactory outcomes. This shows a marked improvement over the 65% of projects completed, and 73% of dollars lent between FY92-94, rated satisfactory.

The Commission focuses on OED's sustainability rating. This identifies projects that require close attention by borrowing governments and the Bank to manage risks that may affect the net benefits expected after the time of evaluation. In this regard, it is not a measure of success or failure, but rather a "red-flag" for projects requiring extra oversight and vigilance due to factors such as country commitment to reform, country economic and financial policies, availability of funds for operations and maintenance, institutional capacity, and political situation. The sustainability assessment rates projects as likely, uncertain or unlikely to be resilient to future risk.

OED's 1999 Annual Review of Development Effectiveness (available on the Bank's web site) showed that the share of projects with "unlikely sustainability" is declining. The share has decreased from 19% for FY90-93 to 14% in FY98-99. Weighted according to disbursements, the share has fallen from 14% to 6%. The Commission lumped into this category any project whose sustainability was now unknown (e.g. a brand new project) to create a negative picture. A 14% rating should not be too surprising, since much of the Bank's lending is for complex poverty reduction sectors in low-income and low-capacity countries.

Similarly, it is not surprising that the likelihood of success and sustainability increases with the income of the borrowing country. This reflects the greater institutional capacity, performance and more advanced stage of development of higher income borrowers. For Africa, the rate is 61%, compared to 83% for Europe and Central Asia. Poorer countries have higher levels of risk since they face the most formidable development challenges and have weak human and institutional capacity.

Nevertheless, we believe that the success rate can be improved, and we have been a strong supporter of Bank reforms that better incorporate OED evaluations into ongoing and prospective Bank lending programs.

## **Box 2: Financial Accounting and the MDBs**

### Cost of Participating in the MDBs

The Commission Report claims, using hypothetical models, that the annual cost to governments of participating in the MDBs is \$22 billion, of which it estimates the U.S. share at \$5.5 billion. In the real world of congressional budgets, U.S. scheduled commitments for the MDBs averaged \$1.2 billion per year between 1995 and 1999, \$700 million less than the level in 1996. The report fails to note that the MDBs leverage our participation a great deal. Every \$1 we contributed between 1995 and 1999 generated \$60 of development assistance.

The Report implies that the current US scoring methodology systematically underestimates the real costs of participating in the MDBs because it does not explicitly include additional charges for opportunity costs or forgone earnings on the paid-in capital, soft-window contributions and retained earnings of the MDBs. In addition, the Report assigns as a “cost” the risk that the callable capital pledged by governments may be called.

The Report’s approach contradicts longstanding CBO and OMB practice on scoring US government expenditures. When Congress appropriates funds for any purpose, for example to build a highway, it would be unreasonable to assert that a future budget “cost” of this one year of funding is seven percent (the rate used in the Report) year after year. Using this logic, a \$100 million appropriation in 1950 to build a road, would have a cumulative annual “cost” to the American taxpayer of \$350 million in 2000 (7 percent of \$100 million over 50 years). The real cost of the project is the amount of funds actually provided by Congress in 1950, not an ever-increasing accumulation of opportunity costs.

As the Report briefly acknowledges, there has never been a call on capital for any of the MDBs. Further, equity available to the MDBs to cover “problem” loans is several multiples greater than that held by commercial banks. Therefore, CBO and OMB practice for 50 years has been to not assign a budget outlay for callable capital. We believe that the current accounting approach for the cost of MDBs is accurate and appropriate.

### Subsidy

The Report states that both market-based and concessional loans confer a subsidy to borrowers. By design, the concessional loans are highly subsidized (i.e., the grant element of IDA loans is now about 70%). This provides a substantial benefit to the poorest countries and is the reason the soft windows of the MDBs were created.

Hard window loan rates are set typically well below the rate at which most countries can borrow in the private markets. They also are set high enough, however, for the MDBs to cover their administrative costs, provide adequate reserves and, in the case of the World Bank, for example, contribute grant finance for global development priorities such as IDA, the Trust Fund for Gaza and the West Bank, HIPC, etc.

