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IMF REFORM: PROPOSALS TO STABILIZE THE INTERNATIONAL FINANCIAL SYSTEM

HEARING

before the

JOINT ECONOMIC COMMITTEE
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IMF REFORM: PROPOSALS TO STABILIZE THE INTERNATIONAL FINANCIAL SYSTEM

October 7, 1998

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Sanford, Thornberry, Ewing, and Hinchey; Senators Bingaman and Robb.

Staff Present: Christopher Frenze, Robert Keleher, Juanita Morgan, Darryl Evans, Andrew Quinlan, Daniel Guido, Joseph Cwiklinski, Howard Rosen, and Tami Ohler.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Inasmuch as there are many things going on in and around the Capitol–there is a party conference down the hall which Members from the Democratic side are attending on urgent business, and I know that there are other Members from the Republican Majority side who will be joining us shortly–but inasmuch as Dr. Frenkel, I know, has a schedule to keep, and Dr. Calomiris, we appreciate you being here, we are going to start on time. Here comes my friend, Mr. Ewing, so we will begin.

I will begin with my opening statement, and then ask others who may be here if they have an opening statement as well.

I am pleased to welcome the witnesses before the Joint Economic Committee (JEC) this morning. We are fortunate to have two experts on international finance testifying on reform of the International Monetary Fund, which we will, of course, refer to as the IMF.

We look forward to a serious analysis and provocative exchange of views on this critically important topic regarding the international financial system.

In recent months, calls for IMF reform have come from the American, British, French, and Italian Governments, as well as from many others. Much of the discussion of IMF reform and the new international financial architecture is very general and abstract, and sometimes it is difficult to know exactly what is actually being proposed when we talk about the definition of reform. This morning, in contrast, we will be discussing some very specific comprehensive proposals for reform of the International Monetary Fund.

This is the fourth in a series of Joint Economic Committee hearings on IMF and international economic policy held this year. The issues related to IMF reform are difficult and ones upon which reasonable people can, and will and do, disagree. As fundamental reform of the IMF has emerged as a major issue, it is important for policymakers to explore alternative proposals.

Last week, the Shadow Financial Regulatory Committee, a nonpartisan group of financial experts, released a set of IMF reform proposals designed to contain moral hazard, restrict subsidized lending, improve IMF transparency and accountability, and improve the evaluation of IMF performance. This general approach is consistent with my much more limited near-term reform proposals for the IMF, and resembles in many respects a proposal before us that we will hear about today.

In brief, one of the proposals presented today by Professor Charles Calomiris first establishes capital standards to protect the soundness of the domestic banking system. His reform of the IMF would, among other things, do the following:

One, require adoption of capital standards in the domestic banking system as a requirement of IMF membership.

Two, end the IMF's current standard practice of lending at subsidized, that is, below market, interest rates and, instead, require interest rates that would be set somewhat above market levels to discourage abuse.

Three, require that IMF loans be collateralized by borrowers offering securities as backing for loans.

Four, require that IMF loans provide for liquidity assistance and, therefore, be limited in maturity to several months rather than several years.

Fifth and finally, dispense with the often counterproductive loan conditions, since borrowers are essentially pre-qualified under the Calomiris approach.

These reform ideas are all designed to restructure the IMF as an institution focused on providing liquidity to illiquid governments. I welcome the proposal by Dr. Charles Calomiris and equally welcome the testimony offered by Governor Jacob Frenkel, who is also with us today.

[The prepared statement of Representative Saxton appears in the Submission for the Record.]

Mr. Ewing, do you have an opening statement at this point?

OPENING STATEMENT OF REPRESENTATIVE THOMAS W. EWING

Representative Ewing. Mr. Chairman, I do not and will not take time to make one, except to thank the witnesses for their time in being here today and congratulate you on moving ahead with the discussion of maybe the most important economic decision that we will make here in Congress before we go home, and I look forward to today's testimony.

Representative Saxton. Thank you very much.

Dr. Calomiris and Dr. Frenkel, we are under only mild time constraints. I understand that Dr. Frenkel has to leave shortly before the noontime arrives. So, Dr. Calomiris, if you would start with your testimony, I understand that you will consume some 20 or 25 minutes and then we will go to Dr. Frenkel.

OPENING STATEMENT OF CHARLES W. CALOMIRIS, COLUMBIA UNIVERSITY

Mr. Calomiris. Thank you.

Mr. Chairman, it is an honor to speak to you today. I will present a summary of a more detailed presentation and I request that it also be entered into the record.

I would like to describe for you a concrete proposal for reforming the so-called global financial architecture, and the IMF in particular, which considers current problems and solutions to those problems.

First, I review a comprehensive list of problems. The point of that discussion is not to determine the relative importance of each one, but rather to see how hard it would be to address all of them together.

Economics normally provides rather dismal news, emphasizing necessary trade-offs among objectives. In the case of redesigning financial architecture, however, such is not the case.

It is not difficult to construct a set of mechanisms that resolve, at the same time, problems of illiquidity, by providing a responsive international lender of last resort facility alongside a domestic deposit insurance system, while avoiding the governance and incentive problems attendant to counterproductive bailouts of risk-takers by ensuring credible market discipline of financial institutions.

The hurdles that must be overcome in designing an appropriate financial architecture then, are not those posed by economics, but rather by politics. The challenge is to get those with vested interests in the current allocation of political power over the global financial architecture–including bankers, developing country oligarchs, and the U.S. Treasury–to relinquish some of the power they currently wield in order to make the global financial system more efficient, competitive, and democratic.

The details of the plan are summarized in Table 1 of the main paper and are also attached to my statement. I emphasize that the success of each component of the proposal depends on all the other components.

Without a reliable means of bringing credible market discipline to bear on banks, to provide strong incentives for prudent risk management, government deposit insurance and IMF lending will spur excessive risk taking with its attendant costs. But in the presence of credible market discipline, deposit insurance and IMF lending, if structured properly, can strengthen the financial system by helping to avoid liquidity crises, which result either from problems of asymmetric information or self-fulfilling expectations.

In implementing such rules, the devil is in the details; hence, my emphasis on "blueprints," specific concrete proposals, rather than simple organizing principles. Slight differences in details can make the difference between a reform agenda that achieves both liquidity and proper incentives toward risk, and one that achieves neither.

This proposal is offered at an opportune time. Contrary to some statements by IMF officials and by officials of the U.S. Treasury, the IMF is facing a long-term funding squeeze but not an immediate budget crisis, as the GAO testimony presented before this committee on July 23 convincingly showed.

IMF funds are still substantial, certainly more than enough to deal with any liquidity crises that are likely to arise in the next few months. So there is no need to rush passage of congressional appropriations for the IMF. On the contrary, the longer-term need to increase the IMF's resources offers member country governments, including the U.S. Congress, a unique window of opportunity to consider meaningful reform of the way the IMF operates.

Last week, as you noted in your opening remarks, the Shadow Financial Regulatory Committee–a nonpartisan, independent group of experts on financial regulation, of which I am a member–issued a statement on the IMF unanimously calling on Congress not to release new funds for the IMF until it had achieved substantive reforms that will prevent the abuse of IMF assistance, clarify IMF objectives, and make the IMF a more accountable institution. My statement today offers details on how to achieve those objectives.

Let me turn now to a brief discussion of the challenges facing the global financial system and my proposals for addressing those challenges.

Over the last 20 years, 90 banking crises have occurred that are equal or greater in magnitude, in terms of banking system losses, to the U.S. banking experience during the Great Depression. In at least 10 cases, banking system losses will exceed 20 percent of GDP, a staggering and unprecedented set of losses, which are occurring during a time of relatively stable and rapid global growth.

Banking system collapse due to excessive risk taking by banks has been a common feature of all the recent financial collapses. Bank losses precede and cause exchange rate collapses.

Banking systems worldwide have become the key source of financial instability. Economists have pointed to several core problems that feed that instability. First and foremost are incentive problems that encourage risk taking, particularly in response to adverse macroeconomic shocks. Before banks were protected by government safety nets, economic downturns produced contractions of bank credit supply and reductions in bank dividends, as banks scrambled to reassure depositors that bank loan losses would not result in losses for depositors.

But safety net protection through domestic deposit insurance and IMF lending has removed that important disciplinary check on bank behavior. Safety net protection, ultimately taxpayer protection of banks and their claimants, relaxes market discipline on bank risk taking and subsidizes higher risk in banks. This effect is especially pronounced after banks experience initial losses to the value of their assets. In the wake of such losses, safety net protection encourages banks to consciously increase their asset risk. Those increases in risk often take the form of increased default risk on their loans and exchange risk, after banks have already seen severe depletion of their capital.

Bailouts of developing economies' banks and international bank lenders to those banks, orchestrated by domestic governments in cooperation with the IMF and the U.S. Treasury, must stop. Not only do they produce inefficient risk taking, fiscal disasters for domestic governments, and enormous distortionary taxes for their taxpayers; by supporting crony capitalism–both within developed and developing economies–they also undermine the core competitive and democratic processes on which successful financial systems depend.

The IMF didn't invent bank bailouts and IMF involvement in bailouts is mainly indirect but nonetheless it is quite destructive. The IMF provides only a small wealth transfer to its borrowers in the form of loan subsidy, and so does not directly pay for much of the cost of the bailout, but the IMF pressures borrowers to bail out foreign bank lenders and lends support and legitimacy to domestic bailouts, too, by requiring government taxation to finance the repayment of IMF loans.

The destruction wrought by these bailouts have led many, including George Shultz and Anna Schwartz, to call for abolition of the IMF. Others however, including myself, argue that liquidity assistance by the IMF could be useful if properly designed. Indeed, IMF liquidity assistance has sometimes been helpful. The most obvious case may be the March 1995 IMF loan to Argentina. Here the IMF lent to a government that had pursued significant tangible fiscal and banking regulatory reforms, and did so with the express goal of financing a defense of the Argentine currency board, not financing a bailout of banks or other government expenditures.

To summarize the discussion in the paper of liquidity problems, the two most important types of problems are (1) banking panics that result from temporary confusion on the part of bank debt holders about the insurance within the banking sector of losses attendant to an observable shock and (2) self-fulfilling collapses of currencies that result from government illiquidity.

To solve the first problem, I propose a set of banking regulations that together would remove the threat of banking panics. These include (1) capital standards founded on market discipline, achieved through a requirement that banks maintain a minimal proportion of uninsured, junior–that is, subordinated–debt; (2) credible deposit insurance for other bank debt claims; (3) a 20 percent "cash", or equivalents, reserve requirement for banks; (4) a 20 percent global securities requirement for banks; (5) free entry by domestic and foreign competitors into banking; and (6) limitations on other government assistance to banks.

In the paper, I discuss in detail how to design effective, credible market discipline. Here, my plan is largely based on the Chicago Federal Reserve's 1989 subordinated debt proposal, although there are some differences.

It is important to emphasize that a broad consensus has emerged on the need to add some form of subordinated debt requirement to the Basle capital standards. Advocates of some form of such a requirement now include the Bankers' Roundtable, an organization of the largest 150 American banks in the United States; the U.S. Treasury; several Federal Reserve Banks; at least one Fed Governor; some Members of Congress; and the Shadow Financial Regulatory Committee. Recently, the Federal Reserve Board has assembled a task force which is now exploring the question of how best to design and implement such a subordinated debt requirement.

The combination of domestic deposit insurance and market discipline, which prevents the abuse of deposit insurance, can resolve the threat of banking panics that result either from confusion about the incidence of shocks to bank loan portfolios or self-fulfilling concerns about the insufficiency of bank reserves.

The IMF's roles would be mainly to address the other liquidity problem, liquidity crises that face member governments as the result of unwarranted speculative pressure on exchange rates. This was the original intent of the IMF's founder and it remains a legitimate objective of IMF policy.

Recent studies that emphasize the value of IMF liquidity protection argue that the current form of IMF assistance is inadequate; it is too little too late, and with too many conditions and delays to be effective in short-circuiting self-fulfilling runs on currencies or government debt.

But how does one provide effective liquidity protection without encouraging counterproductive bailouts of banks and/or governments?

My plan is to replace the current IMF and Exchange Stabilization Fund with a new IMF, which would offer a discount window lending facility. That facility would only be available to IMF members, and membership would require adherence to the aforementioned banking regulations, as well as some additional rules regarding government debt management, and–if a country maintains a fixed exchange rate–a 25 percent minimum reserve requirement for the central bank as well as a requirement that banks offer accounts denominated in both domestic and foreign currency within that country.

By restricting access to the IMF window to members in good standing who conform to a few, simple, and easily verified rules, the IMF avoids free-riding on liquidity protection and the hazard of unwittingly financing bank bailouts in the guise of liquidity protection.

The rules governing the discount window follow Walter Bagehot's classic principles for ensuring liquidity while avoiding free-riding: lend freely on good collateral at a penalty rate.

The specifics of membership rules, limits on collateral, and penalty lending rates–described in Table 1 of the paper–encourage member governments and central banks, like their commercial banks, to diversify their securities portfolios and maintain adequate liquid reserves.

If a member is in good standing, loans are made available on good collateral using week-old prices to value the collateral. The loan interest rate is set at 2 percent above the value-weighted yield to maturity on the collateral offered. That provides a fast and effective means to short-circuit a self-fulfilling "bad equilibrium."

Why are there no additional conditions in my proposal for those loans? For liquidity assistance to be effective, it must be delivered quickly and supplied elastically.

Why no more rules for members? Well, there are lots of basic rules countries should meet to build effective domestic financial systems. These include accounting standards, procedures for registering collateral interests, court enforcement of creditors' and stockholders' rights, a transparent and efficient bankruptcy code, and many, many more. But these rules are sometimes more controversial. For example, I would argue that the Swedish bankruptcy code is far superior to the American one, and these rules are sometimes hard to specify in a simple way. I have not tried to construct a list of all the desirable rules, but rather a set of minimal rules that are important, simple, and easily verifiable.

Furthermore, additional rules–accounting, bankruptcy and commercial laws–will arise endogenously if there is credible market discipline within the financial system, which the subordinated debt requirement and the other rules would ensure. Market discipline provides a strong constituency of banks and their debt holders who will seek ways to improve transparency, contract enforceability, and sensible workout procedures. And I think the evidence that we have from countries that have pursued such increases in market discipline clearly bears that out.

How will the IMF actually operate the "window?" IMF lenders would contribute-that is, lend-bonds to the IMF, which along with the borrower's collateral would be used to access the discount window of the hard currency central banks, who would lend cash to the IMF collateralized 100 percent by the government securities of that central bank's government. The hard currency central banks, thus, would lend risklessly. They would also be free to sterilize the effects of IMF borrowers on the aggregate supply of hard currency. So this in no way would affect U.S. monetary policy.

To avoid the potential for costly bailouts, other redundant mechanisms would be abolished, especially the Exchange Stabilization Fund, and emergency assistance to banks via the World Bank, the IDB, or others.

Having argued that this plan would achieve proper incentives in private banking and in government finance, and would also protect against liquidity crises, I now turn to the more difficult question: whether it is politically feasible.

Clearly, vested interests will oppose this approach, precisely because it might work, and thereby deprive them of a valuable, though socially costly, subsidy. It may be possible and worthwhile, therefore, to "buy off" some of those vested interests-particularly those within the banking systems of these countries-by offering a one-time injection of public funds to recapitalize banks, and thereby make the pill of market discipline easier to swallow. That is, of course, exactly what the Shadow Financial Regulatory Committee of Japan is currently suggesting, as I understand, to resolve the Japanese crisis.

It is also worth considering how domestic governments interested in implementing true reform might be helped by the World Bank and other development banks to achieve membership in the newly constituted IMF. Too often the World Bank has crowded out private lending and removed incentives for countries to adopt credible market discipline. World Bank loans to China are the clearest example of this problem. But in some cases, again notably in Argentina recently, the World Bank has provided subsidies to make privatization and market discipline more achievable. More of World Bank assistance should be directed toward that end, and it would make it a lot easier for countries to qualify for these new IMF membership criteria.

A central principle of my proposal is to clearly separate the functions of the IMF and the World Bank. The IMF would focus on liquidity protection for member countries that have achieved sound financial liberalization. The efficacy of that protection would be much enhanced by focusing on achieving that narrowly defined economic objective.

The World Bank would facilitate liberalization and, hence, help to expand the IMF membership list. Encouraging bona fide liberalization is a long-term process. The form and pace of assistance by the World Bank that is required is different from that of emergency liquidity assistance, and it is very counterproductive to confuse the two missions and the two kinds of assistance.

Possibly, the greatest obstacle to my proposal will be the likely opposition of the U.S. Treasury to repealing the Exchange Stabilization Fund and focusing the IMF on providing bona fide liquidity assistance. The Treasury has regrettably used the Exchange Stabilization Fund and the IMF as slush funds to provide foreign aid, without the inconvenience of seeking congressional approval, in the guise of liquidity assistance. Getting the U.S. Treasury to forswear such activities is a formidable challenge, one that may require veto-proof support in Congress.

If all of these challenges to reform the IMF could be overcome and something like this proposal were enacted, would the IMF abide by the new rules? Obviously the goal of my plan has been to design rules that are transparent to outsiders, which would make it harder for the IMF to "forebear" in enforcing those rules. The more we all talk about ways to further limit the forbearance, the better.

In summary, I think it is economically feasible to restructure the way the IMF does business to promote a more efficient and democratic financial system, one that ensures market discipline while avoiding market chaos.

If the G7 chose such a path, other countries would follow. The rewards to participating in an open, market-oriented, and stable global financial system would be irresistible. The transition process could be facilitated, as I have argued, if the funds currently channeled through the World Bank and other development banks could be redirected toward helping countries to qualify for membership in the newly constituted IMF.

The approach to reform I am advocating has many supporters. Yesterday's *Wall Street Journal* featured op-ed pieces by Martin Feldstein and by the British Chancellor of the Exchequer, Gordon Brown. Let me read a couple of quotes. Mr. Feldstein wrote:

> The IMF can help prevent future crises by creating a collateralized credit facility that lends foreign exchange to governments that are illiquid but internationally solvent. . . A rapid payout facility can reduce the risk of speculative attacks and induce countries to maintain open capital markets and free trade. . . An international credit facility can only work if it provides credit rapidly, at an above-market interest rate that discourages unnecessary use and in exchange for good collateral. . .

