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IMF Reform and the International Financial Institutions Advisory Commission

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IMF Reform and the International Financial Institutions Advisory Commission

Summary

In the fall of 1998, financial crises in Asia, Russia, and Brazil were unfolding, though in different stages, as the 105th Congress was in the process of passing the Omnibus Consolidated and Emergency Supplemental Appropriations Act for FY1999 (H.R. 4328, P.L. 105-277). This legislation increased the U.S. quota of the International Monetary Fund (IMF), but attached a number of conditions to dispersal of the funds. Among them was creation of the International Financial Institutions Advisory Commission (the Meltzer Commission), which Congress chartered to evaluate and recommend future U.S. policy toward the global financial institutions, particularly the IMF.

The Commission released its report on March 8, 2000, calling for changes in the mission and operations of the IMF and the development banks. The 11 commissioners were unanimous *only* in generally recommending that: 1) the IMF restrict its lending to short-term liquidity needs, and 2) that it forgive debt to the poorest developing countries. The report makes the case for restructuring the IMF to reduce and define clearly its mission, and clarify obligations for members of the Fund, as well. At the heart of the proposal is a strong conviction that deep structural reforms, particularly of developing country financial systems, would go a long way toward reducing the potential for currency crises and the related need for large, costly IMF bailouts. It also focuses heavily on the role of moral hazard. These concerns led to specific policy prescriptions, not unanimously embraced, including requiring financial sector reforms as a precondition for IMF assistance, lending for no longer than 120 days (with one rollover period) and at "penalty" rates, and eliminating any long-term lending for structural adjustment or poverty reduction.

Four members of the Meltzer Commission dissented from the report. They supported the call to differentiate clearly the responsibilities of the IMF and development banks, the need for stricter banking systems in developing countries, greater transparency to mitigate abuse by all parties, and debt forgiveness for the poorest countries. They disagreed with the details listed above, arguing that they would conceivably worsen rather than improve the prospect for global financial stability and thereby undermine the fight against poverty and slow development.

A number of respondents to the Commission report also disagreed with what some consider its "narrow" prescriptions, including the U.S. Treasury and the Council on Foreign Relations, which offer alternative reform programs. In addition, financial crises have been a part of the international economic landscape long before the IMF was established, suggesting that too much emphasis on this one institution may not bring the desired stability to the international financial system. Still, the IMF is responsible for addressing the concerns raised by Congress and other government institutions around the world, which have served as a critical impetus for change. Continued oversight will be necessary to keep the reform process moving and more time may be needed to sort out precisely which policy options will suit the collective, but competing, needs of IMF member countries and the broader participants of the global economy.

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In the fall of 1998, as the financial crises in Asia, Russia, and Brazil were unfolding, though in different stages, the 105th Congress was debating a proposed quota increase for the International Monetary Fund (hereafter the IMF or the Fund). At that time, the IMF's struggle to contain these crises strained its financial resources and subjected it to increasing criticism. Following a vigorous debate, Congress approved funds for the quota increase in the Omnibus Consolidated and Emergency Supplemental Appropriations Act for FY1999 (H.R. 4328, P.L. 105-277), but attached a number of conditions to their disbursal. Among them was creation of the International Financial Institutions Advisory Commission (hereafter the Meltzer Commission), which Congress chartered to evaluate and recommend future U.S. policy toward the global financial institutions, particularly the IMF.

Following six months of study and hearings, the Meltzer Commission released its report on March 8, 2000, calling for significant changes in the mission and operations of the IMF and the development banks. The report was approved by an 8-to-3 vote that included dissenting opinions by a number of commissioners. The commissioners were unanimous, however, in their general recommendations to restrict IMF lending to short-term liquidity needs and eliminate extended loan programs for other purposes. This CRS report provides background and analysis on findings and reforms advocated in the Meltzer Commission report, including selected alternative perspectives and critiques that have emerged.

The IMF and the Evolving International Economy

The International Monetary Fund, conceived at the Bretton Woods conference in 1944, is the institution designed to support global trade and economic growth by helping maintain stability in the international financial system. Initially, the IMF served primarily industrialized countries by supporting currency convertibility and providing them with short-term financing when needed to defend their pegged exchange rates. With the demise of the fixed exchange-rate system in 1973, and the huge growth and liberalization of the private international capital markets, industrial countries soon found little need to draw on the Fund. At this point, the IMF increased its assistance to developing countries, some of which were finding themselves increasingly embroiled in financial problems.[1]

Most IMF lending draws from the Fund's permanent assets (some $283 billion), provided by member countries (the capital subscription or quota) as part of their

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[1] For more on how the IMF functions, see: CRS Report RL30575, *The International Monetary Fund: An Overview of Its Mission and Operations*, by (name redacted).

commitment when they join the fund. In addition to being the financial resources of the Fund, the quota is important because it determines a country's voting power and borrowing capacity. The IMF maintains two borrowing arrangements with selected member countries, as well, for times when the Fund may not be sufficiently liquid to meet all borrowing needs. The General Arrangements to Borrow (GAB) is a $23 billion credit line established by 11 industrialized countries in 1962. The New Arrangements to Borrow (NAB) was established following the 1994-95 Mexican peso crisis as a supplemental line of credit by 25 member countries, adding another $23 billion of currency borrowing authority.

IMF lending involves providing hard currencies to member countries with balance of payments problems based on need, willingness to adjust policies, and ability to repay. Three types of financing facilities are available under the general resources account: 1) the stand-by arrangement; 2) the extended arrangement (these two constitute most IMF assistance); and 3) special facilities. Two programs created since December 1997, the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL), amount to special access policies to stand-by and extended arrangements under extenuating circumstances. As part of the IMF's evolving sense of mission, it has developed lending facilities to address the needs of the poorest developing countries: the Poverty Reduction and Growth Facility (PRGF) – renamed in November 1999 from the Enhanced Structural Adjustment Facility (ESAF); and the Heavily Indebted Poor Countries (HIPC) initiative.

Although the IMF has operated for over half a century in an evolving and at times volatile global economy, it was the severity and frequency of the 1990s financial crises that rekindled the recent debate over its core mission. Many competing perspectives have developed, but there are some common starting points to consider. First, since the end of the Bretton Woods era in 1973, the IMF has redirected its attention towards the developing world. Second, IMF arrangements have grown in size and maturity, as it has taken on increasingly larger financial "bailouts." Third, the Fund has expanded its role as a development organization through concessional loan programs to very poor countries. Fourth, short-term balance of payments lending has given way to global financial crisis management.