This subsidy has **no cost** to donor governments beyond appropriated contributions to the hard and soft windows. With respect to the hard loan windows, the preferred creditor status of the MDBs enables them to raise funds at low rates in the capital markets and on-lend to borrowing members. However, we believe that the pricing of the hard windows should be evaluated to reduce incentive for emerging market countries to rely on official financing when it is available on appropriate terms.

## **Debt Reduction for the Heavily Indebted Poor Countries**

*The Commission recommends 100 percent debt reduction by the IFIs and by bilateral creditors for the heavily indebted poor countries (HIPCs).*

### **100 Percent Debt Reduction by Bilateral Creditors**

The Commission recommends that bilateral creditors, such as the U.S. Government, should extend full debt write-offs to those HIPC countries that pursue effective economic development strategies. We support this recommendation. In the context of the internationally agreed enhanced HIPC initiative, we are forgiving 100% of the debt owed to the United States by countries that qualify for HIPC debt reduction. This will result in the elimination of more than \$3.7 billion in debt owed by the world's poorest countries. We have encouraged other official bilateral creditors to take similar actions.

### **100 Percent Debt Reduction by the IFIs**

The Commission recommends that the International Monetary Fund, the World Bank, and the regional development banks write off in their entirety all claims against those HIPC countries that implement effective economic and social development strategies in conjunction with the World Bank and the regional development banks. Although we share the Commission's goal of substantial debt relief for HIPC countries committed to economic reform and poverty reduction, we do not support a complete write-off of IFI debt.

Substantial debt reduction for the poorest countries is a priority of the Administration. In 1996 we led the development of the first comprehensive HIPC initiative. Last year we worked to strengthen the initiative to provide deeper, broader, and faster debt relief for these countries. The enhanced HIPC initiative also makes an explicit link between debt relief and poverty reduction as the countries commit to using the resources freed by debt relief to address critical social needs and promote broad-based growth.

The HIPC initiative was never intended as a panacea for the myriad development challenges of HIPC countries or as a replacement for ongoing donor support. Rather, debt relief "should be seen as an integral part of the broader development agenda, and integrated into an overall strategy of poverty reduction."<sup>3</sup> Enhanced HIPC relief provides countries the opportunity to concentrate on productive investments related to poverty reduction rather than on servicing old debt.

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<sup>3</sup> The HIPC Initiative: Delivering Debt Relief to Poor Countries, World Bank and IMF, February 1999.

The Costs of 100 Percent Debt Reduction

The United States and other nations have worked extensively to reach agreement on a comprehensive approach to addressing the debt problems of the HIPCs. Given that the HIPCs will continue to need substantial amounts of external assistance to finance future development, there has been a strong effort in designing the enhanced HIPC initiative to ensure that the financial costs of debt relief to the IFIs do not undercut their capacity to provide new assistance.

As shown in the table below, under the enhanced HIPC initiative the total cost of debt relief to the IFIs will be about \$14 billion. Financing the initiative poses a substantial challenge for the international community; even after the IFIs maximize the use of their internal resources, bilateral donor contributions of at least net present value (NPV) \$3.6 billion will be required to cover the full costs of IFI participation in the initiative.<sup>4</sup>

In order to completely eliminate HIPC debt, costs for the IFIs would rise dramatically, to roughly NPV\$43 billion. It is not realistic to expect that the IFIs and bilateral creditors would be able to finance these additional costs.