Mr. Brown wrote:

> Our task is not to weaken support for the IMF and World Bank, but to strengthen them by building the operational rules by which we monitor and discipline ourselves. . . The way to do this is to agree to abide by well-understood and internationally endorsed codes of conduct for fiscal policy, monetary and financial policy, corporate standards and social policy. . .

Also in today's *Financial Times*, Sebastian Edwards writes:

> The long history of currency crises in Latin America has shown that, more often than not, the problem is lack of bank supervision, and not excessive capital mobility. This was also the case in South Korea. . . By focusing on capital controls, the multilateral institutions have been barking up the wrong tree. There is a real danger that by doing this, they will not focus sufficiently on what is truly important: achieving transparency, strengthening bank regulation, avoiding corruption, furthering the reforms and, in many cases, pursuing major corporate restructuring.

These voices and many others are calling for a new approach to managing the IMF and the World Bank, one that emphasizes adherence to economic principles that ensure market discipline, liquidity, and competition, and that avoids allowing the IMF and World Bank to be the instruments for the political power plays of vested interests. Thank you.

[The prepared statement of Mr. Calomiris appears in the Submissions for the Record.]

Representative Saxton. Dr. Calomiris, thank you very much. Before we move ahead, let me just note that Dr. Calomiris has prepared for today's presentation to our Committee a full scholarly paper, which his remarks reflected quite accurately, I believe. I just wanted to point that out. It is, or soon will appear on–it is out on the table and will soon be available on the Internet as well.

Dr. Frenkel, if you will just permit me, I would like to introduce those Members who have come in during Dr. Calomiris' testimony. Mr. Hinchey of New York is now with us, as is Mr. Sanford from Georgia and Mr. Thornberry from Texas. Thank you all for being here.

Let me now introduce Dr. Jacob Frenkel. This Committee is especially pleased to have Dr. Frankel here. He currently serves as Governor of the Bank of Israel, and has served in that capacity since 1991, after being appointed during the prime ministership of Yitzhak Shamir. Prior to that, he served as Director of Research at the IMF. And so from a practical experience point of view and from a scholarly point of view, we are very, very pleased to welcome Dr. Frenkel this morning. Dr. Frenkel, you may proceed.

OPENING STATEMENT OF JACOB FRENKEL, GOVERNOR, BANK OF ISRAEL, AND FORMER RESEARCH DIRECTOR, INTERNATIONAL MONETARY FUND

Mr. Frenkel. Thank you very much. Mr. Chairman and Members of the Committee, I truly appreciate the opportunity to be here this morning with you and share my experience in this matter.

Let me begin with a disclaimer. I am not here as a representative of my government. Nor am I here to involve myself in the U.S. policymaking process with regard to a specific issue. Instead, I would like to share my experience by providing a global perspective and speak about the role of the IMF in this regard.

In order to provide some background, allow me to just say two sentences about where I come from personally. I spent about 15 years on the faculty of the Department of Economics at the University of Chicago, and was the David Rockefeller Professor of International Economics for close to a decade. I then moved to the International Monetary Fund during the period 1987 to 1991, where I served as the Economic Counselor and Head of Research. Then, as you indicated, Mr. Chairman, I returned in 1991 to Israel to become the Governor of the Bank of Israel. In this capacity, I have had the privilege of serving under four Prime Ministers, starting from Mr. Shamir through the late Mr. Rabin, Mr. Peres, and presently Mr. Netanyahu.

The present state of the world economy must be in the background of all discussions that concern multilateral organizations like the IMF. It is clear that the global economy is currently in a precarious state.

During the past few days, an international consensus has emerged from the meetings of the interim committee of the International Monetary Fund, the various subgroupings, like the G-7, and the G-22, and now the annual meetings itself. It has become clear that we are in a fragile situation which specifically emanates from and reflects difficulties within the financial markets.

The problem is not a problem of a single country. The problem is global. As a global problem, it must be addressed within a global framework.

Let me give you an indication about the extent of changes in the state of the world over the past two years. In 1997 the world economy grew at the rate of 4.1 percent. This year the world is expected to grow at less than half this rate, 2 percent.

The United States grew at 3.9 percent in 1997 and the forecast for 1999 is almost half that rate, 2 percent.

The G-7 as a group grew at the rate of 2.7 percent in 1997 and output is forecasted to grow this year by 2.1 percent, with a further deceleration in 1999.

The developing countries have grown by close to 6 percent in 1997 and this year by almost a third of this rate, 2.3 percent. Russia grew in 1997 at a rate of close to 4 percent. This year its output will likely shrink by 10 percent. And I do not need to tell this Committee what are the implications of such a change in a country that is going through a complete disarray politically and economically.

The Asian Group of Four, which were known as "the Tigers," grew at a very meager rate of 1 percent in 1997, and are expected to decline by 6 percent this year and next. The world is shrinking.

When the world shrinks, needless to say, the standard of living of individuals all over the world, those who are poor or those who are less poor, deteriorate. Capital markets in the world have dried up and this is the major problem which currently confronts the world economy.

It makes no sense that countries that have behaved extremely irresponsibly and countries that have behaved extremely responsibly face the same dryness of world capital markets which have now gone into an extraordinary overshooting of reluctance to take risks, after excessive risk taking in the previous year.

I think that Dr. Calomiris has pointed out the key elements of sound banking systems, sound financial systems, and moral hazard. I will address them in a moment. I want to make sure that first we understand the background against which we are discussing these issues today.

Where does the IMF stand in this regard? To begin with, since the problems of the world are global and since the world is interconnected, we must have a global framework to address these global issues. For example, the problem of contagion in the current situation is key. Therefore, if we restrict membership in a global organization only to those who qualify under a very strict set of standards–standards that we like–we may still have the difficulty that the criteria are so tight that they outside the membership those countries that in turn will affect the entire membership. In that case there will be no consistent mechanism by which the entire membership can exercise its voice, because the "villains," so to speak, would be outsiders.

We must find a delicate balance by which everyone is inside, in order to hear the voice of reason and sense.

Now is not the time to argue about criteria for a membership fee. I return to my original principle–we are in a new era, and the problems we face are systemic. We must have mechanisms by which membership is broad and, yes, we need to put all our efforts toward improving the behavior and conduct of the members. You will not have the mechanisms if there are more than very few nonmembers.

Reform–who can argue against reform? I think it is essential; it is trivial to argue about it. There is a danger, however. It is like Paradise. Everyone wants to be there, but not yet. So, therefore, we must find a mechanism by which reform is done on an ongoing basis rather than suddenly, standing still at a point in time and saying: "Let's not do anything else until reform is complete."

Mr. Chairman, if this principle prevails, you will have a long line in front of the emergency room. We want to develop mechanisms by which all of us can be fit enough to run five miles per day. I think that's a good objective. But are you going to insist that everyone who comes to the entry of the emergency room should first run five miles in order to prove that he has the capacity to do so? He arrives at the emergency room by virtue of <u>not</u> being able to run in the first place.

We want to educate, we want to improve, we want to reform, and we want to be practical. The problem of contagion means that we cannot afford misbehavior without having the instruments necessary to deal with it.

The world financial system is currently highly integrated. There is no question that moral hazard has been a very important issue. We have found a situation in which countries and firms have undertaken excessive risks, from a social perspective, believing that they will not have to pay the costs; and that big daddy will bail them out at the end of the day. These excessive risks have materialized and all of the public have now ended up in the same boat.

The current situation must be addressed. I think the issues presented in Dr. Calomiris' testimony are very important. But I want to draw your attention to two elements of moral hazard. The first aspect is moral hazard within an individual economy. Time and again we have seen in a country where the government provides implicit or explicit assurances, and that the private sector behaves as if it had an insurance policy without having to pay any premium, the private sector will start behaving recklessly.

The problem becomes a public policy concern when–metaphorically speaking–a driver drives recklessly, and incurs accidents that involve other cars as well.

This is an area of legislation, of supervision, of regulation that each country must exercise and that the international community must have a way to impose on every country. That is one element of moral hazard, that I strongly believe we need to deal with.

There is a second element of moral hazard which relates to the international community. It is the notion that the very fact that there is an IMF induces governments to "drive recklessly," knowing that they will be bailed out. I believe that even though this point may be theoretically correct, the hardship on any country which actually gets in a "car accident" is so high that it is inconceivable that the leaders would say: "If we get some IMF assistance in the future, the risk was worth it"; neither politically, or socially or humanly.

Currently stock markets are declining, firms are losing profits, employment is shrinking, and lenders in many countries are finding that their net-worth deteriorated. Lenders have paid and are paying a significant price. Moral hazard is not an absolute term. You must show that despite the significant capital losses that have occurred, countries still have the incentive to behave recklessly.

The case for the IMF, like in many areas, for example democracy, is the case against the alternative. The IMF has made mistakes; it is not perfect. Yet we cannot dispense with it, and nobody proposes to do so.

But let's be sure, unless there is strong and explicit support for the IMF through a decisive public statement today–and I mean today–the financial system may face greater danger.

There is a nexus between the private sector and public sectors. Public money is insufficient to deal with world financial needs. You must also have contributions from the private sector. But the private sector will not step in unless they see that governments are willing and ready to create the environment of stability and to exercise their capacity to enforce such an environment.

This cannot be achieved without an organization like the IMF. The IMF certainly requires improvement. What worries me is that this improvement cannot paralyze us for even one more week. By then, I don't know what situation Brazil will be in, and I don't know what often crises will emerge. This is a real concern.

I strongly believe that a new economic order or, for that matter, reform should not be introduced as an emergency measure. Reform may be necessary, but it should not be introduced as an emergency measure, but rather as a long-term strategy. For example, if you have a mechanism that focuses on only short-term loans and short maturities, you force "short-termism." There is nothing more dangerous than "short-termism."

As far as the dispensation of conditionality is concerned, there is considerable logic in saying that once you have pre-qualified, you get an entry ticket and thereafter rules apply. But we are not operating in a political vacuum. Each country has a political system, executives, a legislature, and leaders. And the incentives are always there. I believe that if loans are granted without any conditionality, even if countries are pre-qualified in advance, you might provide or plant the seeds for an additional element of moral hazard. This hazard reflects the effort to get an entry ticket and forget the rules of the game once in.

I believe that conditionality is part and parcel of the monitoring mechanisms by which the international community ensures the value of their funds. Thus it is appropriate to discuss what kind of conditionality should be imposed. This very discussion, by the way, is part of improving the system. I fully agree with the notion that given the new reality of world capital markets, the new reality, we must have transparency. The lack of transparency is counterproductive, as it suggest that the public sector can do it all. If we want to draw in the private sector, we must project to the private sector where the public sector wants to be: What is the agenda? What is the commitment? Where is the Fund? Therefore publication of information is essential.

I believe that we should encourage countries, not just through pep talks, to publish reports on their economic situations. Those countries which chose not to publish reports should have to explain their decision to the capital markets. The current crisis suggests that this form of transparency is necessary.

On the other hand, let us also be aware of the fact that some countries have what they believe is privileged information and that negotiations cannot be done over e-mail or in public. There are tremendous interest groups that would be delighted to jump in to use and abuse this information. Once again, the only advice is common sense.

Let me conclude, Mr. Chairman, with one key remark which ties back to my opening statement. The world is facing a genuine financial crisis, which requires decisive leadership. That decisive leadership requires a vote of confidence in the multilateral approach.

Given the current world conditions, a vote of confidence means capacity to immediately execute a plan. This is not the time, I believe, to worry about the grand design of the system, when literally there is a potential that the system will not be able to wait for the grand design to be complete. This is why I believe we should discuss reform on a parallel track, enabling the existing system to remain operational. The system requires strengthening. A stronger IMF is required in order to involve the private sector. And the time-table for the reform should be, on a mutually agreed upon basis, a gradual one.

I think it would be wrong to suggest that the IMF has not made some mistakes. It has made them and individual countries have made them. It would be arrogant to argue that no one who has made mistakes in a system that is so fluid.

There is a story about a child who was called in by his grammar school teacher after he submitted a test. The teacher said, "I read your test and I cannot understand how a single pupil can make so many mistakes on one page!" The student replied, "I did not do it myself. My father helped me."

Well to make so many mistakes, you may need more than one. In fact, there is a partnership of mistake-makers– not just the IMF, but also te clients, the countries. We need political leadership, economic leadership, and intellectual leadership. But we must also have the platform to exercise this leadership. That platform is the IMF! And that is where I would like to close my opening remarks. Thank you, Mr. Chairman.

Representative Saxton. Dr. Frenkel, thank you very much for a most articulate statement.

Let me begin the questioning by exploring some of the thoughts that have been expressed today, particularly by Dr. Calomiris.

Dr. Calomiris, you indicated that it is your view that the IMF does not currently have a short-term budget crisis. This is, I think, a very important point, one to which there has been some disagreement on Capitol Hill already. The IMF, obviously, in requesting that we appropriate an additional $18 billion, says as its rationale that there is a short-term budget crisis; and yet others, such as the General Accounting Office, would agree with your position.

Would you elaborate on why you think these inconsistent claims are occurring and what, in your view, is the real situation?

Mr. Calomiris. Well, I think that the answer is that they are not facing a current budget crisis. But probably the easiest way to explain the disagreement is to define exactly what I mean by that, because maybe part of the disagreement is just over definition.

I haven't really been able to understand the opposing point of view. So let's go into the most immediate concern that many people are raising, Brazil. I think it is a very appropriate concern. Brazil is a country that has made very positive steps over the last few years. They are concerned about the potential of not being able to maintain their exchange rate, and there has been discussion of possibly putting together as much as $60 billion in assistance to Brazil.

It is important to say, first of all, that I think if that assistance were provided to defend the Brazilian exchange rate, under the current IMF system, I would probably be in favor of it. Obviously, it would depend on the way it was done under the current rules, but I think it is a good idea. I know that we are already in a position to be able to provide it.

The IMF does not only have its quota reserves, but it also has other lending arrangements. Now, those lending arrangements require supernumerary majorities of IMF members to agree, but presumably if there really were an important intervention that needed to be made, those supernumerary majorities of votes could be gotten.

Furthermore, the IMF can cobble together a plan with other governments' lending programs, which they have done in the past. So I think it is scaremongering, really, to claim that the current potential problem in Brazil, which is really the one that I think people are most concerned about, somehow couldn't be dealt with using current IMF resources. And I think that what we really want to ask is what we could do over the next six months to a year to work out a compromise where we would resolve the long-term funding needs of the IMF alongside real reform proposals?

Let me also say that I am not suggesting, which was part of Dr. Frenkel's statement, that we tell people coming into the emergency room with a heart attack that they should undertake a vigorous exercise program immediately. Obviously, what doctors do is tell you that if you don't want to come back here, you had better start an exercise program gradually, and as soon as you get home let's phase one in. So that is what I have in mind.

Let's get the reforms agreed to, though, immediately. We can phase them in gradually over a couple of years and, as I pointed out, development banks can be a good form of assistance.

It is not the same to say that you want to have the reforms agreed to now as to say that you want them to be implemented immediately. No sane person would make that claim, and I certainly wouldn't. So I am not sure that we really disagree.

So my point is, we certainly have enough resources to deal with the next six months to a year. That is, we are not in a crisis and we have a window of opportunity. As a parent, I have learned that windows of opportunity are things that should be taken advantage of; I sometimes require discipline before I give away the candy.

Representative Saxton. Dr. Calomiris, let me just pursue this point one step forward. When the GAO issued their report some time ago–I guess it was probably in the neighborhood of two months ago now–they indicated that there was over $40 billion in quota, there was at the time something in the neighborhood of $23 billion in the arrangements to borrow account, that there was a less-than-liquid gold reserve of about $32 billion, and that there were other mechanisms through which the IMF could raise money, which conservatively they estimated at about $60 billion.

Do you agree or disagree with the premise that that is in the ballpark?

Mr. Calomiris. Again, as you move to those larger amounts, you have a progressively more onerous supermajority rule for actually being able to access them. But, as I said, I don't view that as a problem. Of course, you left one thing out, which is that there have been a lot of loan programs that are going to be generating inflows of revenues and repayments to the IMF over the next year.

Representative Saxton. That was not part of the GAO report, I don't believe.

Mr. Calomiris. Right.

Representative Saxton. That number, we believe, in the foreseeable months ahead could be in the neighborhood of $13 billion, or numbers to that effect.

Dr. Calomiris, one of the points that you emphasize is the difference between liquidity and solvency. On one level, this appears to make such a clear and important distinction, but the two concepts don't seem to be adequately distinguished by IMF policy and its lending activities.

Would you discuss this issue and define for us what you mean by liquidity or illiquidity, and solvency or insolvency, and how you think the IMF approaches the difference–these two concepts–and how they ought to, in your opinion, approach these two concepts?

Mr. Calomiris. Certainly. We will have to start with a little bit of basic economics. An illiquid but solvent institution that is troubled during a crisis is an institution that if its depositors did not come in and ask for their money back, on a market value basis then the bank is just fine. But if everyone decided, all of a sudden, to come in and ask for their money back, the bank would have to try to sell off its assets, would have to do so at fire sale prices, and therefore would become insolvent as the result of its illiquidity. That would be a bank which ex ante, at the time we are looking at it, is actually solvent but potentially faces a liquidity crisis.

Representative Saxton. May I just ask—

Mr. Calomiris. Please.

Representative Saxton. Could you equate the term "liquidity" with a term that I refer to as "cash flow" problem?

Mr. Calomiris. It can be, but I haven't gotten to all of the possible meanings. That is certainly one of them. If the bank has low cash flow, or if anyone has low cash flow that it can become illiquid, which could generate an unwillingness on its creditors–in the case of banks, depositors–to continue, because they are worried about being able to get access to funds. They might be unwilling to continue to lend and, therefore, withdraw their funds, which creates an unnecessary loss.

Representative Saxton. Now, the more serious condition would be solvency or insolvency, would it not?

Mr. Calomiris. That is correct.

Representative Saxton. You could equate solvency or insolvency with bankruptcy?