Figure 1 provides a sense for what some consider the IMF's evolving mission. For roughly the first three decades, total IMF outstanding credit was small by historical standards, peaking at SDR[2] 13.7 billion in 1977, much of the increase related to financing severe, but temporary balance of payments deficits of oil importing countries during the mid-1970s oil price shocks. Data for the past two decades point to two additional distinct periods documenting the IMF's elevated exposure to broader global financial troubles. First, the debt crisis in Latin American during the 1980s required vastly greater resources as the IMF took the lead in coordinating the response among the private banks, multilateral financial institutions, and individual bilateral creditors to avoid massive default. The IMF's exposure is

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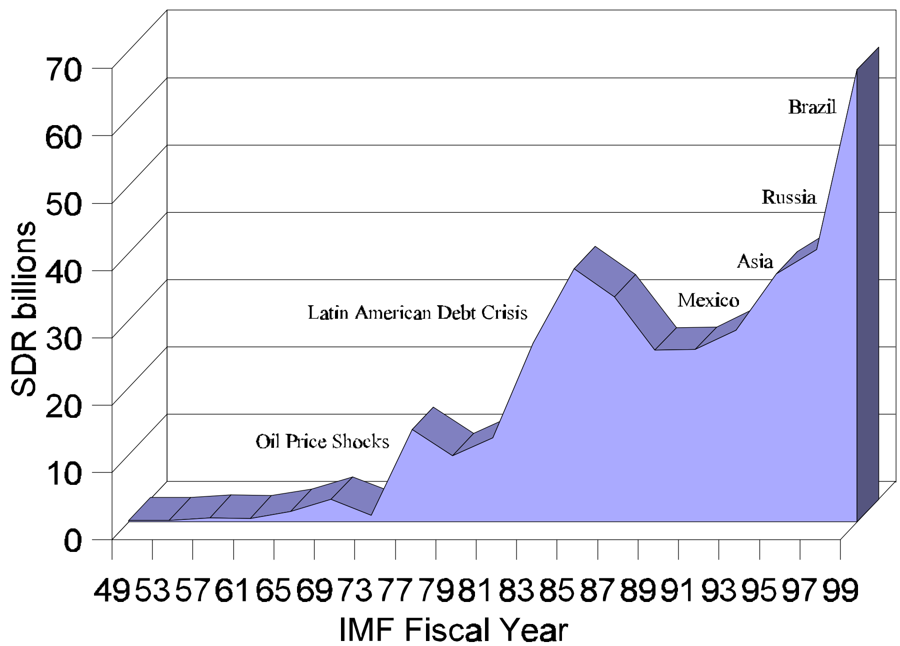
[2] The Special Drawing Right (SDR), created in 1970, is an international reserve asset and unit of account used to settle transactions at the IMF. Its value is calculated as a weighted average of five "hard" currencies, making it a more stable international asset than a single currency, such as the dollar, which used to be the key international reserve currency.

Figure 1. Total IMF Credit Outstanding 1949-1999



Source: IMF, *Annual Report 1999*, p. 142. IMF financial year runs through April 30.

clearly visible in its increased lending, peaking at SDR 37.6 billion in 1985 (nearly three times the previous high in 1977).

Second, beginning in 1995, a series of individual country financial crises resulted in unprecedented IMF lending. First, the Mexican peso crisis unfolded abruptly in December 1994. As Mexico's problems began to wind down, a larger Asian financial crisis erupted in 1997, with Russia and Brazil following on its heels in 1998 and 1999, respectively. These incidents collectively drained IMF funds, with total credit outstanding rising over six fold from SDR 10 billion in 1980 to SDR 67 billion in 1999. Liquidity concerns, along with new policies developed to make access quicker and pleas for additional resources (in both the quota and borrowing limits), pushed the IMF debate to center stage.[3]

During the 1990s, the concentration of IMF lending was particularly evident. **Table 1** shows the percentage of total IMF purchases (draws) to the major crisis countries since 1995. It includes those made through the Supplemental Reserve Facility after 1997 and comprises roughly 90% of the SDR value of IMF purchases for any given fiscal year.[4] As may be seen, Russia has been a significant user of IMF funds since 1995. In 1995 and 1996, when the Mexican peso crisis hit, Russia and Mexico together accounted for 56.8% and 67.4% of IMF purchases, respectively. In fiscal 1997, Russia was the only major borrower, constituting 42.6% of total draws.

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[3] The immediacy of liquidity concerns has since subsided some given large repurchases (effectively repayments) by Brazil, Korea, and Russia in 2000. See: IMF, *Annual Report 2000*, pp. 123-24.

[4] These calculations do not include data from the small concessional PRGF loan facility.

With the advent of the Asian and Brazilian problems, the major crisis countries collectively accounted for 89.8% and then 82.9% of IMF purchases during fiscal 1998 and 1999, respectively.

Table 1. IMF Purchases by Major Crisis Countries, 1995-99
(percent of total IMF purchases or draws by fiscal year)

Country	1995	1996	1997	1998	1999
Brazil					30.2%
Mexico	50.0%	32.2%			
Indonesia				12.5%	19.1%
Korea				58.2%	12.6%
Thailand				11.6%	2.3%
Russia	6.8%	35.2%	42.6%	7.5%	18.7%
Sub-Total	56.8%	67.4%	42.6%	89.8%	82.9%
All Others	43.2%	32.6%	57.4%	10.2%	17.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: International Monetary Fund, *Annual Report*, various years.
* Includes all Supplemental Reserve Fund commitments beginning in 1998; does not include PRGF concessional loan facility data.

If the mission of the IMF were to be defined by its lending portfolio, **figure 1** and **table 1** would suggest that its primary purpose is to lend to countries with major currency crises rather than those with short-term, non-crisis balance of payments problems. Among the fundamental questions that have arisen from this global posture of the IMF are: is the Fund "succeeding" in meeting its core mission of supporting international financial stability, and does the expectation that crisis lending will occur contribute to the possibility of future runs on currencies?