**Box 3: Cost of Debt Reduction: 100% Commission Plan vs. Current Plan**

*US\$ billion NPV, at end-December 1998*

<b>Institution</b>	<b>100% Reduction</b>	<b>Current Plan</b>	<b>Difference</b>
<i>World Bank Group</i>	20.3	6.3	14.0
IDA	(17.9)	(5.7)	(12.2)
IBRD	(2.4)	(0.6)	(1.8)
IMF	6.2	2.3	3.9
AfDB	6.9	2.2	4.7
IDB	2.8	1.1	1.7
Other	7.1	2.2	4.9
<b>Total</b>	<b>43.4</b>	<b>14.1</b>	<b>29.3</b>

*Source: Based on HIPC Documents, creditor statements from the MDBs or, in the absence of such information, the Debt Reporting System database of the World Bank. The data are for the 40 HIPCs.*

*Note: The totals may not sum up due to rounding.*

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<sup>4</sup> This assumes that the IMF and the World Bank cover 100% of their costs (NPV \$8.6 billion), and that all other multilateral creditors together cover one-third of their total costs (NPV \$1.8 billion).



### Implications of 100 Percent Debt Write-off

A significant portion of new concessional assistance from the MDBs comes from resources that are being paid back to the institutions by previous borrowers. For example, under the current IDA-12 replenishment, about 38 percent of the resources for new lending will come from repaid loans, or “reflows.” The most striking impact of the Commission’s recommendation that IFIs write off 100 percent of HIPC debt is that reflows to the concessional windows of the MDBs would be cut by almost half, or about \$31 billion (nominal) over the next twenty years. Reflows to IDA would be cut by roughly 40%, reflows to the IDB’s concessional window would be reduced by about one-third, and reflows to the African Development Fund would be cut by over 80%. Not only would this result in substantially fewer funds for future lending to the HIPCs, it would also leave fewer funds for non-HIPC countries that use concessional loan facilities at the MDBs. To the extent that complete debt forgiveness would also require reducing development assistance for poor non-HIPC countries, it would in effect be “the poor funding the poor.” Concessional finance available for Africa, the continent with the most HIPCs, would be hurt most of all.

### Moral hazard and inequity of treatment

In recommending that 100% of HIPC debt be cancelled, the Commission arbitrarily draws a line between HIPCs and non-HIPCs in terms of debt sustainability. HIPCs would have 100% of their debt cancelled, while other poor and indebted non-HIPCs would receive no debt reduction. The purpose of the enhanced HIPC initiative is, in part, to reduce HIPC debt to a manageable level, placing the HIPCs on a more equal footing with other developing countries. Writing off 100% of the debt for a specific group of impoverished countries poses a severe moral hazard for other poor countries. In a sense, 100% debt cancellation rewards those poor countries with very high debt levels in a manner that is likely to reduce future development assistance for other poor countries.

## **Response to the Recommendations on Reform of the Bank for International Settlements (BIS)**

*The Commission recommends that the BIS should promulgate new liquidity standards to reduce the risk of financial crises, while remaining a financial standard setter. It also recommends that the Basel Committee on Bank Supervision align its risk measures more closely with credit and market risk. The Commission calls for unspecified organizational reform and for expansion to be gradual and deliberate so as to avoid disruption of the information exchange.*

In general, we support the Commission's recommendations regarding the BIS, as they largely reflect U.S. views and the current initiatives of the BIS.

The BIS contributes to the promotion of international financial stability by providing a forum for international monetary and financial cooperation. The BIS hosts meetings of central bankers and provides facilities for various groups, including the Financial Stability Forum secretariat and the committees of the G-10 governors.

The committees of the G-10 governors (which include the Basel Committee, the Committee on the Global Financial System, and the Committee on Payment and Settlement Systems), the International Organization of Securities Commissions and the International Association of Insurance Supervisors identify best practices and develop guidelines and standards. We believe that the efforts of these standard-setting bodies play an important role in the strengthening of the international financial system, thereby reducing the risk of future financial crises.

The United States has actively supported the updating and strengthening of capital adequacy standards as promulgated by the Basel Committee. In June 1999, the Basel Committee released a consultative paper on proposed changes to its 1998 Capital Accord. The proposed changes are intended to more closely align capital with credit risk and to ensure that capital adequacy standards remain responsive to innovations in risk management practices. The three pillars of the Basel Committee's new capital adequacy framework are enhanced, risk-sensitive, minimum capital requirements, an improved supervisory review process, and more effective use of market discipline through disclosure. We support the further efforts of the Basel Committee that will continue through 2000.