Mr. Calomiris. Well, bankruptcy is a legal term, but solvency means that the market value of your assets is less than the face value of your debt obligations. And what we have in all of the countries that we have been talking about is that situation, in advance of the exchange rate collapses. And that situation created enormous fiscal problems for those governments. We are now finding out that in some of these countries, the fiscal burdens on their governments, due to that insolvency in the banking system, may be 30 percent of GDP. That is not an illiquidity problem.

Representative Saxton. Your proposal then would suggest that the IMF deal with liquidity problems, but not necessarily solvency problems?

Mr. Calomiris. It couldn't. If my proposal were enacted, it couldn't deal with solvency problems. It would be almost impossible. But I didn't get to the liquidity problem that I would have them deal with. They would not be dealing with liquidity problems in the banking system. A combination of credible market discipline, a new capital standard requirement, and domestic deposit insurance would take care of that problem.

The new ideas about liquidity that are concerning many economists right now have to do with speculative attacks on exchange rates, even when governments could maintain their exchange rate credibility in the long run–that is, the long-run fiscal and monetary policy of the government is sound. But suppose the central bank gets down to a very low amount of reserves and suppose that speculators start to become concerned that other speculators may run to get those reserves. Then you have the problem of a self-fulfilling run on the central bank of the country.

So that is a different kind of problem. It is an illiquidity problem of the central bank, and that is the sort of thing that my plan would take care of–that the IMF would take care of.

Representative Saxton. Thank you.

Dr. Calomiris, in your plan you make a number of points that your plan does, as I was able to identify in reading your testimony, six things.

One, it establishes capital standards to protect the soundness of domestic banking systems. Two, you reform the IMF and you would make these standards required for IMF membership. Three, you would end subsidization through the IMF of interest rates. Four, you would require the use of collateral for loans. Five, you would limit loan maturity to a few months rather than the current longer term loans. And, six, you would dispense with the intrusion of conditions attached to the loans.

Is that a fair summary of the points that you made?

Mr. Calomiris. Couldn't have done better myself.

Representative Saxton. Let me ask you about the standards. Point number one goes to the standards that you advocate to protect the soundness of the domestic banking systems. What types of standards, and I don't know whether you want to be specific or whether you have a more general answer, but what do you have in mind here?

Mr. Calomiris. I have been working both in the United States and other countries, and one of the things that is common in the banking systems of many countries is that they often have on their books things that sound very good, banking laws that seem to require banks to have a lot of capital, that seem to limit bank risk-taking, and that seem to limit the abuse of the taxpayers by the bank.

But the problem is, what all of those laws, almost all of them, require is that supervisors, who themselves are government employees, make judgments about the value of bank loans, to measure the capital that is in the banks, and to decide whether the capital is there. The most extreme example, of course, is in Japan right now.

The Japanese have signed the Basle capital standards so that there is a claim, which no one believes, that the Japanese banks have positive net worth. Well, we know that is not true but no one is going to stand up, no government is going to stand up, and say that all of these banks are insolvent and are in violation of the Basle capital standards.

So the point of my proposals, and what I would say commends them to you, is their unoriginality–they are proposals that have a very broad base of support–is that we have to have bank regulations that don't require supervisory discretion to measure the value of bank capital. So the things I am advocating would be requiring that banks be on a very small margin of credible market financing.

In other words, banks wouldn't be able to fund themselves 100 percent by debts that are insured by the government. They would have to finance themselves 2 percent using market debt that would not be credibly insured. I don't view that as a draconian or unachievable requirement. Saying that this is a draconian or unachievable requirement is tantamount to saying that the marketplace is truly pathetic. And we know for periods prior to the safety net system that banks did fund themselves, and did find it easy to fund themselves using market sources of funds.

The other main requirement is to require that banks hold a certain amount of liquid assets, that is, not just loans. Again, that is something that can be easily seen from the outside. It is something that is very transparent, and so when Dr. Frenkel was saying that he agreed with transparency, I think he was also in agreement that what we want–I hope he was in agreement–in our bank regulations are rules that are credible and can be easily verified by outsiders.

So what I am trying to do is suggest that capital standards and other regulations have to be sort of supervisor-proof, and that is why Argentina decided to add to the Basle capital standards, a subordinated debt requirement which began in January of this year. I should also mention that this requirement, as I said before, is being considered by the Federal Reserve. It has been supported by some Members of your Committee, by the U.S. Treasury, and by the Bankers Roundtable. So the logic that I have just explained to you is widely understood and agreed upon.

Representative Saxton. Thank you. Let me just ask one further question, and then I will yield to other Members.

One of your recommendations is to end subsidized IMF interest rates. Now, it appears that there are two schools of thought on this, and I am interested in your perspective. There are those who say, well, if a country is in trouble or if a banking institution, the central bank happens to be in trouble, that we don't want to impose a further burden on them. And on the other hand, I believe you have a position that would take some issue with that position. Is that correct? If so, would you explain it?

Mr. Calomiris. Let me explain how the interest rate requirement interacts with the other two. By itself I don't think it would have much force.

The point of the interest rate requirement is to discourage frivolous use of the discount window. That is, if a country didn't really need it, if it weren't really undergoing a crisis, it wouldn't use the wisdom. That was Bagehot's argument. He wanted to discourage frivolous use. But the interest rate by itself would not discourage abuse of a discount window because if a country got into real trouble, paying another 2 percent wouldn't keep it from abusing the discount window.

That is why the membership criteria and the collateralization requirements are central to preventing the abuse of the discount window for countries that are looking for bailouts. The interest rate requirement prevents frivolous use of the discount window but doesn't really prevent, by itself, an abuse of the discount window as a bailout mechanism.

Representative Saxton. Thank you.

Mr. Hinchey.

OPENING STATEMENT OF REPRESENTATIVE MAURICE D. HINCHEY

Representative Hinchey. Thank you very much, Mr. Chairman, and thank you, Mr. Calomiris and Dr. Frenkel–Dr. Calomiris–for two very interesting and thoughtful presentations which I think are very, very helpful in our deliberations as to what to do in this particular circumstance.

I have a sense of urgency about this problem. I believe that we are in a very, very difficult circumstance indeed and it has been growing now for a number of years, and it has gotten to the point where the impact of it is about to fall on our country as it is about to fall on others. It has fallen on many other countries.

So I listen particularly to Dr. Calomiris' presentation with great interest but the sense that what you are proposing, while I can support it, much of it at least, issues of transparency, improved banking regulations, things of that nature I think are very, very critical. To suggest that members of the IMF ought to adopt those standards I think is a very sensible thing to do, and I think that we should move expeditiously in that direction.

However, I am aware, at least I believe that it would be very difficult for my own country to meet the requirements that you have set forth. I am thinking now of Long-Term Capital Management. I am thinking now of the lack of transparency in hedge funds and derivatives of transactions. I am thinking of the fact that we do not have enough banking regulation to control the amount of money that is flowing out of our own banks into those highly speculative areas.

So I am not convinced that even the United States at this moment would be able to meet the standards that you have set forth, although I think we should and I think every country should. But my sense is a sense of urgency. So while I can agree that we ought to move in the direction that you are proposing, I am very uncomfortable with the idea –I don't know if you are suggesting this, you probably are not–that we ought to adopt these reforms before we do anything else with regard to the IMF.

We have a very important question hanging over the heads of this particular Congress. Are we going to provide another $18 billion to the International Monetary Fund or not? And the clock is ticking on us and the time is running out. We have a very short time to make that decision. It is my sense that if we leave town and adjourn the 105th Congress without adopting a resolution to provide that additional capital to the International Monetary Fund, that we are going to be participants in the exacerbation of this problem. That is my sense at this particular moment.

And I am wondering, how long do you think it would take for enough countries to adopt the plan that you are proposing so that it could make it practical in any way for us in the context of the present situation? We are having steel dumped on our markets right now at low production prices. Goods and commodities and manufactured goods are a glut on the economy all over the world, everything from oil to wheat to computers to automobiles. This is an urgent problem.

Mr. Calomiris. I agree with you, but I want to point out that many are worried right now that we are going to take a distinctly wrong turn, and we are seeing it not just on the IMF issue but in the Long-Term Capital issue and other things.

The way I would define the last five or six years of experience in emerging market countries is that many of these countries went through a quasiprivatization where the incentive structures weren't set up properly, the basic rule of law wasn't even in place, and all of a sudden we set up these securities markets on the foundations of very weak financial and legal institutions that are currently having a lot of trouble.

What I am most worried about is that the backlash is going to take the form of ever-expanding bailouts that are very counterproductive, combined with new limits on markets or retreat from markets. I think it is very important, although difficult right now, to say that the right path is toward true liberalization and fixing incentive problems.

I would point out that the Fed thought that by intervening in Long-Term Capital that it was stabilizing markets, and of course in the couple of days following its intervention it went quite the other way because people started to worry about what that intervention meant. So voting for IMF assistance, if it is taken to imply ever-expanding bailouts, could have a very adverse effect.

Representative Hinchey. The intervention without accompanying reforms was a mistake from the point of view of the Fed, from the point of view of our economy. I think that that is absolutely true. So what you are suggesting is that we need to move ahead with reforms, but I do not believe that you are suggesting that we ought not to ensure that the IMF is adequately capitalized itself.

Mr. Calomiris. I agree with you. And when the Shadow Financial Regulatory Committee advocated unanimously not to release funds to the IMF currently without clear conditions being met, none of us had in mind, and certainly I don't today, that we would want to say that all countries must immediately adopt these very new capital standards or these new ideas of how the government's central bank is going to do business.

But the point again is that you can phase it in. To answer your specific question, how long would it take, I think that it would be unrealistic to think that the capital standards I am arguing for could be phased in, even if they were passed today, in less than a year. In Argentina when they developed this program, they gave the banks one year advance warning from the time the legislation was passed, and I think that Argentina is an interesting example. It is not the United States. It is a much less developed financial system.

Countries could phase them in. What I have in mind is not that we make it an immediate requirement or that these other membership criteria be immediate requirements but that they be phased in, and that we encourage the World Bank and other institutions to provide the assistance to recapitalize these banking systems.

Recapitalization would make it possible to move in that direction the way the U.S. did. We had a Reconstruction Finance Corporation assisting in recapitalizing banks in the 1930s. We had an FDIC examining banks to decide whether they qualified for membership. We didn't mix the two. If you didn't qualify for the RFC's recapitalization program, which it made its own decisions on, that was your problem. The FDIC wasn't going to let you through the door.

It is that sort of mix that I have in mind, and the timing is not to require that it happen all right now but to require agreement now.

Representative Hinchey. I very much agree with you, and I think that kind of framework is absolutely necessary. But what you are telling us, I believe, is that it is going to take several years in order to put that kind of framework into place.

Dr. Frenkel, I would be interested in your response to that question and specifically with regard to the Bank of Israel. Would the Bank of Israel be able–does the Bank of Israel meet the Basle requirements now, say, for example? Would the Bank of Israel be able to meet the requirements that were set forth in Dr. Calomiris' testimony?

Mr. Frenkel. To begin with, I wish to share the sense of urgency which you raised in your opening remarks. There is not only a sense of urgency, there is a genuine urgency.

It is clear to anyone participating this week in the World Bank/IMF discussions, which included a wide array of participants–bankers, policymakers, and politicians from all over the world that the clock is ticking. Whether we want it or not, the time frame that was mentioned earlier, the disparity between a week or 10 days on the one hand and a year or several years on the other, requires reconciliation.

In order to reconcile this difference one must ask what risks are we willing to take? Do we want to take all the time needed for reform, hope that the risks will not materialize but realize that in that way one takes the risk of potential meltdown; or alternatively, should we insist that we are serious about the financial system that we are willing to go ahead now in support of the IMF and go on subsequently on the track that will take a little bit more than that in order to go there? I would recommend the later option.

I want to add one more point. The desire for reform cannot be just matched and measured on the scale of how much time it takes. It requires the political will from a wide array of countries. Therefore I would be very, very nervous to basically stand still until everyone fully agrees on the entire range of reform notwithstanding the fact, that currently we are not discussing implementation, but rather agreeing to the design, which in and of itself will take time.

Mr. Chairman, you drew the distinction between illiquidity and insolvency and the cash flow problem. This indeed is the issue, but the greatest danger is ensuring that the liquidity problem does not deteriorate into an insolvency problem.

The only way to prevent that occurrence is to have the capacity to provide liquidity on a timely basis. Otherwise, you provide an incentive to those who are experiencing stretched liquidity to undertake policies that are not called for from the medium-term perspective. Instead, they are pushed to the wall which might bring them to insolvency.

So in a way, these issues are not unrelated. A liquidity problem that is not handled in a timely fashion could deteriorate into the much more serious problem of insolvency. Therefore, I would repeat the sense of urgency must be on top of everything. There is a lot of gloom in the air.

May I tell you another little story Mr. Chairman?

Representative Saxton. Please.

Mr. Frenkel. The Prime Minister of France, Mr. Mendes France, many years ago, wanted to convince his people to stop drinking alcohol and drink more milk. He put signs all over the Paris Metro stations stating, "Don't drink alcohol, it will kill you slowly." Finally somebody wrote underneath it saying "That's OK, I am not in a hurry."

The point of the story is that we must move quickly in dealing with IMF funding. One cannot say tread slowly, we have time. There is a sense of urgency and, how many times one can cry wolf. The question here is the IMF's liquidity.

If two years ago somebody would have come to you and said: "Members of the Committee, we must consider the serious possibility, of simultaneously experiencing a collapse of Russia, the dethroning of the tigers, the deepest recession in Japan's history, serious concerns in some Latin America" countries and that the IMF would actually need to be involved in each case providing the resources, you would have said, "come on, you are crying wolf." That is not a way to compute the needs of the institution. But in designing the institution we always love to ask the question of "what if!" As public policymakers when we design a system we should not assume the best-case scenario; rather we should allow for the worst-case scenario! The worst case scenario is the only responsible guideline to decide on the appropriate amount of resources. Then, one must make sure that the resources are used properly so that they are not wasted.

Mr. Calomiris. May I comment quickly? As I said before, I think the resources that the IMF currently has or could cobble together, let's say they are about $100 billion, and then we have other countries that could be pulled into it. Now we are talking about $18 billion which would allow a total of an additional $100 billion of IMF resources.

But if we really want to be chicken little, $100 billion is nothing. If you really want to take the worst case scenario into account, what is $100 billion of new resources? Long-Term Capital had notional principal on its swaps, we are told, of $1 trillion, and its assets were more than the amount of money we are talking about coming from the whole world to go to the IMF. So let's not, I think, be disingenuous. A hundred billion dollars is not really very much to solve the global meltdown that some people are talking about.

What is really at stake here is not the money, which isn't needed right now for any global emergency and wouldn't be enough if there really were an emergency. What is really at stake is what signal does Congress want to send about its views about the IMF and what is it going to do to push for reform at the IMF. And you are free to send many different ones.

You could say we have no trouble with increased funding and that will come, but we want to have some agreement over the next six months on reform, not to be implemented immediately but to be phased in. That would be a very positive signal. Why, since we are not really talking about the money itself and we are talking about the signal, are we focusing so much on today as opposed to six months from now?

Representative Hinchey. I would just say, Mr. Chairman, I think it is possible for the Congress to walk and chew gum at the same time. I think that we can hold two ideas in our heads and I think we can do two things. I think that it is possible to move ahead on reform at the same time we recognize that this is a serious problem.

And I disagree with you when you say that it is not necessary to recapitalize the IMF, that there is plenty of money there. I think that there is inherent in this particular situation, as there is in any similar economic situation, a strong psychological component. And if we fail to demonstrate that we are prepared to act responsibly, that is, the United States Government demonstrates to the rest of the world that we are not prepared to act responsibly, that will indicate to a lot of other people that they have to take a similar course themselves.

And the danger there is that you are going to see a rapid crash of the ability of the IMF to intervene in this situation because, as you point out, $100 billion is a drop in the bucket. You have Japanese banks sitting on $1 trillion of bad loans, perhaps capitalized at-reserve is about 4 percent of the money that they have got loaned out. Very serious situation. And if we give the–I think we should make it clear that we are for reform, but I also think it is very important for us to act and to act responsibly and to act directly, and to do it in a way that makes it clear that we are committed to this.

I also would argue or disagree with your choice of words with regard to the way you describe the use of the Exchange Stabilization Fund in the IMF as a slush fund. I am thinking specifically with regard to the way the Exchange Stabilization Fund was used in the context of Mexico.

Mr. Calomiris. So am I.

Representative Hinchey. If you have reactionary forces in the legislative branch as you did in the 1930s, for example, when it was imperative for the executive to take action in order to save not just a national economy but the world economy, if you have those kind of reactionary forces abroad in the legislative branch, as I might argue you do to a certain extent today in the legislative branch of this country have reactionary forces abroad, it becomes essential for the executive to act directly because it was quite clear that this Congress was not going to authorize the use of those funds.

And if the Exchange Stabilization Fund wasn't used in that case, I think very appropriately in retrospect, although I wasn't so certain of it at the time, but in retrospect I think it was used very appropriately, we would have seen the total collapse of the Mexican economy. And the consequences of that, in the context of what we now see in the world economy, would have been profound indeed. And of course all of that money has been paid back and it has been paid back with interest.

So I don't think that it is accurate to suggest that the Secretary of the Treasury or the President were using that Exchange Stabilization Fund as a slush fund in that particular case, nor did they intend to use the IMF in that way either.

Mr. Calomiris. May I, because I worked in the Mexican bailout as part of a World Bank team, so let me tell you what I think. First of all, we got our money back, but the Mexican taxpayers have a very large liability as a result, and nothing has been resolved in Mexico. They are still sitting on a mountain of bad debt to cronies, and I don't think that the bailout was very well advised. In fact, I think it was a perfect example of the use of the IMF as a slush fund.

Let me also say that having worked during the crisis in Mexico, I can tell you that both the IMF and the World Bank were told, by the U.S. Treasury, as I understand it, to lay off on trying to enforce any conditions because those weren't convenient to the administration's plan, which was to just give the money away because of the political fallout resulting from the NAFTA agreement.

So my view from Mexico was that this was not a serious program. This was a politically driven program. I was told during presentations about structuring the banking system that this was not going to happen politically and that it was all a show. That was my experience.