The Meltzer Commission Report

In appropriating funding in the fall of 1998 to increase the U.S. quota in the IMF, Congress required that an independent commission be created to evaluate the international financial institutions, giving particular attention to the IMF. The International Financial Institutions Advisory Commission (hereafter the Meltzer Commission) was given six-months to present a detailed report to Congress. Professor Allan H. Meltzer of Carnegie Mellon University, historically a staunch critic of the IMF, was named commission chair.[5]

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[5] See: Meltzer, Allan H. *Shut Down the IMF*. American Enterprise Institute for Public Policy (continued...)

The final report reflects the overarching view that the IMF has overstepped its mission of supporting international financial stability by increasingly undertaking large bailouts of countries in severe economic and financial crisis. Not all commissioners agreed, as reflected in the split 8-to-3 vote approving the final report and in its publication with detailed dissenting opinions. There was consensus on two issues, however, both pointing to reducing the size and scope of the Fund. First, the Commission proposed that the IMF restrict its lending to only short-term liquidity needs of member countries and eliminate its role as a long-term lender, particularly for purposes of reducing poverty or promoting development. Second, the IMF, the World Bank, and the regional development banks should write-off all the debt from the so-called Heavily Indebted Poor Countries (HIPCs).[6]

Foundations of the Argument

The Meltzer Commission report builds its case for redefining the IMF mission based on the following arguments:

1. Since the IMF's creation in 1944, its core mission of supporting global financial stability remains, but an international financial system based on a gold/dollar standard of pegged but adjustable exchange rates and capital controls no longer exists. Since 1973, most industrial countries have adopted flexible exchange rates and strengthened their central banks (lenders of last resort), effectively eliminating their need for IMF assistance;

2. The IMF, in response, adjusted its mission by turning to the developing world, where it has made increasingly large and longer-term loans to crisis countries, and in some cases, has provided concessional loans to the poorest developing countries. According to the report, "mission creep" has led to requests by the IMF for additional financial resources and powers;

3. IMF assistance and conditionality have led to an "unprecedented" amount of influence for a multilateral institution over borrowing countries and fostered their increased dependence on the Fund. Overall economic and development results, however, have been disappointing;

4. The IMF has proven to be poorly suited to anticipate financial crises, slow in dispensing financial assistance, and prone to pushing pro forma policy advice that can compound rather than alleviate problems. The severity and recurrence of these problems suggests that the preventative and coping mechanisms as currently practiced by the IMF are not adequate;

5. The most significant problem related to IMF programs, particularly since the Mexican bailout in 1995, has been the rise of moral hazard, or the over

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[5] (...continued)
Research. August 1995.

[6] *Report of the International Financial Institution Advisory Commission*. Allan H. Meltzer, Chairman. Submitted to the U.S. Congress and U.S. Department of the Treasury. March 8, 2000.

commitment of particularly short-term financing by private investors and lenders to developing countries in part because of an expectation, based on previous experience, that the IMF will provide the foreign exchange liquidity that will allow them to exit the country in time of crisis and without bearing their full losses (Russia is the most prominent example);

6. The report lists a number of other problems internal to the IMF including: failure to enforce IMF conditions uniformly; poor transparency; political manipulation of the IMF by G-7 countries; lack of independent oversight; and overlap of mission with other international financial institutions.[7]

Meltzer Commission Recommendations

The Meltzer Commission makes the case for restructuring the IMF to as part of a more targeted and much reduced mission, with redefined obligations for members of the Fund, as well. At the heart of the proposal is a strong conviction that deep structural reforms, particularly of developing country financial systems, would go a long way toward reducing the potential for currency crises and the related need for large, costly IMF bailouts. Specific report recommendations are grouped below.

Redefine the IMF's Mission. The IMF should be restructured as a smaller organization with three distinct responsibilities: 1) act as a "quasi-lender" of last resort that would restrict lending to short-term liquidity assistance; 2) collect and disseminate country financial and economic data on a timely basis; and 3) provide advice on economic policy rather than impose conditions. Loans would be made *only* to those countries that had met "preconditions" of financial soundness, except under "unusual" circumstances where stability of the international financial system is at stake. All other long-term lending should cease, particularly long-term concessional lending to the poorest countries, to differentiate clearly the IMF's mission from that of the development banks. As a result, the Commission sees no need to consider any additional quota increase in the foreseeable future.

Participation in IMF Programs. All member countries should provide accurate and timely economic and financial information for all market participants to use, both private and public. IMF lending would not be extended to large industrial countries because Fund resources are inadequate to cover their potential needs; in any case they should not be needed in countries with flexible exchange rates and the means to act as their own lenders of last resort. Neither would there be any need to conduct Article IV consultations with developed countries. The IMF could offer policy advice, but the precondition of prudent standards would theoretically obviate the need for the current elaborate conditions for lending.

Rules (preconditions) for Lending. To become eligible for IMF assistance, member countries would need to meet four preconditions or minimum prudential standards: 1) allow entry of foreign financial institutions to deepen competitiveness, reduce corruption, and diversify risk in the banking system; 2) require that domestic

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[7] The Commission does not necessarily endorse all these criticisms, but cites them as the framework from which reform is discussed. *Meltzer Commission Report*, pp. 38-42.

banks be adequately capitalized to establish market discipline; 3) publish the maturity structure of outstanding sovereign and guaranteed debt, and off-balance sheet liabilities to encourage safe and sound behavior; and 4) meet a "proper" fiscal requirement so the IMF would not be used to support irresponsible budget deficits. The IMF should not lend to salvage insolvent financial institutions. The Commission believes that adopting higher IMF-set financial standards and discouraging short-term borrowing can reduce the potential for moral hazard.

Terms for Lending. To support the basic mission of liquidity lending, IMF loans should have short maturities (not to exceed 120 days and one roll-over period), a graduated penalty rate (above sovereign yield), and an explicit legal priority for repayment. Defaulting countries would not be eligible for additional lending by any multilateral agency or IMF member countries, and credit limits would be clearly defined and strictly observed. The new rules could be phased in over three to five years to allow countries time to meet new requirements, with IMF supporting crises in the mean time, but at high loan penalty rates. Extraordinary circumstances for borrowing such as natural disasters, political turmoil, or emergency assistance should be done through the relevant multilateral development institutions (United Nations, World Bank) or bilateral arrangements.