We agree with the Commission that expansion of membership in the BIS should be judicious and deliberate. We believe that the recent additions to shareholder membership have been beneficial, particularly as they have produced a more inclusive forum for central bankers to discuss the prevention and resolution of financial crises. The BIS added to its membership nine new central banks in 1996 and five more in 1999.

## **Response to the Recommendations on Reform of the World Trade Organization (WTO)**

*The Commission recommends that the WTO should not impinge on national sovereignty, either directly or indirectly through WTO rulings or decisions. For countries that do not comply with WTO dispute settlement panels, the Commission recommends that fines or trade liberalization should replace the ability of countries to take compensatory action through import restraints.*

The Commission's recommendations are based on a misunderstanding of the WTO. The United States maintains its national sovereignty as a member of the WTO. No ruling or decision by the WTO can extend the scope of U.S. commitments in the WTO without explicit legislative action by the U.S. Congress. Neither the WTO nor its dispute settlement panels can force the United States to change its laws; only Congress can change U.S. law.<sup>5</sup>

Retaliation by the prevailing party through import restrictions is clearly a less desirable outcome to a WTO dispute than compliance by the losing party with a WTO ruling. Indeed, the WTO agreement describes compliance as the preferred outcome. If the parties to a WTO dispute want to resolve matters by agreeing on equivalent, compensating trade liberalization, they can do so under the existing WTO rules. However, compensation depends upon the willingness of the offending party to provide compensation, and the parties must agree that such compensation would offset the harm done to the economy of the injured party.

Failing compliance or mutually acceptable compensation, however, it is in the interest of the United States to have the suspension of benefits as an incentive for compliance. The injured party must have recourse to the most effective means to reestablish the balance of rights and obligations upset by violations of WTO obligations. To that end, a system of fines does not seem to represent an effective or practical response. It is not clear how the WTO could enforce the payment of fines. Moreover, such fines could be perceived by member states as an unacceptable infringement on national sovereignty.

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<sup>5</sup> Section 102 of the Uruguay Round Agreements Act, enacted by the U.S. Congress in 1994 to implement the Uruguay Round, which established the WTO, provides explicitly that no provision of the WTO Agreement, nor the application of any such provision to any person or circumstance, that is inconsistent with any U.S. law shall have effect. Private parties legally cannot use the WTO Agreement as a basis for challenging any Federal, state or local action in court.

## **Response to the Statement by Commissioner Levinson**

*Commissioner Levinson recommends, inter alia, that continued U.S. support for the Bretton Woods institutions should depend on the U.S. voting against IFI financing for countries that are egregious abusers of core worker rights. He also recommends amendments to the WTO Agreement so it includes a core workers' rights provision and a new chapter to prevent narrow interpretations of GATT Article XX "health and safety" and "endangered species" provisions. He also recommends that the USED have a stated policy that requires private sector creditors and investors to provide a substantial contribution to the financing of Fund programs.*

### **Labor Standards in the IFIs**

The United States has pursued a variety of initiatives in support of core labor standards in the programs and policies of the IMF and MDBs.<sup>6,7</sup> The Treasury Department has put in place a process by which core labor standards are routinely assessed in the context of its review of IFI loans as well as of planning and surveillance instruments. This process provides for input from the Departments of Labor and State, the International Labor Organization (ILO), and national and international labor union organizations and NGOs.

The U.S. Executive Directors have made clear, on numerous occasions, support for core labor standards, including rights of association and collective bargaining, and frequently raise concerns related to these rights, where relevant, in IMF and MDB programs in specific countries. Through these interventions, the U.S. has played a key role in securing protection for core labor standards in several important areas:

- U.S. efforts resulted in protections against the use of child labor in projects in Bangladesh and Indonesia and the establishment, within the World Bank, of a Child Labor Program dedicated to supporting efforts to combat child labor and other child labor-related programs.
- Several of the MDBs have adopted policy guidelines protecting labor rights and standards in lending programs, including rights of association and collective bargaining, and assessing core labor standards in their planning processes.