Representative Saxton. Thank you very much.

Mr. Ewing.

Representative Ewing. Thank you, Mr. Chairman, and again my thanks to the witnesses for their patience and for their input.

I think you came very close to answering the question that rattles around in my brain every time I think about the IMF and $18 billion. I really can't fathom how $18 billion or $100 billion on top of what they already have can keep us from having a major problem economically around the world if it is really out there. I mean, it is such a small percentage of what the liabilities are in the world economy.

And I just thought maybe you would focus or comment on how the IMF could or should or does, either of you, meet that need? We talk like if we put the $18 billion into the IMF, and I support that, then we won't have a problem. And I guess I am not sure of that.

Mr. Calomiris. Just to repeat, the whole point of my plan is to make the IMF's liquidity assistance much bigger than what we are currently talking about, to make it able to be a much larger and more elastic source of liquidity assistance but with good incentives. I propose this precisely because dribbling out a few billion dollars at a time after you have had lengthy negotiations and conditions attached has nothing to do with providing liquidity assistance.

In fact, you might ask why is it that the money is dribbled out in such a slow way. And the reason is that the money is part of a political deal, not liquidity assistance. Let me read, since the question of whether the IMF is being used that way has come under some question, from a paper by Sebastian Edwards in the autumn 1989 Carnegie Rochester Conference series.

He says, he is talking about the mistakes the IMF made in facilitating the rollover of debt during the 1980s, that the Fund has not participated in this delusion willingly. "In many cases its participation was a result of political decisions made by the largest members, in particular by the United States. For political reasons dictated by geopolitical or other considerations, and many times against the judgment of the staff, the U.S. and other industrialized countries saw fit to request, force the Fund to approve unrealistic programs for Egypt, the

Sudan, Nicaragua, Argentina, and Brazil. What has happened is that concessionary development funds have been given through the IMF. Of course there is nothing, per se, wrong with providing aid."

Why are we talking about $100 billion, even though this really isn't a sufficient liquidity fund? It is an end-round foreign aid fund, basically controlled by the large member country governments, particularly the United States. So my problem with it is that when we are giving additional money, it will be a significant boost to the Treasury Department's ability to circumvent due process when setting up foreign aid programs. It will have no effect on liquidity.

Representative Saxton. If I may just take the prerogative to ask you, Sebastian Edwards was associated with the IMF at one point, was he not?

Mr. Frenkel. I have known Sebastian Edwards for many, many years. In fact, I chaired his Ph.D. dissertation. He is a brilliant man. He was at the University of California at Los Angeles, and then came to the World Bank. There he performed, like many analysts do, a postmortem of a variety of experiences. It is very important to note that this is not the time, to go into a real postmortem of the last 50 years of the IMF. I know of many, many examples of how IMF involvement has saved countries. The worst enemy of the very good is the excellent, but now is the time to be practical.

As one talks about and enters into a discussion with a sense of urgency which is not manipulated but is real, it is important at the same time to look at a longer-term reform strategy. I would give the advice that one should attempt to walk and chew the gum at the same time. There are really two issues that are not mutually exclusive, and if one does not address the two at the same time, then one may not have the opportunity to address the two when the time comes.

I want to say one more word about the amount of money being requested. I did not plan this morning to talk about nickels and dimes. Yes, relative to the size of volume of the capital markets, $18 billion is not much. Therefore the real issue is not whether these funds can meet all the financial needs of the world. Clearly, they cannot.

As a matter of fact, we should not design any international multilateral organization that is going to be built on the assumption that it will be the provider of funds. The major provider of funds for the future must come from the private sector. The real question is how to encourage the private sector to participate.

You can have an advisory catalyst. You can give the best advice without providing a penny. In reality, this is not enough. There must be a balance of some financial assistance, which is small relative to the needs but large relatively to the signal needed.

On the topic of signals, I must take issue with the notion of promising funds in the future as a signal. We do not have the luxury of playing chess with ourselves. A signal has a transmitter and a receiver. It is not enough for the transmitter to say "This is my signal."The signal must be received and interpreted in a similar way. The financial community is looking for a different signal beyond just words and promises. They are looking for a signal of a financial commitment which might be small relative to the market, but large enough to show some leadership. In the international financial community, leadership is required for the financial sector and the private sector to decide to go forward and take some new risks.

Two years ago the problem in the financial markets was excessive chasing after yields, forgetting about risks. This brought us to a disaster. The chase after yields brought about by excessive risk-taking, and investors are currently overshooting in the opposite direction. The financial sector is paralyzed. Nobody wants to take risks. No loans are being made. Capital markets are dry.

And those emerging markets that have taken the right policies do not have the capacity to tell the market, " We are different from those who have not taken the right policies." Markets are now color-blind. For emerging markets, this is a stigma. Therefore the public sector must step in. Speeches are cheap and not enough when it comes to the signal. The question is: What is the minimum number of dollars necessary for the signal.

Representative Saxton. Thank you very much.

Senator Bingaman.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. Thank you very much, Mr. Chairman. This discussion has been very interesting. I appreciate the very insightful words we just heard.

I would like to make a brief comment concerning Congressman Hinchey's point that the government is refusing to provide the $18 billion for the IMF. Actually, it is the House of Representatives which is refusing to provide the funds. The Senate has already approved the funds and the President is clearly insisting that Congress will pass it. I hope very much the House will approve the $18 billion very soon.

Let me try to put this discussion in some context. My layman's view of what led Korea into financial crisis is that international banks loaned substantial amounts to Korean banks and that the Korean banks were not liquid enough to repay those loans on time. And a lot of these loans were short term. Accordingly, there was a crisis, and Korea–an economy which people thought was very robust–all of a sudden was thrown into recession and depression. In response to this crisis, the IMF stepped in. In addition, and probably more significantly, representatives of these international banks–from Europe, Japan and the United States–came together and were persuaded that it was in their self-interest to restructure the outstanding debt. As Dr. Frenkel just said in his comments, the economic health of these countries depends much more on private investment than it does on public investment. The agreement between the banks, worked out in order to restructure that debt, is what allowed the situation to stabilize somewhat in Korea.

I would like each of you to comment first on whether my analysis of the Korean case is accurate. Second, I would be interested in hearing your views on how important the involvement of the industrialized country banks was in addressing the situation. How do the proposed reforms being discussed this morning deal with that issue? Is there something in your proposed reforms that will ensure that we don't have European and American and Japanese banks providing all sorts of capital which cannot be repaid in the time frame that has been agreed upon?

Mr. Calomiris. Well–the proposal–by placing banks in all countries that are members on a binding market discipline margin would prevent you from getting into the trouble that the Korean banks had gotten into in the first place.

Senator Bingaman. So that margin would apply to our banks as well as any other bank?

Mr. Calomiris. Any member of the IMF. Of course, we in the U.S. have already been talking about this in a different context: We are probably going to do it or we should do it, and have been discussing it in the U.S. anyway.

In the handout that I gave you there is an article by Sebastian Edwards. There are a couple of paragraphs in there on Korea that will be consistent with what I am about to say. The Korean banks, prior to the crisis, for years prior to the crisis, were known to be in solvent financial institutions and that as they got deeper and deeper into trouble, they increased their loan-to-deposit ratio so that prior to the crisis they were literally lending out, usually to the chaebols, 99 cents on the dollar of their deposits. This is not prudent banking. This is not market-oriented banking.

Senator Bingaman. That is about the percentage we were lending to Long-Term Capital, right?

Mr. Calomiris. Well, that is an unrelated hedge fund, not a bank. That is a distinction that is worth drawing.

Senator Bingaman. But there were bank funds going into that hedge fund.

Mr. Calomiris. Oh, yes. And there are banks who lent to Korea. It is important to note that the Korean Government assumed the debts of those banks, which everyone expected in advance. These banks weren't borrowing based on their own accounts, based on their own asset capital values. It was all well known. These banks were in all senses nationalized institutions when it came to borrowing, as are many banks throughout the world.

And so when those banks got into worse and worse trouble, that meant the fiscal obligations of the Korean Government became worse too. Of course the main problem with IMF assistance in Korea is that, as we know from all of the reports, the money that was channeled from the IMF went directly through the government to the banks, and directly from the banks to the chaebols, the big conglomerates whose problems got the banks into trouble in the first place. Korea is a perfect example of what is wrong with the way the IMF structures these bailouts.

Senator Bingaman. As I understand it, the Korean economy has stabilized somewhat. Korea is one of those countries that people point to as an example of possible success by the IMF, even though the success may be very preliminary.

Mr. Calomiris. People also point to Mexico as a success, and I pointed out all the reasons why if you were a Mexican taxpayer it was a disaster. The same is true for Korea. Despite the objectives of the Korean leadership which are laudable, it doesn't look like they are going to have the political muscle to actually wrest the control of the financial system away from the conglomerates. It is a political problem, and the IMF has unfortunately become a–don't want to say that they've been doing it on purpose–but they really have become part of the problem there, just as they were in Mexico.

Senator Bingaman. Dr. Frenkel, did you have any thoughts on my question?

Representative Saxton. Before Dr. Frenkel answers, let me just announce that Dr. Frenkel has requested that he be excused approximately 10 minutes from now, so we will honor your request if you still wish. Obviously you are welcome to stay with us longer if you also wish.

Thank you. Go ahead.

Mr. Frenkel. Thank you. I think the description of the origin of the Korean situation was just right. There was a combination of corruption, the implicit insurance which led people to think that things were safe and that Big Daddy would be there, and a very convoluted system of conglomerates. The banks and the corporate sector were so much intertwined that first the decision of to whom to lend and second, under what conditions, were not always guided by business banking practices.

Secondly, it was very difficult to determine the true value of their balance sheets. This was due to the fact that good and not so good firms were part of the same conglomerate. This is why the element of transparency in the proposals being discussed is so important.

Furthermore, in Korea the ratio of debt to equity has been so high that the practices of the corporate sector in financing their operations have created a lot of vulnerability. However, in my own judgment, the markets at least have recognized and identified the situation in Korea as one of the most successful experiments, compared to what has happened in some other neighboring countries.

By the same token, frankly, I believe the markets think that the Mexican program was a success. Could it have been improved? Definitely. But this really brings me back to the general principle of how to assess the performance of a program. With the benefit of hindsight and with the realization of many other things, undoubtedly, everyone would have done things differently. The question is, with the information that one had at the time, should there have been a different approach? In the end, I believe that the programs would of have been very different and, by and large, the issue was not the role of the IMF.

It is also my judgment, that unless confidence is enhanced, in other words–unless the IMF emerges from the current situation with enhanced financial resources–then we will have a de facto system without the IMF. You can come and argue until tomorrow that we are designing or even better system for better days. But in order to ensure that those better days are more than a dream, you must have the IMF.

Eighteen billion dollars is as good as any other number. Since we are in the business of signals, once it has been mentioned, then a nickel less means a less than full commitment and a nickel more may be redundant. You know, numbers are created by man but once they have been mentioned, they create a signal and take on a life of their own.

Representative Saxton. Thank you very much, Dr. Frenkel and Senator Bingaman.

Mr. Sanford.

OPENING STATEMENT OF REPRESENTATIVE MARK SANFORD

Representative Sanford. I would pick up where Dr. Frenkel just was, and he was talking about the Mexico City bailout and defining it as a success. I guess it would depend on one's perspective. In other words, if you were a New York money center bank you would say it was a great success. But if you were a Mexican middle class worker who basically had a generation worth of wealth wiped out, you would say it wasn't such a great success.

So in all of this I think it comes down to perspective, and with that in mind, I always think about issues like this, because we have been continually talking about–in essence, the code word in this conversation has been acting responsibly. What is acting responsibly?

I always think of a real middle class working guy back home in my district. There is a fellow by the name of Steele who is an older fellow. He runs a BP gas station in Moncks Corner, South Carolina, and I think, what is acting responsibly to Steele there in Moncks Corner?

And it seems to me, inasmuch as we are charged with watching out for each one of his dimes that he sends up here in taxes, that we ought to look at the big picture. The big picture here is, how do we find stability? What is acting responsibly?

If you look at the Japan situation, for instance, it seems to me we have got Japan with in essence $1 trillion worth of debt that has got to be written off in some form or another, and the question is how did Japan ever get into that picture? Part of the reason Japan got into that picture is they had totally unrealistic balance sheets. The, quote, worth of property in downtown Tokyo was equal to the market value of all California real estate. I mean, how realistic is that?

And so what we are really dealing with, it seems to me, is a contraction in balance sheets, which is never a pleasant experience but it seems to be not an experience tied to capital flows. So what we are reacting to as politicians up here is, what are we going to do? We have got to do something.

We have got to do something, and all I think a number of us are saying is, in a rush to, quote, do something–and in some cases we can't do anything as you begin to mark downtown Tokyo real estate to its real worth. That we don't go out and build castles on shifting sand because if we do, again, we will have done something but we wouldn't have done anything that is lasting. And so I would say that we want to do something that will last.

And I couldn't find the article. There was a great article that appeared in the *New York Times* about six months ago talking about the last tranche–it was either before or, again, in the six month time frame–but talking about the last tranche of IMF funding to Russia and how basically Rubin, Summers and others had admitted as much to the fact that it was pretty much a waste of money. It had been money washed down the hole without any significant effect. I couldn't find that article, but it had great examples of where money had just bled through the system without any lasting effect.

And so I go back to, currency, which is a meeting of exchange. It is a store of value, but we always have to look at the underlying balance sheet that creates, whether in a family or a business or a government, that creates its store of value. Much of this cannot be solved by the IMF. I would make that point.

Two, I would ask for a little help with definitions. And again, I would put myself on the far end of the Richter scale, if you want to call it that. I think we could very well go into a global depression but, as it has been stated here earlier, $100 billion is not going to solve that problem. Ultimately markets, it is a rough process. We will walk it through that process. But, one, I would go into definitions–I need a little help, in other words.

Rubin has continually said IMF doesn't cost the taxpayer one dime. And yet what I learned in Finance 101 back in business school was the present value of money, and if you had a higher interest rate, it was possibly a greater or smaller present value based on essentially assumed interest rates.

If a student loan back home in my district, if a student is paying 8 percent for his student loan but an IMF loan is at 4-1/2 or 5 percent, or if Russian bonds are actually at 30 or 40 percent, that interest rate spread, as I understand it, is basically an interest rate subsidy paid by the United States taxpayer. Is that correct or not correct? I would just be curious. Either one of you could respond to that.

Mr. Calomiris. Absolutely correct.

Mr. Frenkel. I will not refer necessarily to what Mr. Rubin has said, because I am not aware of it. Instead, I would like to respond to your overall comments.

Representative Sanford. Let's come back to that. In other words, I just have a few minutes.

Mr. Frenkel. O.K., fine.

Representative Saxton. For point of clarification, this is very unfortunate, we have two votes which have been called and we are going to have to be on the floor in approximately 10 minutes from now to catch the first vote, and then there is a second vote.

Representative Sanford. Could I do this, Mr. Chairman?

Representative Saxton. Sure. And then we will have to conclude.

Representative Sanford. Could I throw out my two questions, and then you all answer for the record as you like?

One question would be, what does it really cost the taxpayer in terms of interest rate subsidy?

Two, there has been the suggestion that there has never been a default on IMF. I have things that suggest otherwise in terms of a variety of different countries around the world, in terms of technical default.

And then, three, I would ask for, when we talk about reform right now when we fund the IMF, it does not count as an expense to the Federal Government. And yet each of us, finance people or bankers or whatever we might be, if the same Federal Government, our Federal Government, appropriates money that goes to buy 100,000 acres of real property in South Carolina or Nevada or who knows where, that does count as an expense. Does that seem logical to you all? And, two, which collateral seems better to you, the IMF drawing right or the real property in one of our States within our country?

Those would be my questions.

Mr. Frenkel. I will just take one second to explain the calculus. This morning I watched a program on CNN which described the amount of the slowdown in exports from the United States to countries in Asia, which has resulted from the decline in Asian economic activity. This decline in U.S. exports, in turn, is causing a decline in economic activity in regions throughout the United States.

I would only urge you that when you do the calculus about the cost to taxpayers of the IMF, you must also take into account the impact on growth in the region, which directly translates into the ability to generate demand for U.S. products. Increased U.S. exports to the region can mitigate a slowdown in the U.S. economy, thereby reducing unemployment and expenditures on unemployment benefits. A complete calculus must take all of this into account. I am only concentrating on the nickels and dimes and not on the human side of the calculation.

I agree with you 100 percent that IMF programs should be designed to restore sustainable growth in some of these countries. This should be the primary criterion. We do not want just to send money as emergency aid. I do not like that and I don't think anyone from the IMF would like to be described as providing aid, but rather as catalysts for policies that are designed to restore growth. In this regard, then, I would say that a much longer-term calculation would be necessary.

I agree with you, and here I must confess that this is my own personal bias. In Israel I am regarded as the arch conservative. I identify myself by the idea that "don't just stand there, do something," is something which should be defended. We must do the right things. That is the point.

Representative Sanford. On that very point, in other words, do you think greater stability would come from capital flows, which in essence is what the IMF is about, or the basic underlying foundation, again getting away from the rule, the shifting sands of rule of law, of transparency in terms of financial policy, predictable regulatory policies. In other words, those foundations, which one do you think creates greater stability?

Mr. Frenkel. They are complementary. You must have the infrastructure, transparency, and legal system, among other things, right. But you must also have the right economic policies in place. In order to generate the right economic policies, you must have the time frame and the political support for them. When your back is to the wall and you are basically kicked out from the capital markets, there is no appetite or sympathy on the part of any policymaker to think about the morning after. All they want is to survive this day. The role of bridging the private sector, with encouragement by the public sector, is to be judged in terms of how well it leads to the right, sound economic policies and the soundness of the public sector.

Representative Sanford. But you would agree, though, that there is no bridge that is going to somehow recreate Tokyo land values being worth-equal all the State of California, right?

Mr. Frenkel. Well, I think that any battles, if they can be identified early on, should be taken care of, whether it is the New York or the Japanese real estate market-which has been a serious problem. By the way, many of the problems all over the world in this regard are concentrated in areas like real estate, including in this country, for that matter.