Exchange Rate Policy. To permit the greatest latitude for adjusting to changes in both domestic policy choices and external economic events and to avoid costly attempts to stave off devaluations, countries should shun any of various adjustable peg exchange rate systems, relying instead on either a firmly fixed or flexible exchange rate regime. More importantly, countries should be strongly encouraged to adopt appropriate "stabilizing monetary and fiscal policies" to reduce the possibility of economic shocks that might require dramatic adjustment in either the exchange rate (devaluation) or price level (interest rates).

Debt Issues. IMF arrangements historically (e.g. the 1980s Latin American debt crisis and 1994 Mexican peso devaluation) have kept private lenders and investors from realizing their full losses and having to implement debt restructuring on their own. Sovereign borrower and lender conflicts should be worked out by the participants without resorting automatically to IMF assistance. In the case of the so-defined Heavily Indebted Poor Countries (HIPCs), however, all IMF (and other) debt should be written off because of their inability to repay "under any foreseeable future developments." Debt relief would be contingent upon debtor countries implementing broad reforms and adopting an "effective" development strategy.[8]

IMF Finance and Accounting Reforms. The Fund's accounting system should be simplified and rationalized to improve transparency and better approximate standard accounting procedures that reflect assets and liabilities in meaningful ways (such as distinguishing between the usefulness of various currency holdings.) In

[8] For more on the HIPC initiative and developing country debt, see: CRS Report RL30214, *Debt Reduction: Initiatives for the Most Heavily Indebted Poor Countries*, by (name redacted), and RL30449, *Debt and Development in Poor Countries: Rethinking Policy Responses*, by (name redacted).

concert with the proposed reduced role of the IMF, no further quota increases should be considered in the foreseeable future.

Meltzer Commission Dissenting Opinions

Four members of the Meltzer Commission dissented from the report and three formally voted against it, although they were agreed on the need for IMF reform. They supported the report's call to differentiate clearly the responsibilities of the IMF and development banks and its conclusions that stronger banking systems in developing countries are imperative, that greater transparency mitigates abuse by all parties, and that the poorest countries need debt forgiveness and grants from industrial countries to help cover basic public goods. The dissenting opinion disagrees, however, with the details on how to achieve these goals.

Dissenting commissioners had varied opinions, but the collective dissenting statement challenges the report on its analysis, interpretation, and recommendations regarding the role of the IMF in the international economy. The dissenters suggest that the report's analysis mischaracterizes the effects of international financial institutions over the past five decades. They contend that the international economy, despite periods of volatility, has performed well since World War II and countries with severe financial problems have all been helped by IMF assistance. These include most of those that faced crises in the 1990s (Indonesia and Russia being the exceptions), which have since "experienced rapid V-shaped recoveries."

The dissenters also point out that while the report criticizes the international financial institutions for undermining democracy by dictating policies that should be domestically determined, the past decade has witnessed an unprecedented transition to democracy in much of the world. The dissenting commissioners argue that the Commission recommendations, if implemented, might actually worsen rather than improve the prospect for global financial stability and thereby potentially undermine the fight against poverty and underdevelopment. They also maintain that the recommendations are not well supported by evidence in the report.

Promoting Financial Instability. Dissenters argue that the report's key recommendation that the IMF restrict its operations *only* to countries that prequalify for assistance based on reforming their financial systems and do so without IMF authority to impose policy conditions is a flawed strategy because: a) the authority to impose policy changes is necessary to encourage macroeconomic corrections, such as insisting huge fiscal deficits be reduced; otherwise, IMF assistance might fuel rather than fight the crisis; and b) those countries that would not or could not meet IMF standards would be at even greater risk of turmoil if a financial problem arose. To the extent that this might include large developing countries, the international economy may be at greater risk of systemic financial upheaval.

Dissenters found fault with five of the reports key "lines of analysis." These are listed below, with the dissenters response following in parentheses:

- the main problem is moral hazard, (for which dissenters claim there is little empirical evidence);

- "penalty" rates will deter excessive borrowing (dissenters assert that borrowing will not be tempered by higher costs during a liquidity crisis);
- the IMF fails to require banking reform in crisis countries (when it actually does);
- literature on the effectiveness of IMF "conditionality" has been represented as negative (when actually it is more balanced); and
- there is no discussion of what would happen in the absence of IMF assistance (which some argue could lead to worse outcomes).

Undercutting the Fight Against Poverty. The dissenting opinion argued against the report's recommendation to terminate long-term poverty lending at the IMF as it could militate against poverty reduction efforts, as would relying only on appropriations from rich countries to fund assistance to poor countries. The IMF's Poverty Reduction and Growth Facility (PRGF) is represented as helping millions of the world's poorest people and worthy of continued support. Further, the report's recommendation that advanced developing countries rely only on private capital markets for external finance could hurt them during times of financial market volatility or panic.

Unsubstantiated Proposals. Dissenters also criticized the lack of detailed evidence in support of pursuing many of the Commissions' proposals, suggesting that without more thorough documentation, the report presents opinion as much as reasoned analysis. Other questions were raised regarding the wisdom of: 1) precluding the IMF from assisting high-income countries; 2) requiring countries to adopt only selected exchange rate systems; 3) insisting on separate new rules or ideas for developing country banking systems when the Basel Core Principles have been agreed to and serve the same purpose.

Dissenters also argued that the report failed to address some key issues, such as: 1) advocating for a better "early warning" system to respond in an anticipatory manner to future financial crises; 2) outlining an adequate role for private sector burden sharing in times of financial trouble; and 3) giving more attention to detailed exchange rate options.

U.S. Treasury Response

Responding to the Meltzer Commissions recommendations, the U.S. Treasury issued a formal report supporting the overall mission and effectiveness of the international financial institutions, acknowledging the need for reform, but disagreeing with "the bulk of the Commission's reform prescriptions."[9] The Treasury report expresses the need to evaluate IMF reform in the context of how it can be done best

[9] U.S. Treasury. *Response to the Report of the International Financial Institution Advisory Commission*. Washington, D.C. June 8, 2000. p. 2.

to ensure that global economic challenges are met that are "critical to U.S. interests." This perspective is decidedly different from others regarding how to assess benefits and direction of IMF reform. Although the U.S. Treasury makes its own detailed recommendations, they would not result in any significant changes from the way the IMF operates today based on continuing reform efforts largely designed with U.S. influence.