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<sup>6</sup> U.S. policy on labor issues at the IFIs is guided by Section 526 (e) of P.L. 103-306, the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1995, and Section 610 (a) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1999.

<sup>7</sup> Pursuant to Section 526 (e) of P.L.103-306, Treasury reports annually on the full range of its engagement on labor issues at the IFIs in its Annual Report to Congress on Labor Issues and the International Financial Institutions. The most recent report was submitted in December 1999.

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- The World Bank has established a Labor Markets Group that works closely with the ILO, trade union and employer organizations, and other external partners. The Group supports World Bank staff and borrowing countries through research and analysis, training, and operational support, on the full range of labor standards and related labor issues.

Treasury's objectives are to help ensure that IFI policies and practices with respect to labor issues are consistent with our support for core labor standards, and that project assistance be extended, where relevant, in support of core labor standards. In this area of IFI reform, we also believe that there is important, further scope for changes. We will continue to press for more attention to key labor issues in the work of the IMF and MDBs and greater cooperation with the ILO. Our objectives require a multifaceted approach, which includes, and extends considerably beyond, votes and statements before the respective Executive Boards.

### **Amendments to the WTO**

With respect to the World Trade Organization, the Administration continues its efforts to develop a consensus within the WTO on the relationship between trade and labor in response to many of the same concerns and issues that were presented to the Commission and formed the foundation of Commissioner Levinson's dissent from the Majority Report. The WTO Singapore Ministerial Declaration renewed the commitment of WTO members to the observance of internationally recognized core labor standards. WTO members also stated that the International Labor Organization (ILO) is the competent body to set and deal with the standards and affirmed their support in promoting them. We believe that the WTO and ILO would benefit from active collaboration and that the WTO should have a key role in analyzing the fundamental relationships between trade and labor. It is for this reason that the Administration has proposed a WTO Working Group on Trade and Labor.

The Administration does not believe that it is necessary to create a new chapter in the WTO Agreement to address the provisions of Article XX(b) and (g) on "health and safety" and "endangered species." The WTO's Appellate Body has explicitly rejected the view that exceptions such as GATT Article XX must be interpreted narrowly. It is simply not accurate to say that U.S. invocations of exceptions under Article XX have been rejected in the three cases mentioned.

### **Private Sector Involvement in Addressing Financial Crises**

The U.S. Treasury supports appropriate contributions of private creditors to the financing of Fund recovery programs. Where possible, the official sector, through its conditionality, should support approaches – as in Korea and more recently in Brazil – that enable creditors to recognize their collective interest in maintaining positions, despite their individual interest in withdrawing funds. However, it would be counterproductive to make a formal contribution from private creditors a requirement for all Fund lending. In some cases, the combination of catalytic official financing and policy adjustment should allow the country to return quickly to private markets to meet its financing needs and should depend on the specific circumstances of the crisis country. Such flexibility is essential to the Fund's ability to promote effective adjustment and to catalyze effective solutions to financial crises.