Representative Saxton. Dr. Calomiris, Dr. Frenkel, I want to thank you both for being with us. This has been a very interesting and enlightening two hours.

I would just like to conclude by saying it sounds like there is some degree of agreement between you, as very knowledgeable people in the field of international finance, as to the need to continue funding for the IMF. There is some agreement that there are changes that ought to be made to the IMF. There are different ideas, and there should be different ideas, about what those changes ought to be and the timing through which they are implemented. I would like to thank you for expressing your views on those issues.

Let me just say that today our leaders are searching for answers, global leaders are searching for answers to the disarray in the international financial markets. The current IMF/World Bank meetings indicate that to date, in my opinion at least, no easy consensus about how to reform the international financial architecture has emerged. Hopefully, this hearing has contributed ideas that may serve as building blocks to constructing such a consensus.

Thank you very much for being with us. We appreciate it.

[Whereupon, at 12:02 p.m., the hearing was adjourned.]

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SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF JIM SAXTON, CHAIRMAN

I am pleased to welcome the witnesses before the Joint Economic Committee (JEC) this morning. We are fortunate to have two experts on international finance testifying on reform of the International Monetary Fund (IMF) today. We look forward to a serious analysis and provocative exchange of views on this critically important topic regarding the international financial system.

In recent months, calls for IMF reform have come from the American, British, French, and Italian governments, as well as from many others. Much of the discussion of IMF reform and the new international financial architecture is very general and abstract, and sometimes it is difficult to know exactly what is actually being proposed. This morning, in contrast, we will be discussing some very specific and comprehensive proposals for reform of the IMF.

This is the fourth in a series of JEC hearings on the IMF and international economic policy held this year. The issues related to IMF reform are difficult, and ones upon which reasonable people can disagree. As fundamental reform of the IMF has emerged as a major issue, it is important for policy makers to begin to explore alternative proposals.

Last week, the Shadow Financial Regulatory Committee, a non-partisan group of financial experts, released a set of IMF reform proposals designed to contain moral hazard, restrict subsidized lending, improve IMF transparency and accountability, and improve the evaluation of IMF performance. This general approach is consistent with my much more limited near-term reform proposal for the IMF, and resembles in many respects a proposal before us today.

In brief, one of the proposals presented today by Professor Charles Calomiris first establishes capital standards to protect the soundness of the domestic banking system. His reform of the IMF would, among other things:

- Require adoption of capital standards in the domestic banking systems as a requirement for IMF membership.
- End the IMF's current standard practice of lending at subsidized, below market interest rates. Instead, interest rates would be set somewhat above market levels to discourage abuse.

- Require that IMF loans be collateralized by borrowers offering securities as backing for loans.
- Require that IMF loans provide for liquidity assistance, and therefore be limited in maturity to several months.
- Dispense with the often counterproductive loan conditions since borrowers are essentially pre-qualified.

These reform ideas are all designed to restructure the IMF as an institution focused on providing liquidity to illiquid governments. I welcome this proposal by Professor Charles Calomiris, and equally the testimony offered today by Governor Jacob Frenkel.

Blueprints for a New Global Financial Architecture
Summary Statement, Joint Economic Committee
Charles W. Calomiris
October 7, 1998

Mr. Chairman, it's an honor to speak to you today. I will present a summary of a more detailed presentation, and I request that it also be entered into the record.

I would like to describe for you a concrete proposal for reforming the "global financial architecture" (and the IMF in particular) which considers current problems and solutions to those problems.

First, I review a comprehensive list of problems. The point of that discussion is not to determine the relative importance of each one, but rather to see how hard it would be to address *all of them together.*

Economics normally provides rather dismal news – emphasizing necessary tradeoffs among objectives. In the case of redesigning financial architecture, however, such is not the case. It is not difficult to construct a set of mechanisms that resolve <u>at the same time</u> problems of *illiquidity* (by providing a responsive international lender of last resort facility alongside a domestic deposit insurance system) while avoiding the *governance and incentive problems* attendant to counterproductive bailouts of risk takers by ensuring credible market discipline of financial institutions.

The hurdles that must be overcome in designing an appropriate financial architecture, then, are not those posed by *economics*, but rather by *politics*. The challenge is to get those with vested interests in the current allocation of political power – including bankers, developing country oligarchs, and the U.S. Treasury – to relinquish some of the power they currently wield in order to make the global financial system more efficient, competitive, and democratic.

The details of the plan are summarized in Table 1. I emphasize that the success of each component of the proposal depends on all the other components.

Without a reliable means of bringing credible market discipline to bear on banks, to provide strong incentives for prudent risk management, government deposit insurance and IMF lending will spur excessive risk taking, with its attendant costs. But in the presence of credible market discipline, deposit insurance and IMF lending (*if structured properly*) can strengthen the financial system by helping to avoid liquidity crises, which result either from problems of asymmetric information or self-fulfilling expectations.

In implementing such rules, the devil is in the details, hence my emphasis on "blueprints" (specific concrete proposals) rather than simply organizing principles. Slight differences in details can make the difference between a reform agenda that achieves both liquidity and proper incentives toward risk taking, and one that achieves neither.

This proposal is offered at an opportune time. Contrary to some statements by IMF officials and by officials of the U.S. Treasury, the IMF is facing a long-term funding squeeze, but not an immediate budget crisis, as the GAO testimony presented before this committee on July 23 showed.

IMF funds are still substantial, certainly more than enough to deal with any liquidity crises that are likely to arise in the next few months. So there is no need to rush passage of Congressional appropriations for the IMF. On the contrary, the longer term need to increase the IMF's resources offers member country governments (including the U.S. Congress) a unique window of opportunity to consider meaningful reform of the way the IMF operates.

Last week, the Shadow Financial Regulatory Committee – a bipartisan, independent group of experts on financial regulation of which I am a member – issued a statement on the IMF unanimously calling on Congress not to release new funds for the IMF until it had achieved substantive reforms that will prevent the abuse of IMF assistance, clarify IMF objectives, and make the IMF a more accountable institution. My statement today offers details on how to achieve those objectives.

Let me turn now to a brief discussion of the challenges facing the global financial system, and my proposals for addressing those challenges.

Over the last 20 years, 90 banking crises have occurred equal or greater in magnitude (in terms of banking system losses) to the U.S. banking experience during the Great Depression. In at least 10 cases, banking system losses will exceed 20% of GDP – a staggering and unprecedented set of losses, which are occurring during a time of relatively stable and rapid global growth!

Banking system collapse due to excessive risk taking by banks has been a common feature of all the recent financial collapses. Bank losses precede and cause exchange rate collapses.

Banking systems worldwide have become the key source of financial instability. Economists have pointed to several core problems that feed that instability.

First and foremost are incentive problems that encourage risk taking, particularly in response to adverse macroeconomic shocks. Before banks were protected by government safety nets, economic downturns produced contractions of bank credit supply and cuts in bank dividends, as banks scrambled to reassure depositors that bank loan losses would not result in losses for depositors.

Safety net protection has removed that important disciplinary check on bank behavior. Safety net protection (ultimately, taxpayer protection of banks and their claimants) relaxes market discipline on bank risk taking and subsidizes higher risk in banks. This effect is especially pronounced after banks experience initial losses to the value of their assets. In the wake of such losses, safety net protection encourages banks to consciously increase their asset risk. Those increases in risk often take the form of increased default risk and exchange rate risk *after banks have already seen severe depletion of their capital.*

Bailouts of developing economies' banks and international bank lenders, orchestrated by domestic governments in cooperation with the IMF and the U.S. Treasury, *must stop*. Not only do they produce inefficient risk taking, fiscal disasters for domestic governments, and enormous distortionary taxes for their taxpayers; by supporting crony capitalism – both within developed and developing economies – they also undermine the core competitive and democratic processes on which successful financial systems depend.

The IMF didn't invent bank bailouts and IMF involvement in bailouts is mainly indirect, but nonetheless, it is quite destructive. The IMF provides only a small wealth transfer to its borrowers in the form of its loan subsidy, and so does not directly pay for much of the cost of the bailout. But the IMF pressures borrowers to bail out foreign bank lenders, and lends support and legitimacy to domestic bailouts too by requiring government taxation to finance the repayment of IMF loans.

The destruction wrought by these bailouts have led many – including George Schultz and Anna Schwartz – to call for abolition of the IMF.

Others, however, argue that *liquidity* assistance by the IMF could be useful if properly designed. Indeed, IMF liquidity assistance has sometimes been helpful. The most obvious case may be the March 1995 IMF loan to Argentina. Here the IMF lent to a government that had pursued significant, tangible fiscal and bank regulatory reforms, and did so with the express goal of financing a defense of the Argentine currency board (not financing a bailout of banks or other government expenditures).

To summarize the discussion in the paper of liquidity problems, the two most important problems are (1) banking panics that result from temporary confusion on the part of bank debt holders about the incidence within the banking sector of losses attendant to an observable shock, and (2) self-fulfilling collapses of currencies that result from government illiquidity.

To solve the first problem, I propose a set of banking regulations that together would remove the threat of banking panics – including (1) capital standards founded on market discipline, achieved through a requirement that banks maintain a minimal proportion of uninsured, junior (or subordinated) debt; (2) credible deposit insurance for other bank debt claims; (3) a 20% "cash" (or equivalents) reserve requirement; (4) a 20% "global securities" requirement; (5) free entry by domestic and foreign competitors into banking; and (6) limitations on other government assistance to banks.

In the paper, I discuss in detail how to design effective, credible market discipline. Here, my plan is largely based on the Chicago Fed's 1989 subordinated debt proposal, although there are some differences.

It is important to emphasize that a broad consensus has emerged on the need to add some form of subordinated debt requirement to the Basle capital standards. Advocates of some form of such a requirement now include: The Bankers' Roundtable, the U.S. Treasury, several Federal Reserve Banks, one Fed Governor, some members of Congress, and the Shadow Financial Regulatory Committee. Recently the Federal Reserve Board assembled a task force which is now exploring the question of how best to design and implement a subordinated debt requirement.

The combination of domestic deposit insurance and market discipline (which prevents the abuse of deposit insurance) can resolve the threat of banking panics that result either from confusion about the incidence of shocks, or self-fulfilling concerns about the insufficiency of bank reserves.

The IMF's role would be mainly to address the other liquidity problem – liquidity crises that face member governments as the result of unwarranted speculative pressure on exchange rates. This was the original intent of the IMF's founders, and it remains a legitimate objective of IMF policy.

Recent studies that emphasize the value of IMF liquidity protection argue that the current form of IMF assistance is inadequate – it is too little, too late, and with too many conditions and delays to be effective in short-circuiting self-fulfilling runs on currencies or government debt.

But how does one provide effective liquidity protection without encouraging counterproductive bailouts of banks and/or governments?

My plan is to replace the current IMF and ESF with a new IMF, which would offer a discount window lending facility. That facility would only be available to IMF members – and membership would require adherence to the aforementioned banking regulations, as well as some additional rules regarding government debt management, and (if a fixed exchange rate is maintained), a 25% minimum reserve requirement for the central bank and a requirement that banks offer accounts denominated in both domestic and foreign currency.

By restricting access to the IMF window to members in good standing who conform to a few, simple, and easily verified rules, the IMF avoids free-riding on liquidity protection, and the hazard of unwittingly financing bank bailouts in the guise of liquidity protection.

The rules governing the discount window follow Walter Bagehot's classic principles for ensuring liquidity, while avoiding free riding: lend freely on good collateral at a penalty rate.

The specifics of membership rules, limits on collateral, and penalty lending rates (described in Table 1 of the paper) encourage member countries' central banks (like their banks) to diversify their securities portfolios and maintain adequate liquid reserves.

If a member is in good standing, loans are made available on good collateral using one week old prices to value collateral. The loan interest rate is set at two percent above the value-weighted yield to maturity on the collateral offered. That provides a fast and effective means to short-circuit a self-fulfilling "bad equilibrium."

Why no additional conditions for loans? For liquidity assistance to be effective, it must be delivered quickly and supplied elastically.

Why no more rules for members? There are lots of basic rules countries should meet to build effective domestic financial systems. These include accounting standards, procedures for registering collateral interests, court enforcement of creditors' and stockholders' rights, a transparent and efficient bankruptcy code, and many more. But these rules are more controversial (for example, I would argue the Swedish bankruptcy code is far superior to the American), and are hard to specify in a simple way. I have not tried to construct a list of all desirable rules, but rather, a set of minimal rules that are IMPORTANT, SIMPLE, and VERIFIABLE.

Furthermore, additional rules (accounting, bankruptcy, and commercial laws) *will arise endogenously if there is credible market discipline within the financial system, which the subordinated debt requirement and other rules will ensure.* Market discipline provides a strong constituency of banks and their debtholders who will seek ways to improve transparency, contract enforceability, and sensible workout procedures.

How will the IMF actually operate the window? IMF lenders would contribute (that is, lend) bonds to the IMF, which (along with borrowers' collateral) would be used to access the discount window of the hard currency central banks (who would lend cash to the IMF collateralized 100% by the government securities of that central bank's government). The hard currency central banks, thus, would lend risklessly. They would also be free to sterilize the effects of IMF borrowings on the aggregate supply of hard currency.

To avoid the potential for costly bailouts, other redundant mechanisms would be abolished – especially the Exchange Stabilization Fund, and emergency assistance to banks via the World Bank and IDB.

Having argued that this plan would achieve proper incentives in private banking and in government finance, and would also protect against liquidity crises, I now turn to the more difficult question: *whether it is politically feasible.*

Clearly, however, vested interests will oppose this approach, precisely *because* it might work, and thereby deprive them of a valuable (though socially costly) subsidy. It may be possible, and worthwhile, to "buy off" those vested interests (particularly within the banking system) by offering a one-time injection of public funds to recapitalize banks, and thereby make the pill of market discipline easier to swallow.

It is also worth considering how domestic governments interested in implementing true reform might be helped by the World Bank and other development banks to achieve membership in the newly constituted IMF. Too often the World Bank has crowded out private lending and removed incentives for countries to adopt credible market discipline. World Bank loans to China are the clearest example of this problem. But in some cases (notably in Argentina recently) the World Bank has provided subsidies to make privatization and market discipline more achievable. More of World Bank assistance should be directed toward that end.

A central principle of my proposal is to clearly separate the functions of the IMF and the World Bank. The IMF would focus on liquidity protection for member countries that have achieved sound financial liberalization. The efficacy of that protection would be much enhanced by focusing on achieving that narrowly defined *economic* objective.

The World Bank would facilitate liberalization (and hence help to expand the IMF's membership list). Encouraging bona fide liberalization is a long-term process. The form and pace of assistance required is different from that of emergency liquidity assistance, and it is very counterproductive to confuse the two missions, and the two kinds of assistance.

Possibly, the greatest obstacle to my proposal will be the likely opposition of the U.S. Treasury to repealing the ESF and focusing the IMF on providing bona fide liquidity assistance. The Treasury has used the Exchange Stabilization Fund and the IMF as slush funds to provide foreign aid (without the inconvenience of seeking Congressional approval) in the guise of "liquidity" assistance. Getting the U.S. Treasury to forswear such activities is a formidable challenge – one that may require veto proof support in Congress.

If all these challenges to reforming the IMF could be overcome, and something like this proposal were enacted, would the IMF abide by the new rules? Obviously, the goal of my plan has been to design rules that are transparent to outsiders, which would make it harder for the IMF to "forebear" in enforcing those rules. The more we all talk about ways to further limit such forbearance, the better.

In summary, I think it is economically feasible to restructure the way the IMF does business to promote a more efficient and democratic financial system – one that ensures market discipline while avoiding market chaos.

If the G7 chose such a path, other countries would follow – the rewards to participating in an open, market-oriented, and stable global financial system would be irresistible. The transition process could be facilitated if the funds currently channeled through the World Bank and other development banks could be redirected toward helping countries to qualify for membership in the newly constituted IMF.

The approach to reform I am advocating has many supporters. Yesterday's Wall Street Journal featured op-ed pieces by Martin Feldstein and by the British Chancellor of the Exchequer, Gordon Brown.

Mr. Feldstein wrote:
"The IMF can help prevent future crises by creating a collateralized credit facility that lends foreign exchange to governments that are illiquid but internationally solvent...A rapid payout facility can reduce the risk of speculative attacks and induce countries to maintain open capital markets and free treade...An international credit facility can only work if it provides credit rapidly, at an above-market interest rate that discourages unnecessary use and in exchange for good collateral..."

Mr. Brown wrote:
"Our task is not to weaken support for the IMF and World Bank, but to strengthen them by building the operational rules by which we monitor and discipline ourselves...The way to do this is to agree to abide by well-understood and internationally endorsed codes of conduct: for fiscal policy, monetary and financial policy, corporate standards and social policy..."

Sebastian Edwards, in today's Financial Times writes:
"The long history of currency crises in Latin America has shown that, more often than not, the problem is lack of bank supervision, and not excessive capital mobility. This was also the case in South Korea....By focusing on capital controls, the multilateral institutions have been barking up the wrong tree. There is a real danger that by doing this they will not focus sufficiently on what is truly important: achieving transparency, strengthening bank regulation, avoiding corruption, furthering the reforms and, in many cases, pursuing major corporate restructuring."

These voices and many others are calling for a new approach to managing the IMF and World Bank, one that emphasizes adherence to economic principles that ensure market discipline, liquidity, and competition, and that avoids allowing the IMF and World Bank to be the instruments for the political power plays of vested interests.

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Statement of the Shadow Financial Regulatory Committee

On

PRINCIPLES FOR REFORMING THE "GLOBAL FINANCIAL ARCHITECTURE"

September 28, 1998

In recent weeks, President Clinton and Prime Minister Blair, among others, have called upon other countries to discuss ways in which the "global financial architecture" might be improved. These calls have been prompted by instability in world financial markets in the wake of the Asian financial crisis, the recent devaluation of the ruble, and the moratorium Russia has placed on repayment of many of the country's debts.

In response to these events, there have been suggestions that markets need the guiding hand of more extensive regulation, especially by international institutions, to restore stability. Some have advocated restrictions on capital flows between countries for the same reason.