Treasury is sympathetic to the call for developing countries to improve their financial sectors, to become more transparent in reporting financial and economic data, to adopt exchange rate regimes and the related policies that lend credibility and stability to their economies, and to improve market incentives and avoid undue use of the IMF. Treasury disagrees with the Meltzer Commission's strategy for achieving these goals. Treasury's central concern is that the recommendations would not allow the IMF to respond to future financial crises adequately, perhaps deepening and protracting their effects abroad and in the United States, as stated in its summary of the Meltzer Commission report:

> 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 prequalify for IMF assistance.[10]

The Treasury finds fault with this approach suggesting that: 1) it would potentially restrict the IMF from responding to financial emergencies in many large countries that did not prequalify, including the weaker countries that need assistance most, perhaps aggravating broader systemic problems; 2) prequalification criteria are too narrow, focusing on financial sector issues, which alone are not sufficient to "significantly reduce" risk of crisis; 3) prequalified lending could increase rather than decrease moral hazard if countries targeted policy reform for the express purpose of meeting only IMF guidelines; 4) eliminating conditions for lending would reduce leverage for policy change, as well as increase the possibility of financial assistance being misused; 5) very short loan maturities and excessive interest penalties would force repayment prematurely at excessive cost, worsening borrowing countries already tenuous financial position; and 6) eliminating poverty assistance lending would remove IMF and its macroeconomic expertise from the development adjustment process involving the international financial institutions.

While recognizing a mutuality of concern between the Treasury's perspective and that of the Meltzer Commission, and that significant progress has been made in reforming the IMF, Treasury proposes a different agenda for altering IMF policies to improve its responses to financial emergencies. The general thrust of these recommendations is in line with many others, but differs in detail. There are five major categories of improvement suggested:

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[10] Ibid, p. 6.

1) Improve information flow from governments to markets, not just the IMF "club of nations." Treasury emphasizes importance of IMF's new Special Data Dissemination Standard (SDDS), with some modifications;

2) Give more attention to financial vulnerabilities, with IMF surveillance emphasizing key liquidity indicators (e.g. debt management guidelines) and identifying unsustainable exchange rate regimes;

3) Use IMF financing facilities more strategically, focusing on crisis prevention and emergency situations in emerging economies. Treasury calls for adjusting the Contingent Credit Line (CCL), using a graduated scale of lending rates based on size of the draw to discourage excessively large or extended lending arrangements. It is presented as the best anticipatory response to crises that would serve better than the narrow prequalification scheme advocated by the Meltzer Commission. The Supplemental Reserve Facility (SRF), which provides IMF financing at higher rates than normal stand-by arrangements, is a successful tool for higher loan pricing and so would encourage early repayment and judicious borrowing (Brazil being the most recent case). Treasury would not remove the PRGF from IMF management believing it has a role to play in helping countries enact necessary macroeconomic adjustment policies in addition to development bank expertise in other critical policy areas.

4) Emphasize market-based solutions to crises to lessen moral hazard and facilitate return of crisis countries to "normal market access." It believes the call for 100% debt relief of HIPC countries is too high to be financed by the IFIs and developed countries. In addition, it would increase potential for moral hazard. The idea behind the HIPC initiative is to reduce the debt burden of very poor countries to levels of other developing countries. Full debt relief might encourage increased indebtedness to qualify as a HIPC country. In addition, funds forgiven are not available for re-lending to other countries in need of borrowing, especially from concessional facilities at the World Bank and IMF.

5) Modernize the IMF by establishing a permanent independent evaluation office and create a liaison group of private financial market participants to improve its understanding of global market trends. Other recommendations counter to the Meltzer Commission included leaving future quota increase decisions to the long-established quota review process, requiring all countries to continue undergoing Article IV consultations (to emphasize the "universal nature of Fund"), and suggesting that the IMF already has priority for repayment among public and private creditor institutions.

Council on Foreign Relations Report

In a separately issued study prior to release of the Meltzer Commission report, the Council on Foreign Relations presented the recommendations of another panel of experts on the global financial system.[11] In agreement that many of the key problems identified by the Meltzer Commission exist, this report, the "broad thrust" of which was supported by all 29 members, takes a complementary overall approach to resolving these concerns. Believing that markets provide the clearest signals of problems in the international financial system, the Council on Foreign Relations report recommends that a market-based approach guide reform efforts in borrowing countries. The "broad thrust," therefore, is to "place the primary responsibility for crisis avoidance and resolution in emerging economies back where it belongs: on emerging economies themselves and their private creditors, which dominate today's international capital markets."[12]

The Council report also agrees with the Meltzer Commission on some broad policy directions including: 1) strengthening crisis prevention management; 2) discouraging pegged exchange rates, to the point of having the IMF refuse assistance to countries with "unsustainable" pegs; 3) refocusing the IMF toward monetary and financial policies and away from structural reform and development needs, which are better handled by the World Bank; 4) enhancing IMF operational transparency, including expanded use of its Special Data Dissemination Standard (SDDS); and 5) ensuring that individual countries take political responsibility for their economic and financial policies and actions. It goes one step further in calling for using transparent and nondiscriminatory tax measures as a way to control short-term capital movements, which are viewed as a potential leading factor of financial instability.

The Council report differs from the Commission, however, on how to accomplish specific market-based reform of IMF operations. First, rather than force countries into a narrowly defined reform structure, the lack of which would prohibit receiving IMF assistance, the Council on Foreign Relations report advocates an incentive system to encourage "good housekeeping" ranging from insisting on sound policy decisions such as fiscal responsibility, prudent debt management, and avoidance of overvalued exchange rates, to making deeper structural changes, such as financial sector reform, with particular attention to developing bank deposit insurance systems. This could be accomplished, the report concludes, by lending on more favorable terms to countries that meet these goals rather than forsaking noncomplying countries all together, as recommended by the Meltzer Commission.

Second, IMF assistance should not be used simply to bail out private sector lending and investment. To promote private sector burden sharing (address the moral hazard issue), borrowing countries should use "collective action clauses" in bond

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[11] There is no dearth of recommendations on IMF reform. For a summary of earlier proposals, see: Eichengreen, Barry. *Toward A New International Financial Architecture: A Practical Post-Asia Agenda*. Institute for International Economics. Washington, D.C. February 1999. pp. 101-03 and 124-32. The Council on Foreign Relations report is presented here because: 1) it presents the collective view of 29 prominent scholars, former senior policy officials, and private sector corporate executives; 2) it is detailed and comprehensive; and 3) it has attracted congressional and other attention.