## Appendix

### **Foreign Operations, Export Financing and Related Programs Appropriations Act, 1999**

#### Section 603. Advisory Commission

- (a) IN GENERAL.—The Secretary of the Treasury shall establish an International Financial Institution Advisory Commission (in this section referred to as the “Commission”).
- (b) MEMBERSHIP.—
  - (1) IN GENERAL.—The Commission shall be composed of 11 members, as follows:
    - (A) 3 members appointed by the Speaker of the House of Representatives.
    - (B) 3 members appointed by the Majority Leader of the Senate.
    - (C) 5 members appointed jointly by the Minority Leader of the House of Representatives and the Minority Leader of the Senate.
  - (2) TIMING OF APPOINTMENTS.—All appointments to the Commission shall be made not later than 45 days after the date of enactment of this Act.
  - (3) CHAIRMAN.—The Majority Leader of the Senate, after consultation with the Speaker of the House of Representatives and the Minority Leaders of the House of Representatives and the Senate, shall designate 1 of the members of the Commission to serve as Chairman of the Commission.
- (c) QUALIFICATIONS.—
  - (1) EXPERTISE.—Members of the Commission shall be appointed from among those with knowledge and expertise in the workings of the international financial institutions (as defined in section 1701(c)(2) of the International Financial Institutions Act), the World Trade Organization, and the Bank for International Settlements.
  - (2) FORMER AFFILIATION.—At least 4 members of the Commission shall be individuals who were officers or employees of the Executive Branch before January 20, 1992, and not more than half of such 4 members shall have served under Presidents from the same political party.

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- (d) PERIOD OF APPOINTMENT; VACANCIES.—Members shall be appointed for the life of the Commission. Any vacancy in the Commission shall be filled in the same manner as the original appointment was made.
- (e) DUTIES OF THE COMMISSION.—The Commission shall advise and report to the Congress on the future role and responsibilities of the international financial institutions (as defined in section 1701(c)(2) of the International Financial Institutions Act), the World Trade Organization, and the Bank for International Settlements. In carrying out such duties, the Commission shall meet with and advise the Secretary of the Treasury or the Deputy Secretary of the Treasury, and shall examine—
  - (1) the effect of globalization, increased trade, capital flows, and other relevant factors on such institutions;
  - (2) the adequacy, efficacy, and desirability of current policies and programs at such institutions as well as their suitability for respective beneficiaries of such institutions;
  - (3) cooperation or duplication of functions and responsibilities of such institutions; and
  - (4) other matters the Commission deems necessary to make recommendations pursuant to subsection (g).
- (f) POWERS AND PROCEDURES OF THE COMMISSION.—
  - (1) HEARINGS.—The Commission or, at its direction, any panel or member of the Commission may, for the purpose of carrying out the provisions of this section, hold hearings, sit and act at times and places, take testimony, receive evidence, and administer oaths to the extent that the Commission or any panel or member considers advisable.
  - (2) INFORMATION.—The Commission may secure directly information that the Commission considers necessary to enable the Commission to carry out its responsibilities under this section.
  - (3) MEETINGS.—The Commission shall meet at the call of the Chairman.
- (g) REPORT.—On the termination of the Commission, the Commission shall submit to the Secretary of the Treasury and the appropriate committees a report that contains recommendations regarding the following matters:
  - (1) Changes to policy goals set forth in the Bretton Woods Agreements Act and the International Financial Institutions Act.
  - (2) Changes to the charters, organizational structures, policies and programs of the international financial institutions (as defined in section 1701(c)(2) of the International Financial Institutions Act).

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- (3) 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.
  - (4) Possible mergers or abolition of the international financial institutions (as defined in section 1701(c)(2) of the International Financial Institutions Act), including changes to the manner in which such institutions coordinate their policy and program implementation and their roles and responsibilities.
  - (5) Any additional changes necessary to stabilize currencies, promote continued trade liberalization, and to avoid future financial crises.
- (h) **TERMINATION.**—The Commission shall terminate 6 months after the first meeting of the Commission, which shall be not later than 30 days after the appointment of all members of the Commission.
- (i) **REPORTS BY THE EXECUTIVE BRANCH.**—
- (1) Within three months after receiving the report of the Commission under subsection (g), the President of the United States through the Secretary of the Treasury shall report to the appropriate committees on the desirability and feasibility of implementing the recommendations contained in the report.
  - (2) Annually, for three years after the termination of the Commission, the President of the United States through the Secretary of the Treasury shall submit to the appropriate committees a report on the steps taken, if any, through relevant international institutions and international fora to implement such recommendations as are deemed feasible and desirable under paragraph (1).