The Committee believes that, to the contrary, events over the past year demonstrate that governments and international financial institutions, such as the International Monetary Fund (IMF), have undermined market discipline by lending to countries whose currencies have been under pressure. In addition, many countries themselves have failed to ensure a proper role for market discipline in their own financial systems. Accordingly, the main objective of future reforms in the "financial architecture" should be to find ways to ensure that markets work better, rather than to have markets displaced or restricted.

Toward this end, the Committee offers the following specific principles it believes should be an integral part of any reforms of the international financial system. Some of these principles should be adopted by individual countries. Others should be adopted by the IMF.

Table 1

Elements of the Reform Plan

Membership Criteria for the IMF

Bank regulations:
- Basle standards (but without restrictions on subordinated debt/tier 2 capital)
- 2% subordinated debt requirement (with rules on maturities, holders, and yields)
- 20% cash reserve requirement
- 20% "global securities" requirement
- Free entry by domestic and foreign investors into banking
- Bank recapitalizations are permitted, but strict guidelines must be met (and must follow pre-established rules, as in preferred stock matching program)
- Domestic lenders of last resort avoid bank bailouts by following Bagehotian principles

Other membership criteria:
- Limits on short-term government securities issues
- If fixed exchange rate, 25% minimum central bank reserve requirement
- If fixed exchange rate, banks offer accounts in domestic and foreign currencies

IMF Lending Rules

- Loans are provided only to members in good standing (those following above rules)
- If a member defaults, it may not borrow for 5 years, and then only after arrears paid
- Loans are for 90 days
- Supernumerary majority of members required to roll over loans for another 90 days
- Loans are collateralized by 125% of value of loan in government securities
- 25% of the 125% collateral must be in foreign government securities
- The interest rate on the loan is set at 2% above the value-weighted yield on the collateral observed one week prior to the loan request
- The IMF reserves the right to refuse a loan to a member
- No conditions are attached to IMF loans

IMF Funding

- The IMF borrows from the discount windows of the Fed and other central banks
- IMF borrowings from central banks are 100% collateralized by government securities issued by the government of the lending central bank
- Government securities that serve as collateral for IMF borrowings from central banks are lent to the IMF by its member countries

Other Emergency Lending

- IMF, World Bank, IDB, and others would make no other emergency lending available
- The Exchange Stabilization Fund would be abolished

Principles For Countries

1. Deal Expeditiously With Insolvent Institutions

Countries with insolvent financial institutions should promptly resolve them. Delaying this process - "regulatory forbearance" - invites further risk-taking by their owners, especially of banks, whose deposits tend to be implicitly or explicitly ensured by governments. Furthermore, governments can and should minimize the cost of resolving their financial difficulties by being open to long-term foreign direct investment.

2. Adopt and Enforce Capital Standards

Countries should adopt and strictly enforce sufficient capital standards for depository institutions. Policy makers in the United States have found that a system of "prompt corrective action" - whereby regulators are required to apply automatic and progressively stiffer penalties to banks and thrifts as their capital positions dwindle - has been useful in encouraging depositories to fully capitalize and discourage excessive risk-taking. If they have not already done so, other countries should adopt a similar system.

3. Encourage Market Discipline

Governments should explore ways of encouraging more market discipline of their financial institutions to supplement and strengthen regulation and supervision. This becomes increasingly important as the complexity of financial activities outstrips the ability of regulators to stay abreast of current techniques and developments. The Committee has previously suggested, for example, that bank regulators require large banks to back a certain portion of their assets with uninsured, subordinated term debt, which would ensure a greater role for market discipline.

4. Maintain Free Flow of Capital

Governments should preserve the free flow of capital across national borders, with very limited exceptions. It might be appropriate for countries with troubled financial institutions to discourage borrowing in foreign currency, especially at short maturities. Otherwise, maintaining the free flow of capital is essential for facilitating trade and growth around the world.

Principles For Reform of the IMF

The Committee believes that the current debate in Congress over additional funding for the IMF affords a unique opportunity to implement reforms that can enhance the role of market discipline throughout the world and curtail the "moral hazard" associated with past IMF rescue efforts. Indeed, the Committee believes that such further funding should not be provided unless at least the following reforms are made.

1. Incentives for Financial Reforms By Countries

The interest rates at which the IMF extends loans should take into account the extent to which countries adhere to the principles listed above, especially their adherence to the principles governing the regulation and supervision of their financial systems.

2. Discipline Foreign Currency Creditors

As the Committee stated in May 1998 (Statement No. 145), the IMF should seriously consider the adoption of a "conditional haircut" system for foreign currency creditors of banks, the actors in the financial system who have been most insulated from loss in previous IMF rescues (because the proceeds of the loans tend to find their way to the banking systems, and thus to the creditors of banks). Under the Committee's proposal, IMF lending (or at least the interest rates on its loans) should be conditional on countries having a system in place that automatically subjects the foreign currency loans made by creditors of banks to a haircut unless those creditors roll over their loans or otherwise do not withdraw their funds. In addition, governments should avoid extending guarantees of those loans. Such a system would promote stability (by keeping funds in a country in a crisis) and curtail moral hazard by confronting foreign currency lenders with potential losses, which they would factor into the rates they charge in the future.

3. Accounting For IMF Assistance

The IMF should require countries receiving assistance to provide a fuller account of how they have spent the proceeds of their IMF loans. The Committee recognizes that money is fungible. Nonetheless, frequent reports on the flows of funds of countries receiving assistance would help the Fund, its members, and also the public to understand how effectively the additional resources have been used.

4. Fuller Disclosure

The IMF should work with all of its members to improve the timely availability of key financial data on the accounts of governments, central banks, and commercial banks to help market participants make more informed judgments. Of particular importance are data on net international reserves (gross reserves minus forward currency commitments) and total foreign currency borrowing.

5. Objectives and Accountability

The IMF should clearly articulate its goals and the ways in which it would measure success in achieving them. The IMF should use these criteria in regular reports to its members on the extent to which those objectives have or have not been met.

BLUEPRINTS FOR A NEW GLOBAL FINANCIAL ARCHITECTURE

Charles W. Calomiris

Prepared for Presentation
for the
Joint Economic Committee
United States Congress

October 7, 1998

Blueprints for a New Global Financial Architecture

Charles W. Calomiris*

October 7, 1998

I fear that I must not expect a very favorable reception for this work. It speaks mainly of four sets of persons...and I am much afraid that [none] will altogether like what is said of them...

Walter Bagehot, *Lombard Street*

I. Introduction

This paper considers current problems in what is often termed the "global financial architecture" and proposes a set of solutions to those problems. The solutions take the form of redesigning (in combination) rules governing domestic bank safety net policies, lending by the International Monetary Fund (IMF), international competition in banking, global capital flows, and government debt management policies.

Section II outlines the problems the proposal is meant to address. Section III describes the principles that should guide reform. Section IV discusses details of how to implement those principles, including specific rules governing domestic bank safety nets, IMF membership and IMF lending policy. These would replace not only the current IMF, but other lending programs including the Exchange Stabilization Fund (ESF) and ad hoc emergency lending by the World Bank the InterAmerican Development Bank. Section V discusses the political economy of the new set of rules and whether enforcement would be credible. Section VI concludes.

Economics normally provides rather dismal news, emphasizing tradeoffs among

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objectives and hard choices. In the case of redesigning the global financial architecture, however, such is not the case. It is not difficult to construct a set of mechanisms that resolve problems of illiquidity (by providing a responsive lender of last resort facility) while avoiding the governance and incentive problems attendant to counterproductive bailouts of risk takers. The claim that it is possible to deliver liquidity assistance without bailouts presumes an *economic* definition of liquidity assistance, a concept with clear and narrow meaning. Politicians and bureaucrats, in contrast, often define "liquidity" crises and "liquidity" assistance broadly and vaguely to disguise transfers of wealth that have nothing to do with true liquidity assistance.

In essence, my proposal would replace ex post negotiations over conditions for IMF lending with ex ante rules for IMF membership and restrictions on the manner in which the IMF lends to its members. These rules and restrictions would automatically constrain the circumstances under which assistance would be provided, and at the same time make potential assistance much more rapid and effective. Proposed membership criteria include rules that impose market discipline on banking systems and limit government abuse of liquidity protection.

A credible reform of bank capital regulation that ensures market discipline makes it possible to construct an effective domestic bank safety net in the form of a deposit insurance system, which addresses liquidity problems attendant to banking panics. These domestic safeguards ensure that IMF protection – if provided through an appropriate lending mechanism – will not be abused. Requiring that IMF members meet standards that ensure market discipline in their banking systems and protection against domestic banking panics makes it possible for the IMF to fulfill its proper role in global financial markets – preventing unwarranted speculative attacks on member countries' exchange rates. Private market discipline, therefore, is the linchpin of effective domestic and international safety net reform.

While I argue that providing liquidity protection without bailouts is feasible economically, I recognize that the political economy of the global safety net poses formidable obstacles to its rationalization. It will be hard to design effective rules that will not be fought by special interests, and hard to design mechanisms that ensure that those rules will be reliably enforced. The approach I advocate tries to come to grips with political challenges to reform and enforcement.

II. The Weak Foundations of the Current Global Financial Structure

Financial crises are the defining moments of the problems that confront policy makers. This section reviews and interprets the recent history of crises, and the factors that are alleged to have produced them. The list of problems includes (1) fundamental policy-design flaws in banking systems and in international assistance programs that subsidize risk and foment fundamental bank and government insolvency, and (2) inherent problems of financial systems that aggravate those shocks through four different channels (which are referred to collectively as "liquidity" problems).

The last twenty years, and particularly the last five years, have witnessed an unprecedented wave of financial collapses. The magnitude of the losses incurred by banks during these collapses is staggering. The negative net worth of failed banks in the U.S. for the years 1931-1933 was roughly 4% of GDP. Nearly a hundred crises with losses of this or higher magnitude have occurred over the past two decades. Twenty of those crises have resulted in losses in excess of 10% of GDP, and ten have produced losses in excess of 20% of GDP.

Another novelty of the new crises has been the simultaneous collapse of banks and fixed exchange rates. Exchange rate collapses historically were sometimes associated with banking system collapses, but historically the two occurred together much less often than today, and the historical exchange rate collapses were less severe.

What is driving these crises? The literature has produced a number of explanations, which are not mutually inconsistent. Since the purpose of this paper is to devise solutions (not just for the sake of devising them, but also in the hope of fostering change) I do not pre-judge the weights that should be attached to the various views. For a proposed set of reforms to the global financial architecture to attract supporters, it must encompass a broad spectrum of views.

Problem 1: Counterproductive financial bailouts of insolvent banks, their creditors, and debtors by governments, often assisted by the IMF, have large social costs. Bailouts are harmful for several reasons.[1] First, they entail large increases in taxation of average citizens to transfer resources to wealthy risk-takers. Tax increases are always distortionary, and serve to accentuate the unequal wealth distribution. Second, by bailing out risk takers local governments and the IMF subsidize, and hence encourage, risk taking. Moral-hazard incentive problems magnify truly exogenous shocks that confront banking systems. Excessive risk taking by banks results in banking collapses and produces the fiscal insolvency of governments that bail out banks, leading to exchange rate collapse. Banks willingly and knowingly take on more risks – especially default risks and exchange risks – than they would if they were not protected by government safety nets.

Risk taking often follows a two-stage process. Initially, macroeconomic shocks (e.g., a decline in the terms of trade) reduce bank capital and raise the possibility of currency devaluation. That changes both the incentives for banks to take risks and their opportunities to do so subsequently. The incentives to take risk rise both because bank capital is lower and because banks seek to protect their loan customers (who sometimes also own the bank) from the effects of the adverse macroeconomic shock. The opportunity for taking on risk during a downturn is higher both because of increases in the credit risk of borrowers and because of increased exchange rate risk. Furthermore, a rising risk of depreciation lowers the relative cash flow cost of borrowing dollar-denominated funds, which can make borrowing in dollars attractive to distressed firms and banks. Banks that borrow short-term dollar-denominated funds economize on the current cash flow cost of those borrowings, but take on a large risk of capital loss if the exchange rate peg collapses.

In the absence of safety net distortions that encourage risk taking, macroeconomic shocks would encourage the opposite behavior – a reduction in bank risk exposure to reassure bank debt holders.[2] But overly generous protection of banks insulates them from market discipline and makes them willing to increase their asset risk in the wake of adverse shocks. Banks are willing to do so because potential losses will be borne by taxpayers through government-sponsored bailouts of the banking system.

The risks in these banking systems constitute an off-balance sheet liability of their governments, since governments either explicitly or implicitly guarantee to bail out banks that fail. Thus bank risk and fiscal risk grow together and explain the simultaneity of banking and exchange rate collapses. The differences between emerging market financial crises of the last two decades and historical crises--the larger size of current banking system losses, and the coincidence of banking system and exchange rate collapses – are attributable to the new link between private risk taking and public financing of the losses produced by those risks.[3]

Banks are not the only entities protected by government safety nets. Large, politically influential firms other than banks often receive implicit protection from the government on their debts, which encourages a similar tendency to bear exchange risk and to rely on short-term dollar-denominated funds, particularly in the wake of shocks that raise the risks of devaluation.

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[1] For more details, see Calomiris (1998a) and Meltzer (1998a, 1998b).

[2] For a discussion of the responses to loss by New York banks during the Great Depression, see Calomiris and Wilson (1998).

[3] For details on the moral-hazard costs of safety nets over the past two decades, see Caprio and Klingabiel (1996a, 1996b), Lindgren, Garcia, and Saal (1996), Demirguc-Kunt and Detragiache (1997), Calomiris (1997, 1998a), Meltzer (1998a, 1998b), and Kane (1998) for summary analyses; De la Caudra and Valdes (1992) on the Chilean crisis of 1982-1983; De Krivoy (1995) on the Venezuelan crisis of 1991-1993; and Wilson, Saunders, and Caprio (1997) on the Mexican crisis of 1994-1995.

The moral hazard problem also can exacerbate the extent of devaluation during exchange rate collapses. Domestic banks that bet against devaluation prior to the exchange rate collapse (by borrowing dollars or entering forward exchange contracts) can magnify the extent of the collapse by adding selling pressure to the market once the collapse begins. As banks experience initial losses on their open exposures to exchange risk, they may be forced to sell their positions suddenly, which magnifies short-term devaluation pressures. In Mexico, this process of unraveling excessive bank (or non-bank) exposures to exchange risk (in the form of dollar-denominated borrowings and derivative positions) contributed to the severity of the exchange rate collapse in 1995. Garber (1997) argues that the dumping of derivative positions and the scramble for cash by Mexican banks in response to large losses on those positions led banks not only to liquidate their long peso positions, but also to dump their short-term government securities (tesobonos) on the market, which put added pressure on the peso in early 1995 and contributed to government problems in rolling over maturing treasury debt.

In addition to the immediate economic costs associated with bailouts (tax increases and moral hazard), there is also a longer-term cost from the way bailouts affect the political process domestically and internationally. Domestically, bailouts encourage crony capitalism in emerging market economies and thus help to stunt the growth of democracy and reform. Bailouts also undermine democracy and economic competition in industrialized countries. Bailouts (whether channeled through the IMF or the ESF) are often a means for the U.S. Treasury to provide subsidies to international lenders and foreign governments without Congressional approval under the guise of liquidity assistance.

IMF policies exacerbate all these problems.[4] The IMF's role in bailouts is threefold. It provides a small wealth transfer (via the interest subsidy on its loan). Second, and more importantly, it pressures countries to bail out international lenders who are often complicit in excessive risk taking. Third, the IMF helps to ensure that domestic taxation (to finance the bailout) will occur, by lending legitimacy to the bailout and by requiring increased taxation as a condition of IMF assistance.

So far I have argued that moral hazard is the key villain in the recent, unprecedented wave of financial system collapses. That is not to say that *all* the costly consequences of financial crises are an unavoidable consequence of moral-hazard-induced fundamental bank insolvency and its fiscal consequences.

If the only costs of financial system collapse were the *direct* costs of fundamental insolvency – that is, the amount of wealth lost directly through the actions of protected banks and borrowers – then the only threat to the global financial system would be safety net protection itself. In that case, the simple solution to redesigning the IMF arguably would be simply to abolish it, as Schwartz (1998) suggests. The argument for reforming the IMF, rather than abolishing it, revolves around the view that there are important indirect costs attendant to "liquidity problems" that magnify the direct costs to fundamental bank and government solvency. The potential importance of these indirect costs, and the potential for the IMF to mitigate them, underlies the argument for preserving the IMF. Concerns about liquidity costs can be divided into four additional problems, which are discussed separately below.

Problem 2: Asymmetric information about the incidence of observable shocks within the financial system, especially when combined with short-term debt finance can magnify the economic consequences of fundamental shocks by leading to a liquidity crisis. The historical

[4] For details, see Calomiris (1998a) and Meltzer (1998a, 1998b).

evidence on banking panics in the U.S. and elsewhere suggests that panics resulted from observable economic shocks with unobservable consequences for individual financial intermediaries. The vulnerability of financial intermediaries to crises reflects the fact that the value of their assets are hard to observe (loans are not marked to market) and their debt is very short term (often demandable). Those characteristics are intrinsic to the value-creating functions of banks, but they also make banks vulnerable to crises. Small fundamental shocks to aggregate banking system solvency can promote widespread disintermediation from banks, leading to a contraction in credit, a decline in economic activity, price deflation, and "fire sale" losses as banks and their loan customers scramble to gain liquidity.