[12] The Council on Foreign Relations. *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture Report of a Independent Task Force*. Hills, Carla A. and Peter G. Peterson, chairs. New York, N.Y., 1999. p. 4.

contracts, for example, to ensure that all parties, public and private, are compensated on the same terms and holdouts cannot impede attempts at orderly debt rescheduling when widely accepted as the appropriate course of action. Where debt rescheduling is considered necessary, the IMF should lend only if "good faith" discussions on rescheduling are being pursued with private lenders.

Third, the Council report also recommends that the IMF not pursue large bailouts by limiting credit to levels defined in existing Fund guidelines.[13] Combined with charging higher rates of interest for riskier loans, limiting lending will reduce the risk of moral hazard. In addition, when a financial crisis threatens the international financial system, the Council recommends the IMF use its credit lines (the GAB and NAB) for when countries are largely responsible for their own problems. If a country's financial problems are deemed largely externally driven, a separate special "contagion facility" should be used in place of the CCL and SRF to respond to the threat of systemic crisis. These provisions differ significantly from the Meltzer Commission's narrower view that only very short-term liquidity lending is needed if reform efforts are embraced. The Council on Foreign Relations anticipates that future speculative financial crises may require deeper, longer-term assistance, but not to the extent that has been offered in the 1990s.

Reform Proposals Compared

Reducing the number and severity of financial crises is a universally desired goal, but determining how best to accomplish this task and defining the IMF's role in this process is a hotly disputed matter. A broad range of solutions are being proposed to improve IMF operations within the context of a changing and frequently volatile international economy (see **appendix 1** for a side-by-side comparison). Most observers support some type of IMF reform including clarifying its mission relative to the development banks, reconsidering how it can emphasize prevention and greater private sector participation in negotiating more orderly workouts of financial crises, and determining how the Fund can best serve as a catalyst for financial reform in developing countries.

There is also broad agreement that the IMF should operate as a monetary institution focusing on fiscal, exchange rate, and monetary policies and leave long-term structural reform to the development banks. Less agreement exists on the disposition of the Poverty Reduction and Growth Facility (PRGF). The Meltzer Commission would close it, the dissenters resist this idea, the U.S. Treasury actively supports its continuation, and the Council on Foreign Relations makes no specific recommendation. Operational changes at the IMF that are widely embraced include promoting greater transparency in virtually all aspects of information gathering and dissemination including adopting a standardized presentation of accounting and financial data to improve market decision-making ahead of potential crises.

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[13] International Monetary Fund. *Financial Organization and Operations of the IMF*. Fifth edition. Pamphlet Series No. 45. Washington, D.C. 1998. p. 63.

Beyond these general considerations, there is much disagreement over specific courses of action. The Meltzer Commission argues that having the IMF "bailout" countries experiencing large financial crises is a losing proposition. It has neither the financial resources nor the clout to avert a currency run once begun, nor has its conditionality requirements been effective in bringing about the structural reforms in countries that many argue are needed to help avert future crises. The assurance of IMF lending further exacerbates the problem by encouraging moral hazard, considered the single most critical problem that can be solved in the public policy process. Its fundamental stand hinges on the belief that reform must precede (if not be held hostage to) IMF assistance, otherwise the cycle of excessive lending and sudden withdrawal of capital will not be broken.

The Meltzer Commission believes the IMF should return to short-term liquidity lending, where financial assistance can be disbursed quickly, unencumbered by extensive conditionality requirements. This is why it strongly advocates countries meeting preconditions for IMF eligibility. If reform has already proceeded to a certain level, conditionality of IMF assistance is unnecessary. In cases where countries either cannot or will not comply with IMF preconditions, they will eventually be subjected to the unfettered actions of the international capital markets. Experience would instruct policy makers as to which produces the least desirable outcome. As such, the IMF would have a much reduced mission, eliminating all long-term assistance, particularly for development purposes, and focus on very short (four months), but quickly disbursed lending arrangements at "penalty rates."

The Meltzer Commission dissenters agree with the need for structural reform of developing country financial sectors, the preference for short-term IMF lending, greater transparency, and the need for debt forgiveness for the poorest countries. They argue, however, that the role of moral hazard is overplayed and that IMF conditionality can reduce the magnitude of a crisis and is necessary to enforce reform efforts. In this light, dissenters question the specific recommendations of the Meltzer Commission report, particularly the strong stands on prequalifying for assistance, reducing IMF policy leverage by eliminating conditionality, and lending at very short maturities at above market (penalty) rates, which would potentially eliminate assistance to some large countries, "increasing the risk of global economic disorder."

These reservations have been reiterated by both the U.S. Treasury and the Council on Foreign Relations. The Council report argues that developing countries should adopt sound economic policies, but rather than make them a prequalifying condition for IMF assistance, a graduated lending rate scale should be used to encourage reform. The Council also supports the use of some type of capital control to discourage over-reliance on short-term investment capital, which is the first to leave if economic conditions deteriorate, hastening financial crises. Avoiding large bailouts is possible by adhering to the IMF-imposed lending limits already in existence and by relying more on market discipline to bring in greater private sector burden sharing, while restraining IMF assistance if there is no good prospect for resolving a country's balance of payments problem.

The U.S. Treasury argues that changes are needed in the IMF to meet new challenges of the global economy, but that the IMF is in the process of addressing many of the concerns that have been raised by the Meltzer Commission. Treasury asserts that the Commission's specific recommendations, taken together, would deter the IMF from doing its job, which would not further U.S. interests. It argues that reform of the financial sector and other areas is critical, but that making it part of preconditions for IMF eligibility would likely deepen and prolong financial crises for countries not assisted. In its view, other avenues for encouraging reform are available and IMF conditionality has been a necessary part of the process. Limiting loan maturities to four months, when, for the average crisis, it has taken a minimum of eight months to restore confidence in the private capital markets, indicates that the Meltzer Commission suggestion is too restrictive. Treasury also argues that the Poverty Reduction and Growth Facility (PRGF) has a constructive role to play in assisting the development banks by offering IMF macroeconomic expertise.