Asymmetric-information-induced runs on banks prompted by fundamental shocks to bank asset values characterized the panics of 1873, 1884, 1890, 1893, 1896, and 1907. The weeks and months prior to these banking panics witnessed *uniquely adverse combinations* of the growth of business insolvencies and declines in equity prices. Previous and subsequent financial panics, in and outside the United States, have been similarly traced to observable fundamental shocks with unobservable consequences for individual banks and bank borrowers. [5]

Because bank panics result from bank vulnerability to asset value shocks, bank diversification can be extremely useful in forestalling panics. The peculiar propensity for banking panics in the U.S. reflected the fragmentation of U.S. banks by location, which made bank loans less diversified than in other countries. That observation suggests that an important ingredient in reducing banking risk in today's global economy is to encourage banks to operate branches throughout the world, and to hold an internationally diversified bundle of securities in

[5] Calomiris and Gorton (1991) review models of banking panics and provide empirical evidence on their causes. See Mishkin (1991) and Wicker (1998) for complementary evidence. Bordo (1985), Calomiris and Schweikart (1991), Calomiris (1993, 1994), and Calomiris and Mason (1997) provide similar perspectives on the Panic of 1857, the Penn Central Crisis of 1970, historical banking panics outside the United States, and the Chicago Banking Panic of June 1932.

their portfolios. Lack of bank diversification has been shown to be a major contributor to bank instability in emerging market economies in recent times, as Caprio and Wilson (1997), Wilson, Saunders, and Caprio (1997), and Kane (1998) emphasize.

Problem 3: The expectations of speculators can exaggerate the effects of adverse shocks, and can even precipitate self-fulfilling financial collapses when weakened financial systems are also illiquid. Current IMF assistance is inadequate to deal with this problem because it offers too little assistance, and attaches too many conditions to that assistance at the time of the loan request, which delays the availability of funds. There is a "Sachs version" of this alleged liquidity problem, and a "Mahatir version." The Sachs version (outlined in Sachs et al. 1996, Cole and Kehoe 1996) recognizes that economic fundamentals still drive crises to some degree (which, for example, explains why Singapore has not come under speculative attack in the recent crisis). The Mahatir version, predictably, sees speculative attacks as conspiracies that victimize the innocent.

My own view is that the evidence does not support placing much weight on multiple-equilibria explanations of current financial crises. The Mahatir version has been contradicted by recent empirical studies of the behavior of hedge funds and other institutional investors (see Brown et al. 1998, Choe et al. 1998). The Sachs version is also very weak on empirical support. As a general theory of crises it should apply not only to the current wave of disasters, but to historical cases as well. But the evidence cited above on the history of financial crises, contrary to Radelet and Sachs's (1998) claim, does not support the view that historical crises are explicable as bad equilibria within the context of the Diamond-Dybvig (1983), or the Sachs, models of multiple equilibria. In other words, a model that would explain the current wave of crises as bad equilibria must also explain (as these models do not) why these purported bad equilibria are new. The moral-hazard approach can do so (since safety net protection and the quasi-privatization of risk are relatively new phenomena); it is not clear whether the multiple-equilibria approach can.

Furthermore, Sachs and others search for multiple equilibria explanations mainly because they find little evidence of extreme fundamental weakness in macroeconomic *flow* indicators (e.g., conventional measures of government deficits or current account deficits). But, as argued above, they are simply looking in the wrong place for evidence of fundamental weakness. Expectations of future government expenditures often drive crises, not current expenditures. Financial sector imbalances (expected government costs of a bank bailout, or the bailout of an underfunded pension system) produce fiscal imbalance through the off-balance sheet contingent liabilities of the government, not through measured flows that show up in today's current account balance or current taxes and expenditures. In a world where banking sector collapses often produce fiscal costs in excess of 20 percent of GDP, and where government expenditures move smoothly compared to changes in off-balance sheet liability exposures of governments (since banking system losses can occur very quickly), a focus on macroeconomic flows as measures of fundamentals leaves the price out of the play.

Despite these objections, there surely is something to Sachs's argument if rephrased as the simple claim that a country with very low international reserves is more vulnerable to speculative attacks on its exchange rate or banking system than are others. Furthermore, as Garber (1997) points out, it is very hard to reject rational-expectations multiple-equilibria explanations econometrically. For these reasons, for the purposes of developing my proposed reforms I will assume that the Sachs and Mahatir views have some validity, and that it would be desirable for a global safety net to address the potential for self-fulfilling financial crises to emerge from a combination of small fundamental weaknesses and low liquidity (i.e., low bank and central bank reserves relative to short-term obligations).

Problem 4: "Contagion" across countries in securities and loan markets. Correlations in asset returns are much higher across emerging market countries during crises than at other times, and even government bond yields move together to an unusual degree during financial crises. There are several explanations for this "contagion." One is irrationality on the part of investors. A second is rational portfolio rebalancing by international investors; if portfolio investors (like banks) target a given default risk on the debt they *issue*, then they will *endogenously* shrink asset risk in one country in response to capital losses or exogenous increases in asset risk in another country. A third explanation revolves around linkages in international trade that can transmit economic decline, which is then reflected in asset prices. A fourth explanation revolves around multiple equilibria (either through changes in speculators views about the probability of bad equilibria, or through reductions in central bank liquidity following a global flight to quality). To the extent that cross-country contagion reflects irrational speculation or multiple equilibria, policies that would solve those problems would also eliminate cross-border spillover effects.

Problem 5: Government debt management sometimes leans too much on short-term debt. There are good reasons (incentive compatibility) for governments to shorten their debt maturities during times of fiscal uncertainty. Indeed, governments have been doing so for centuries.[6] But doing so might promote self-fulfilling attacks on currencies (following the multiple-equilibria reasoning of Cole and Kehoe 1996, and Sachs et al. 1996). Mexico's financial crisis is often held up as an example of such a problem. While I have argued that these authors likely overstate the empirical evidence in support of that view (particularly in Mexico, where weak fundamentals in the banking system and in central bank policy were clearly present by late 1994, and persist to the present), there is a version of this view that is reasonable: A short term structure of

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[6] For a review of the use of short-term debt finance by the United States historically, see Calomiris (1991).

government debt probably aggravates liquidity problems that have their origins in other fundamental shocks (fiscal risks associated with banking system collapse), as in Mexico during the tesobono selloff of 1995.

There is another reason to be concerned about the short-term stucture of government debt. Governments suffer a moral-hazard problem with respect to the maturity structure of their debts because IMF protection removes the cost of taking illiquidity risk through the shortening of government debt term structure. In an environment where the IMF cannot credibly say no to bailing out governments who abuse its protection, the IMF may be encouraging financial fragility by not penalizing government debt structures that rely excessively on short-term obligations.

From the perspective of these five challenges to financial system stability, current IMF policies are woefully inadequate, and indeed, are part of the problem. When a country suffers a banking system-cum-exchange rate collapse, its government protects politically influential domestic stakeholders by bailing out banks, their debtors, and their creditors, all at the expense of taxpayers. IMF loans to countries suffering financial collapse serve as bridge loans to permit the rescheduling of debt. The conditions imposed by the IMF along with its financial support help to ensure that tax increases to finance the bailout will be forthcoming, making the IMF an accomplice to the transfer of wealth from taxpayers to domestic oligarchs and global lenders. Banking reforms, promoted by the IMF as a condition for assistance, are inadequate and there is no credible mechanism for ensuring that "mandated" reforms will be carried out.[7]

Furthermore, IMF assistance is provided only after an agreement is reached, and funds are released in limited amounts over several months. That way of providing assistance is not effective in solving liquidity problems, which require large amounts of funds to be available on

[7] IMF conditionality is not always ineffectual. But banking reform is a protracted process, and cannot be accomplished easily through IMF pressure (see Calomiris 1998a).

very short notice. Thus current IMF assistance is a non-starter, both from the standpoint of limiting moral hazard problems and reducing the risks of liquidity crises.

We can do much better. Public policy cannot eliminate unavoidable shocks to the financial system. But thoughtful policy can reduce the five avoidable risks listed above, which magnify the costs of exogenous shocks that buffet banking systems and government finances.

III. Principles on Which to Build A Global Financial System

In light of Section II's discussion, *the central two-fold objective of policy is to avoid moral-hazard problems that give rise to imprudent banking practices while also protecting against the four "liquidity" problems that can magnify fundamental shocks*. A careless approach to providing liquidity assistance results in excessive and counterproductive assistance – a tendency to "throw money" at fundamental problems, which aggravates problems of imprudent banking and encourages unwise fiscal, monetary and debt management policies.

Finding the right balance between liquidity assistance and market discipline is the crux of the policy problem. A financial system safety net will not achieve that balance by making it impossible for banks to fail or for exchange rates to collapse. A system that would eliminate the possibility of collapse would also encourage poor management of private and public affairs. Banks should sometimes fail, exchange rates should sometimes depreciate, and governments should sometimes have trouble rolling over their debts.

While finding the appropriate balance requires care, I will argue that constructing a balanced safety net does not pose an intractable economic dilemma. It is not the case that policy makers confront an inevitable dismal tradeoff between higher incentive costs from the safety net and greater benefits from safety net protection against liquidity crises. It is possible to capture the benefits of legitimate "liquidity insurance" without suffering the costs of moral hazard.

How can financial system safety nets provide systemic insurance against illiquidity without engendering moral hazard? To achieve that goal credible ex ante rules must be devised that properly allocate ex post losses to private agents, local governments, and international agencies. *A global financial safety net, therefore, must define more than the IMF's lending policy, it must define the "tranches of risk" that are credibly assumed by parties other than the IMF, as well as the risks the IMF assumes.*

This goal is not new. In fact, it underlay Walter Bagehot's (1873) classic policy prescriptions for domestic central banking: to lend freely at a penalty rate on good collateral. Bagehot argued an elastic and immediate supply of liquidity was essential to an effectively structured lender of last resort, and that appropriate loss sharing rules in the form of collateral requirements and penalty interest rates would discourage abuse of the safety net.

Successful lenders of last resort historically have had in common an ability to set credible rules for defining the sharing of risk that minimize moral hazard while maximizing the ability of the system to provide liquidity during crises. In the United States prior to the Civil War, three states (Indiana, Ohio, and Iowa) successfully operated mutual insurance systems for member banks, which revolved around that principle (Calomiris 1989, 1990, 1993). These were imitated by the New York Clearing House, and by other private clearing houses (Cannon 1910, Gorton 1985). Member banks were constrained by rules and credible monitoring arrangements that limited the riskiness of their debts. Insolvent banks were ejected from coalitions that provided liquidity protection for solvent banks. Enforceable rules requiring the pooling of risks during crises to solve liquidity problems ensured sufficient collective protection. These systems provide examples worthy of imitation today. All successful historical safety net systems revolved around credible arrangements for limiting moral hazard by clearly defining how losses incurred by members would be allocated.

Defining the allocation of risk for the global safety net requires a segmentation of risk into three tranches: the private tranche (exposures to loss incurred by private claimants of individual financial institutions), the domestic government tranche (exposures to loss assumed by local government bank safety nets, and hence, local taxpayers), and the IMF tranche (exposures to loss assumed by the IMF). The other key design feature of the global safety net is determining how the IMF's financial positions are financed (how risks taken by the IMF will be passed on to other parties).

The role of financial system regulations, which include IMF membership criteria and the rules for IMF lending, is to clearly define when and how the IMF lends, and how losses are allocated within the financial system to maximize the effectiveness of protection against illiquidity, while minimizing the moral-hazard costs of protection. To be effective, those rules not only have to make economic sense, but must be *transparent* and *credible*. In other words, the rules governing the global safety net have to qualify not only as economically sensible, but also as politically robust.

IV. A New Institutional Structure for Credible Loss Sharing

Without a credible "first tranche" of private loss, moral hazard will plague any attempt to provide liquidity, either from domestic governments or the IMF. What is needed is a set of transparently credible rules that impose a margin of private loss on bank claimants, which limits the exposure of taxpayers to bailout costs ex post, and in so doing, limits banks' willingness to undertake risks ex ante. Putting those safeguards into place should be a requirement of membership in the IMF. Members would then be eligible for IMF liquidity protection – loans from the IMF that are specifically designed to resolve liquidity problems, not to bail out insolvent banks.

By setting these clear, credible criteria for IMF membership, and devising rules for IMF lending that guard against liquidity problems without providing bailouts (that is, without absorbing bank solvency risks), the IMF and its loan programs would help to stabilize global financial markets. What sorts of rules would work to accomplish these objectives? The rules divide into three types: (1) domestic regulations required as a condition for IMF membership, (2) rules governing IMF lending to members, and (3) rules defining the way IMF loans are financed.

Credible Bank Regulation: Subordinated Debt, Liquidity, Insurance, and Free Entry

The bank regulatory requirements that should be mandatory for IMF members include four components: (1) capital requirements (including, in particular, a subordinated debt requirement as part of the capital requirement), (2) "reserve" requirements (minimum ratios of assets in cash and in "global securities"), (3) the explicit insurance of bank deposits, and (4) "free banking" (unlimited chartering of banks conforming to common regulatory standards, and unlimited investment by foreigners in banks, conforming to the same standards as domestic investors).

A key function of capital regulations is to provide a credible first tranche of private loss by ensuring that uninsured bank claimants (stockholders and subordinated debt holders) will lose wealth when banks suffer adverse shocks to the values of their risky assets. Minimum cash reserve ratio requirements serve a similar function (effectively ensuring a margin of protection for insured debt), and also enhance bank liquidity. A minimum amount of "global securities" – domestic and foreign marketable instruments – adds to the transparency of bank balance sheets and helps to diversify bank risk. Thus restrictions on asset holdings and on the composition of bank liabilities provide crucial buffers that ensure the privatization of bank losses, and thus make it easier for local governments and the IMF to provide liquidity protection cost effectively.

These regulatory requirements are a first line of defense that reduces the risk of bank failure, the potential for costly bank bailouts, and the liquidity risk that banks face.

Free entry into banking by foreign investors provides an important source of capital (to meet regulatory capital requirements). It also helps to diversify both the ownership base of banks and their asset portfolios (since foreign banks naturally hold more globally diverse portfolios), which makes banks more resilient in the face of adverse domestic shocks. Finally, foreign banks provide important competitive pressure that improves the quality of domestic bank management (Demirguc-Kunt and Levine 1998, Kane 1998).

Because of the importance of *credibility* and *transparency,* bank capital and portfolio regulations must be designed carefully. Credibility and transparency require a reliance on *market discipline* to enforce bank regulations (Keehn 1989, Wall 1989, Flannery 1998, Berger et al. 1998). In capital standards, the devil is in the details. A key flaw in the Basle capital requirements to date has been their emphasis on government supervisory standards when measuring capital. Book value equity is measured by supervisors who often have little skill, and even less incentive, to report bank asset losses accurately. Second, the Basle standards imply an arbitrary link between their measure of asset risk and book value capital, while the true asset risk of the bank can differ from the Basle measure of "risk-weighted assets." The mandated 8% capital requirement is not sufficient if banks assume very high asset risk, and the measurement of risk-weighted assets under the Basle standards leaves much room for bank manipulation of risk.

The Basle capital requirements can be substantially improved by incorporating into the Basle framework a minimal (say, 2%) subordinated debt requirement, as a means to ensure a credible relationship between capital and asset risk via market discipline. This approach was first proposed by the Chicago Federal Reserve Bank (Keehn 1989) and the Atlanta Federal Reserve Bank (Wall 1989) in response to the U.S. S&L and banking crises of the 1980s. The approach outlined here is a modified version of the Chicago Fed plan.

As part of the existing 8% tier 1 and tier 2 Basle capital requirement, banks would be required to issue at least 2% of risk-weighted assets (as defined under the Basle standards) in the form of a new class of subordinated debt. That debt would be subordinated to (that is, junior to) other bank debts. Unlike equity holders, subordinated debt holders do not benefit from "asset substitution" (increasing asset risk in order to exploit the implicit put option value of deposit insurance). Thus subordinated debt holders would be a conservative force for restricting bank risk taking, and protecting relatively senior bank deposits. Because subordinated debt is easy to measure (unlike the book value of equity), a minimal subordinated debt requirement avoids the problems of relying on domestic bank supervisors to measure compliance with equity standards. Furthermore, the yields on the debt are observable, which provides a continuous and transparent market opinion about bank risk.

To be successful, however, subordinated debt issues should be restricted in several ways. To ensure that it serves its role as a source of market discipline, subordinated debt must be held at arms length, and therefore, cannot be held by any willing purchaser. I recommend that the debt be non-tradable, and held only by a group of approved and registered holders (which would differ for each issuer). Each bank's group of qualified holders would be a subset of, say, 50 institutions pre-approved by both the domestic regulator and the IMF as reputable *foreign* financial institutions with no other financial transactions with the issuing bank. Placing subordinated debt in the hands of well-diversified foreign institutions also helps to ensure that subordinated debt holders will not be bailed out, which is necessary for subordinated debt to serve as a source of market discipline.

It is also essential that a subordinated debt requirement specify how increased bank risk (visible in the yields of subordinated debt) would be penalized by bank regulators. Perhaps the simplest procedure is to set a maximum yield spread over comparable maturity treasury instruments (say, 5%) and require that subordinated debt not be issued at yields in excess of that maximum spread. Banks that fail to roll over their debts at or below the mandated yield spreads eventually would have to contract their risk-weighted assets to remain in compliance with the 2% subordinated debt requirement.

The maturity of subordinated debt should reflect the right balance between enhancing market discipline (by requiring that the debt be rolled over sufficiently frequently) and limiting the amount of rollover that can occur over short intervals (to avoid the risk of sudden illiquidity). For example, requiring that subordinated debt be issued in the form of 24 overlapping generations of two-year debt – one-twenty-fourth of which mature each month – would be a reasonable way to achieve discipline without leaving banks vulnerable to liquidity crises. That arrangement would limit the rate of decline of subordinated debt to roughly 4% per month. Given the required minimum ratio of subordinated debt to risk-weighted assets, that would also limit the maximum monthly decline of risk weighted assets mandated by the requirement to 4%.

The subordinated debt requirement is designed to encourage prudent behavior by banks ex ante (since, on the margin, they are always subject to market discipline), and to encourage appropriate adjustment of asset risk to adverse shocks ex post. Unlike many banks currently, banks subject to a subordinated debt requirement would not purposely increase risk in the wake of losses. Instead, banks would have strong incentives to reduce asset risk and cut dividends (or find alternative ways to raise capital) in the face of losses, much as banks did before safety nets changed their incentives to react appropriately to shocks.

Because subordinated debt holders bear risks that come from both on-balance sheet and off-balance sheet asset risks, they discourage attempts by banks to avoid regulatory capital standards by placing transactions off banks' balance sheets. Subordinated debt holders also encourage banks to develop clear reporting procedures and effective tools for risk management.