The U.S. Treasury presents the IMF's ongoing reform efforts as essentially meeting most of the concerns raised by the Meltzer Commission report. Specifically it points to: 1) transparency goals being met by the increasing number of IMF documents released to the public;[14] 2) crisis prevention improving by the ongoing implementation of the IMF's Special Data Dissemination Standard (SDDS) and adoption of the "preventative" Contingent Credit Line (CCL); 3) emphasis on improving country financial standards to Basel Core Principles; 4) enhanced government oversight of IMF resource use and other anti-corruption guidelines; and 5) continuing review of IMF operations in light of ongoing criticism.

These specific Treasury recommendations reflect the IMF's perspective rather closely and although the Fund has not addressed specifically the Meltzer Commission suggestions, it has continued to respond to the international community's critique of its operations. The IMF has acknowledged the need to improve core areas of concern raised by the various reports, including: transparency, accountability, unified reporting standards, domestic financial systems, crisis prevention early warning methods, clearly defined private sector involvement, and internally consistent macroeconomic and exchange rate policies. It has responded with a detailed *Code of Good Practices on Transparency in Monetary and Financial Policies*, which incorporates guides such as the Special Data Dissemination Standard. The current IMF Managing Director views this as a "work in progress," however, entailing adapting the Fund to the changing world economy rather than remaking it from scratch and has not suggested reducing any of its current programs.[15]

Balancing Perspectives

Clearly, there are differences of opinion regarding the best path to achieve IMF reform despite a general agreement that it should happen. There are also differences

[14] See the IMF website at: [http://www.IMF.org].

[15] See: International Monetary Fund. *Toward a More Focused IMF.* Address by Horst Kohler, May 30, 2000. *Report of the Acting Managing Director to the International Monetary and Financial Committee on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System*. April 12, 2000, and *Supporting Document to the code of Good Practices on Transparency in Monetary and Financial Policies. July 24, 2000.*

in how to bring about reform of developing country financial systems, despite universal agreement that some level of minimally acceptable standards are needed and that the IMF is unlikely to be successful at managing this on its own. The overall question may become not whether the IMF should exist, but how it can best support international financial stability along with a host of other official and private sector organizations.

In considering the merits of these reports,[16] much can be learned from a historical analysis of financial crises. Most retrospective discussions of the IMF begin with its creation at Bretton Woods in 1944. Financial crises, both in the United States and abroad, however, have a much longer history. One study points to the lessons from past financial crises, comparing the troubled nineteenth and early twentieth century period with the1990s. The author documents how the United States endured a financial crisis on average every eight years before making sweeping changes to its financial operations, such as creating the Federal Reserve System in 1913. Further serious banking reform was delayed until after the Great Depression hit. This experience points to the difficulty in making such deep structural reform that many developing countries now face, which they often resist, as did the United States a century ago, and the apparent serious level of motivation, both politically and economically, needed to spur such change.[17]

Three insights emerge from this study. First, financial sector reform is not needed for capital to return to a country that has undergone some type of financial crisis. Financial capital, for various reasons, has repeatedly found its way back to troubled countries, including the United States in the nineteenth century, despite numerous setbacks. The need for financial sector reform, however, may be more compelling because of this trend; that is, financial sector reform is necessary not because capital will fail to return to crisis countries, but precisely because it will return and hence be a disincentive for reform, setting the stage for the next crisis.[18] This supports the universal call for financial sector reform, but not necessarily the Meltzer Commission's implication that market discipline can force it.

Second, the IMF is not the cause of financial crises. Crises were a part of the financial landscape long before Bretton Woods, when capital moved relatively freely among countries and in similar volumes relative to the size of economies at the time, and continued through history regardless of the international monetary system in place. Whether the IMF has been an agent aggravating financial crises is less clear, but this research suggests that solutions, such as closing the IMF, would appear to

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[16] There are other relatively recent responses to the Meltzer Commission, some of them summarized in: Williamson, John. *The Role of the IMF: A Guide to the Reports*. International Economics Policy Briefs No. 00-5. Institute of International Economics. Washington, D.C. May 2000. Can be found at: [http://www.iie.com]..

[17] DeLong, J. Bradford. Financial Crises in the 1890s and the 1990s: Must History Repeat? *Brookings Papers on Economic Activity 2*. Brainard, William C. and George L. Perry, eds. Washington, D.C. 1999. pp. 267-69.

[18] Ibid, p. 270.

have little effect on deterring future financial crises in and of themselves.[19] There is some evidence that international "bailouts" may have some effect on hastening recovery in financially troubled countries, which can be thought of as a "benefit" to counter the "cost" of moral hazard.[20] Still, there is broad preference to find a better, more orderly, way to manage crisis situations.

Third, in comparing the exchange rate problems of the 1990s with those of a century earlier (the gold standard), it has become clear that there are solid benefits associated with firmly fixed exchange rates. Such fixing, however, requires a commitment to policies that will support the exchange rate. In today's world of pegged exchange rates with less than credible promises given the proclivity of governments to reverse policy when international pressures mount, it appears there is little reason to believe that any of various alternatives to floating exchange rates or some extreme form of fix (dollarization) is possible. This is in keeping with most current exchange rate analyses.

In light of these insights, if there is a central conclusion that can be gleaned from the varied approaches to IMF reform discussed in this report, it may be that it is too much to ask the Fund to tame an international financial system where capital moves freely and speculatively, capable of causing severe macroeconomic problems. The Council on Foreign Relations idea that limited capital controls be reconsidered, for example, may garner broader support in this context. This is not to deny the benefits of increased oversight of the IMF, of continuing to emphasize adopting changes already in progress at the IMF, or of more stringent Fund advocacy for improving borrowing country policies. It may suggest, however, that because many players with far more resources and clout than the IMF are involved (governments and financial institutions), that reform of more than the IMF may be needed to improve the prospect for greater stability to the international financial system.

In particular, there is a growing body of literature seeking to find a middle path between continuing large IMF bailouts and leaving financially troubled countries to be disciplined by panicked capital markets, both of which frequently result in turmoil. One thrust argues for changing lending rules to include specific contractual obligations that require creditors to pursue a collective orderly debt workout if a crisis hits. This might diminish the frequency of future crises by incorporating a more appropriate level of risk into lending arrangements and thereby reducing the amount

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[19] Ibid, p. 271. This point is reiterated and supported in comments on p. 286 and also in Eichengreen, *Toward A New International Financial Architecture*, pp. 97-98.

[20] Ibid, p. 273, f. 42. Based on a conversation with a top IMF official, the author cites the case of Mexico in 1982, where the extent of international financial support was considerably less (although unprecedented for the time) than that following the peso crisis in 1995. It is argued that this distinction contributed to the fact that in 1982 there was a five-year lag before capital returned, whereas in 1995, capital began returning within a year of the crisis peak. Brazil, which in its 1999 crisis experienced a relatively short time before capital began returning, might be a better example, given the large preemptive loan arrangement that was negotiated, a case, interestingly enough, not evaluated by the Meltzer Commission. For details on Brazil, see: CRS Report 98-987 E, *Brazil's Economic Reform and the Global Financial Crisis*, by (name redacted). Updated June 19, 2000.

of capital flowing into developing countries. It could also lessen the depth of crises by reducing the amount of capital that could leave the country at the IMF's expense. The IMF could serve as an active proponent of this approach through its consultation and conditionality efforts, as well as, by lending into arrears as a support mechanism for keeping all parties to the debt renegotiation table.[21]

It appears that oversight actions by the U.S. Congress and institutions representing the international community have been critical in fostering the many changes that are taking place within the IMF. Congress has its most leverage, however, when considering appropriations legislation involving IMF funding increases. Since the quota review occurs only once every five years and does not always result in a recommendation for an increase, in the interim, Congress must rely on the public forum and exerting policy pressure through U.S. representation at the IMF as its primary options for making its voice heard. Continued oversight surely will be necessary to keep the reform process moving, but more time may be needed to sort out precisely which policy options will suit the collective, but competing needs of the IMF member countries and other constituents of the global economy.

[21] Council on Foreign Relations, *Safeguarding Prosperity in A Global Financial System*, pp. 69-72 and Eichengreen, *Toward A New International Financial Architecture*, pp. 65-78, 113, and 121.

Appendix 1. Selected IMF Reform Proposals

Meltzer Commission Issue	Meltzer Commission Dissenting Statement	U.S. Treasury Response	Council on Foreign Relations
IMF Mission: 1) limit lending to short-term liquidity assistance; 2) distinguish from World Bank; no long-term structural adjustment or development assistance lending – close Poverty Reduction and Growth Facility (PRGF); 3) collect and disseminate country financial and economic data on a timely basis; 4) surveillance and advice (not IMF conditionality) on economic policy through open Article IV consultations.	Agrees with need to reform IMF, differentiate it from World Bank, and provide better data. Does not support eliminating longer-term lending, closing PRGF, or policy advice replacing IMF conditionality.	Agrees with need to differentiate IMF from World Bank and for better data dissemination, enforced with strong surveillance. Would not eliminate longer-term lending, the PRGF, or IMF conditionality.	Focus IMF on fiscal, monetary, exchange rate surveillance and issues (including loan conditionality). Use smaller, less frequent "bailouts," emphasize quick reform after crisis. PRGF not addressed.
Participation in IMF Programs:1) members provide accurate and timely information for all market participants; 2) large industrial countries act as own lenders of last resort, not eligible for IMF loans; 3) no required Article IV consultations for developed countries; 4) minimum prudential standards as preconditions for automatic financial assistance.	Supports improved rules on information flow, disagrees with no lending to large developed countries, does not address Article IV, encourages higher financial standards, but not as precondition for borrowing.	Supports better standards for all country reporting to market participants via expansion of IMF's Special Data Dissemination Standard (SDDS), Article IV reports, and greater use of liquidity indicators.	IMF should make public Article IV consultations and a "standards report" assessing a country's compliance with international financial standards (e.g. SDDS and Basel Core Principles).

Meltzer Commission Issue	Meltzer Commission Dissenting Statement	U.S. Treasury Response	Council on Foreign Relations
Rules (preconditions) for Lending: 1) allow entry of foreign financial institutions; 2) require capital adequacy of domestic institutions; 3) publish maturity structure of sovereign and guaranteed debt (including off-balance sheet liabilities); 4) meet "proper" fiscal requirement.	Does not address foreign banks, supports stronger domestic banking and Basel Core Principals on capital adequacy, does not address debt data, disagrees with need for specific fiscal requirement.	Disagrees with preconditions for lending. Supports advocating financial sector reform using IMF conditionality.	No preconditions, use incentive system (variable lending rates) based on reforms that reduce vulnerability to crises (e.g. good bank deposit insurance system).
Terms of IMF Lending: 1) 120-day loans with one rollover; 2) graduated penalty rates; 3) explicit legal priority for repayment over other debt; 4) clearly defined and observed credit limits; 5) defaulters denied access to credit from other IFIs* and IMF members.	Disagrees with all provisions.	Disagrees with all provisions. Supports use of existing IMF programs emphasizing a modified CCL* for crisis prevention and graduated lending rates with SRF.*	No huge bailouts, use existing IMF lending limits, reform-based graduated rates, special "contagion facility" to replace CCL/SRF for systemic crises.
Exchange Rate Policy: discourage use of various pegged exchange rates in favor of firmly fixed or flexible exchange rate regimes.	Suggests more details needed on how developing countries can manage this issue.	Would not support lending to countries with incongruent exchange rate and macroeconomic policies.	Refuse assistance to countries with unsustainable currency pegs. Supports non-discriminatory short-term capital inflow taxes.

Meltzer Commission Issue	**Meltzer Commission Dissenting Statement**	**U.S. Treasury Response**	**Council on Foreign Relations**
Debt Workouts: 1) private sector must remain engaged in debt workouts to deter resorting automatically to IMF assistance, lending preconditions and limiting IMF response will help; 2) HIPC debt forgiven with policy reform.	A more detailed formula is needed for private sector involvement, agrees with HIPC debt relief.	Supports market-based debt workouts and increased debt relief through current HIPC initiative, but not full debt forgiveness.	Private-sector burden sharing defined in loan contracts (collective action clauses), IMF relief for default only if "good faith" rescheduling talks are in progress. HIPC not addressed.
IMF Operational Reform: 1) rationalize and simply accounting system; 2) improve transparency; 3) no further quota increases.	Supports gist of reform, does not address quota.	Improve IMF governance and accountability with efforts to establish private financial market advisory group and permanent independent evaluation office. No change to quota review process.	Supports IMF efforts on transparency. Does not address IMF quota review process.
* IFI = International Financial Institution, CCL = Contingent Credit Line, SRF = Supplemental Reserve Facility.			