A banking system governed by a credibly uninsured subordinated debt requirement is self-equilibrating. Banks may have difficulty rolling over subordinated debt in response to severe shocks (given the proposed yield spread limit on subordinated debt). The failure to roll over subordinated debt mandates a contraction of risk weighted assets (e.g., a contraction of loans). That contraction itself reduces asset risk, eventually allowing the market spread on subordinated debt to fall within the prescribed limits of the regulation.

Restrictions on bank asset composition are also desirable, both to promote liquidity for the system as a whole, and to provide a transparent safeguard against bank default risk in addition to requiring subordinated debt. Argentina's high reserve requirements were extremely useful in helping Argentine banks to weather the tequila crisis in early 1995. Argentina has also shown creativity in the way it allows banks to meet those reserve requirements. Banks are encouraged to hold up to 50% of their reserves offshore in private commercial banks, and may hold much of their reserves in the form of standby arrangements with foreign commercial banks (for which the Argentine banks pay a fee) rather than in the form of actual dollar deposits. Like a subordinated debt requirement (also a feature of the Argentine system) this arrangement rewards low-risk banks who are able to pay low fees for their standbys.

I propose a similar requirement as part of the mandatory minimum reserve requirement for banks – a 20% reserve requirement relative to bank debt, with half to be held offshore (partly to protect against government confiscation of bank resources). Banks can satisfy the 10% offshore reserve requirement by maintaining standbys in that amount with any AA rated international bank.

The "global securities" requirement would also be set at 20% of deposits. At least half of that securities portfolio must consist of foreign hard-currency-denominated (meaning denominated in dollars, yen, or euros) debt securities placed and priced in international public markets, with yield spreads at the date of purchase of less than 3% over the comparable maturity treasury instrument (of either the U.S., German, or Japanese governments denominated in their respective currencies). The other half of the required securities portfolio could consist of any publicly traded debts (including local government and private bonds), so long as their yield spreads were less than 5% over comparable treasury securities at the date of purchase. The securities portfolio requirement serves the dual function of encouraging global diversification and providing an additional liquidity buffer for banks.

The final regulatory requirement is deposit insurance. All bank debt that is not included in subordinated debt should be explicitly insured by the local government. Doing so would eliminate the possibility of banking panics, either due to asymmetric-information problems (Section II's "Problem 2"), or multiple equilibria (Section II's "Problem 3).

The argument for government deposit insurance is primarily a political, rather than an economic, one. Arguably, private methods of protecting against banking panics may be superior to government deposit insurance. But since governments tend to be incapable of credibly committing not to provide insurance ex post, it is not possible to construct effective private systems.

Explicit government insurance is superior to implicit government insurance. While there are some theoretical and empirical arguments in favor of "constructive ambiguity" in deposit insurance that might favor implicit over explicit insurance, those arguments are not convincing. Implicit insurance does not provide as much protection against runs. Also, making insurance explicit allows governments to charge insurance premia for the protection, and helps government actions to conform better to stated government policy (surely a desirable principle in a world where reputation building has value).

In the presence of the other prudential regulations (the subordinated debt requirement and the portfolio requirements), deposit insurance should not be very costly. In a world where market discipline constrains bank behavior, there are likely to be few bank failures, and small losses from insuring banks.[8]

These four regulations – subordinated debt requirements, minimum reserve and securities ratios, free banking, and deposit insurance are a *minimal standaru*, which should be required as a condition for membership in the IMF. I would recommend that countries go beyond that minimal standard when devising their bank regulations, particularly in the areas of insider lending limitations, barriers between commerce and banking, regulations of market risk exposures, and more realistic definitions of risk weighted assets than those found in the Basle standards. For example, risk weighted assets should be defined in a way that is more sensitive to real risk than are the Basle standards. In Argentina, risk weights on loans are determined by the interest rate on the loan, and can be as much as 600% of the book value of the loan for very high interest loans.

While it is desirable to improve bank regulation by including requirements in addition to the four minimal standards, some regulatory standards should vary across countries. Furthermore, a subordinated debt requirement, and the market discipline it brings, arguably subsumes other regulatory standards, and makes additional measures less important. If banks have to satisfy market discipline, markets will informally "impose" safeguards against market risks, insider lending, and other potential problems, since banks will have to satisfy market perceptions about their overall risk profile.

By keeping the list of required regulations short and simple it will be easier for the IMF to credibly enforce the rules it sets (see Section V below). By vigorously enforcing these rules (e.g., ejecting countries from the IMF if they fail to enforce minimal requirements or if they bail out subordinated debt holders when banks experience losses) the IMF will return reason and

[8] For historical evidence supporting this view, see Calomiris (1989, 1990, 1993).

balance to international banking, and prevent its own protection from being a source of financial instability.

A reformed global banking system will also reduce the riskiness of emerging market securities. Banking systems as a rule have been run inefficiently in emerging market countries, and banks often pursue opportunities more on the basis of insiders' interests than a proper valuation of loans. For that reason there are many viable projects that should be financed by banks rather than via securities issues (that is, projects that require ongoing monitoring and discipline by banks through concentrated local holdings of claims on borrowing firms), but are pushed into securities markets for lack of a local means of bank finance. In a properly functioning global banking system, those projects would be financed by banks, and banks would be more internationally diversified to permit them to deal with the risks that arise from those risky projects.

The four core banking regulations would ensure a properly functioning global banking system. Free entry, competition, and credible market discipline would encourage proper diversification, prudent management of risk, and an efficient allocation of bank capital. It would also make it possible for the IMF to do the job it was chartered to do – providing liquidity insurance – without the destabilizing side effects of moral hazard.

Other IMF Membership Requirements

Thus far I have focused on the structure of banking systems, and on proposed mandatory bank regulatory requirements for IMF membership. That emphasis is appropriate given the important role banking system losses and moral hazard have played in exchange rate collapses and IMF-sponsored bailouts. But there is more to the global financial architecture than the regulations governing banks.

In addition to the mandatory bank regulations, the IMF should impose restrictions on government recapitalizations of banks (or implicit subsidization of banks through a variety of other means), and set minimal standards for government debt maturity structure, and for a prudent fixed exchange rate policy. It is appropriate for the IMF to set standards for debt management and exchange rate policy, as well as banking practices, since the IMF will provide liquidity assistance to buttress fixed exchange rates or to facilitate debt rollover.

The main purpose of restrictions on government assistance to banks is to ensure that the market discipline brought by the subordinated debt requirement is not undermined by government assistance through channels other than deposit insurance. A detailed discussion of the limits on recapitalization policy are described below under the rubrics of "transition problems" and "large macroeconomic shocks."

As in the case of mandatory banking regulations, the other rules should be as few and as simple as possible, and should be designed to make compliance with them easily observable to the IMF and to third parties. Countries should face a ceiling on the proportion of short-term sovereign debt they issue. For example, members could be required to maintain ratios of short-term debt that were no more than 25% of the previous year's export earnings, and no more than 25% of total sovereign debt.

Countries should not be required to maintain fixed exchange rates, but if a country does peg its exchange rate, then it should be required to meet two additional requirements. First, it should have to maintain a minimum ratio of reserves to high-powered money. Economic theory has little to say about the "right" reserve ratio for a central bank to maintain, except that the right minimal proportion of reserves depends on the confidence the market places in fiscal and monetary policy. Countries operating currency boards maintain ratios of nearly 100%, but there are many examples of countries that have been able to maintain exchange rates for long periods of time with much smaller reserve ratios (the United States prior to 1933, for example). Rather than requiring everyone to hold 100% reserves, or trying to set standards for reserves that depend on hard-to-observe fiscal and monetary fundamentals, I propose requiring a low minimal reserve ratio (25%), and encouraging countries to properly manage their reserve policies by making it clear (by enacting the aforementioned reforms) that the IMF will provide support only to resolve bona fide liquidity problems.

Second, member countries with fixed exchange rates should be required to permit banks to offer deposits denominated in both domestic and foreign currency. Doing so (as Argentina did when it adopted its currency board) helps to insulate banks from the risk of devaluation; funds can flow out of the domestic currency without flowing out of the banks. Bank deposit accounts in both currencies also provide continuous market information about the risk of devaluation. Domingo Cavallo, the Argentine finance minister, has argued that observing interest rates in both currencies gives domestic policy makers a valuable signal of market perceptions of government policies that bear on the maintenance of the exchange rate (Cavallo 1999).

Observing interest rate differentials prior to a speculative attack also gives the IMF valuable information which may be useful in judging the causes behind a speculative attack. If the perceived risk of devaluation (reflected in the interest rate differential) rises gradually over a matter of months, while the government makes little effort to diffuse market concerns through increases in reserves or fiscal reforms, then it is hard to blame the speculative attack on multiple equilibria or irrationality. In some cases, as discussed below, the IMF might wish to withdraw its support for an exchange peg that so obviously ignores market concerns over long-term fundamentals.

I do not include any membership requirements with respect to capital controls or devaluation policy. It would be too difficult to devise general rules to cover these areas; moreover, the appropriate policies with respect to capital controls and the appropriate circumstances for a devaluation should be left to governments to decide for themselves.

Many economists have rightly argued that the proper alternative to bailouts is a functioning bankruptcy code that can distribute loss according to clearly specified rules. I agree with that point of view, but do not attach it here as a condition for IMF membership for two reasons. First, it would be hard to specify the terms of that bankruptcy code in an uncontroversial way (the Swedish code is my personal favorite). Second, it is probably not necessary to add bankruptcy reform as an additional requirement of IMF membership. A banking system that is responsive to market discipline will be a powerful force for creating bankruptcy reform endogenously. The same can be said for the endogenous reform of commercial law, collateral registration procedures, and accounting standards.

I also omit any discussion of fiscal policy targets. It is too hard to design useful, credible, uniform rules about fiscal policy – for example, off-balance sheet exposures are often crucial to long-term fiscal health and are very hard to measure.

IMF Goals, Lending Policy, and Sources of Funds

Thus far, I have outlined the criteria for membership in the newly constituted IMF. IMF membership depends on satisfying four bank regulatory requirements (free banking, market-based capital standards, reserve and securities requirements, and deposit insurance), and three additional policy requirements (limits on short-term government debt, and two additional rules for fixed-exchange-rate economies: a minimal central bank reserve requirement, and the requirement that banks be permitted to offer accounts denominated in both domestic and foreign currency). Countries that do not satisfy these seven requirements would be ejected from the IMF; there would be no room for discretion in bending those rules.

Now I turn to the question of what function the IMF would serve, and how it would achieve its objectives. The goal of the IMF would be to mitigate problems of illiquidity that may arise when a country is pegging its exchange rate. Note that most of the problems listed in

Section II are addressed by IMF membership requirements. Problems associated with bailouts, and banking panics resulting either from asymmetric information about bank loan portfolios or multiple equilibria, are addressed by the requirements that limit abuse of the safety net and by mandatory insurance of bank deposits. Problem 5 (government debt rollover risk) is addressed by limiting short-term sovereign debt issues, which also prevents governments from free riding on IMF insurance against liquidity risk.

The systemic risk that remains to be addressed is the possibility that central bank illiquidity could produce a speculative attack on the exchange rate peg caused either by multiple exchange rate equilibria or irrational speculators, rather than by fundamental fiscal and monetary policy weakness. Preventing such attacks was the clear intent of the IMF's founders who sought to provide a safeguard against unwarranted currency depreciation that might result from sudden pressures on the balance of payments.

To provide liquidity protection I propose that the IMF operate a discount window to lend to central banks. The proposed discount window lending policy is based on Bagehot's (1873) rule: lend freely during crises on bona fide collateral at a penalty rate. By penalty rate I mean a rate higher than the preexisting market clearing rate, but not as high as the rate would be if no protection were offered. Bona fide collateral is defined as any government debt instrument held by the central bank that is priced in the market, so long as at least 25% of the amount of the collateral offered is in the form of *foreign* government securities.

To be concrete, a government that is a member in good standing would be able to have its central bank borrow dollars from the IMF for a short period of time (say, 90 days) if it posts 125% of the borrowed amount in securities. Collateral securities would be valued using prices from one week prior to the request. The borrowing interest rate would be two percentage points above the value-weighted yield on that bundle of securities one week before the request. Thus, since the bulk of collateral will consist of the borrowing countries' sovereign debt, by setting the interest rate at a fixed amount above the lagged yield on the sovereign debt, IMF lending can successfully provide an elastic supply of liquidity, and can short-circuit a "bad equilibrium" in which self-fulfilling expectations produce a collapse in the value of government debt.

To ensure that bank regulatory protections remain in place, central banks would not be permitted to post as collateral securities they borrowed or purchased from their local commercial banks. IMF loans should not be rolled over for an additional 90 days without some form of special approval (say, a large supernumerary majority of IMF members voting in favor of extending the loan).

To avoid abuse of IMF protection, it may be desirable for the IMF to retain the option to turn down a request if it could provide evidence that the fundamentals driving the value of the collateral securities had deteriorated precipitously in the week before the request. For example, if yield spreads between bank accounts denominated in local and foreign currency had widened dramatically in response to political events that weakened fundamentals, then the IMF might reasonably refuse assistance. Russia's experience during August 1998 is an example of such a precipitous fundamental deterioration.

The 125% collateralization, along with the requirement that 25% of the collateral take the form of government securities issued by foreign governments, and – perhaps most importantly – the banking reforms that limit member government fiscal exposure to bank losses all serve to limit the default risk suffered by the IMF and encourage central banks to maintain foreign government securities holdings in addition to cash reserves, which bolsters the credibility of the exchange rate. The collateral requirements, the short duration of the loan, and the penalty interest rate together limit the size of the credit subsidy received by the borrowing central bank, which discourages frivolous use of the IMF discount window. Countries that default on IMF loans should be barred from borrowing for some time (say, 5 years), and should not be permitted to re-enter as members until they have repaid their debts in full (including accrued interest).

The new IMF discount window would provide significant protection against short-term liquidity problems. Governments would be able to convert large amounts of their bonds into cash on short notice, provided that they also maintained sufficiently large holdings of foreign government securities to meet the 25% collateral requirement. Assistance would be available on short notice, and no conditions (other than membership) would be attached to it.

Of course, this discount window would not protect a country against persistent balance of payments outflows, and it should not attempt to do so. Persistent outflows, which would lower central bank holdings of hard currency and hard-currency-denominated securities, would be a sure sign of fundamental weakness. IMF lending should not try to lend to prop up unsustainable currency pegs. It should lend freely, however, to ensure that sudden "self-fulfilling" speculation does not undermine an otherwise sustainable peg.

It is worth emphasizing that a Bagehotian lender of last resort cannot provide much protection against banking panics that are caused by asymmetric information about bank loan quality, since lending against securities collateral makes the value of deposits more, rather than less, susceptible to declines in the value of bank loans.[9] That is why it is necessary to combine a Bagehotian lender of last resort (like the reformed IMF discount window envisioned here) with credible protection against asymmetric-information problems in the banking sector. Deposit insurance eliminates depositors' incentives to run banks when they become concerned about the value of loan portfolios. Credible market discipline (through a subordinated debt requirement and asset portfolio requirements) reduces the incidence of such asymmetric-information problems and provides strong incentives for banks to control loan risk, which eases the funding burden of providing deposit insurance protection, and fosters deposit insurance credibility. Thus the IMF's ability to provide liquidity protection against speculative attacks on exchange rates will only be effective if combined with those other regulatory requirements.

How would the IMF finance its lending to central banks? The IMF would borrow cash from the central banks that issue it (in the U.S., Germany, or Japan). IMF borrowings from central banks would be fully collateralized by the government securities of the hard-money country of issue. Those collateral securities would be contributed by all IMı members, and held by the IMF to be used as needed. For example, if the IMF were borrowing dollars from the Fed, it would post 100% collateral in the form of U.S. government securities. IMF members would share the financial burden of supplying that collateral, and therefore would share the risk of the borrowing country defaulting on its IMF loan. IMF lending would not imply an increase in the aggregate supply of hard currencies, since the Fed, the Bank of Japan and the European Central Bank would all be free to sterilize the effects of their loans to the IMF.

Transition Problems

Some of the world is very far from meeting the conditions specified above for IMF membership. How difficult would it be for countries to satisfy the seven membership requirements, and what transitional policies could facilitate that process?

The central bank reserve requirement, the limits on government debt maturity, and the requirement that banks be permitted to offer accounts in domestic and foreign currency would be relatively easy to satisfy. The main difficulty is transforming the banking systems of many countries (including those in some Western European countries, as well as the vast majority of those in developing economies) into competitive, market-oriented systems. The problem is not mainly an economic one; if governments opened their banking systems to foreign entry and imposed the regulations suggested above, efficient banking systems would develop quickly. The problem, however, is the politics of banking – the resistance of entrenched special interests to

[9] For further discussion, see Calomiris (1994), Calomiris and Mason (1997), and Mason (1997).

reforms that would erode the rents they currently enjoy. The challenge reformers face is to find a way to placate that political opposition.

The resistance to market discipline can be found even in relatively efficient banking systems (like that of the United States), where only recently some of the largest banks have begun to call for subordinated debt requirements to eliminate "too-big-to-fail" protection. Those banks consistently opposed such measures over the past decade, predictably preferring to maintain the implicit subsidy from the taxpayers. But now many of them (and, notably, The Bankers Roundtable, which represents the largest 150 U.S. banks) are calling for reform because they see credible market discipline, and a subordinated debt requirement in particular, as a means of permitting an expansion of bank powers (The Bankers' Roundtable 1998).

Deregulation is one way of buying support for market discipline, but in many developing economies (where banks already enjoy broad powers, and where bank owners would have great difficulty in meeting market-enforced capital standards), it may be necessary to buy support more overtly through a government-financed recapitalization of existing banks. That recapitalization would make it easier to swallow the pill of market discipline, and if a one-time subsidy would set the stage for credible regulatory reform (on the lines described above), it would be well worth the cost.

Such a recapitalization must be carefully designed, however, so that it is cost effective, and does not undermine market discipline in the future. One approach to providing government subsidization of bank recapitalization without undermining the effectiveness of market discipline is proposed in Calomiris (1998b, 1999). Assistance would take the form of subsidized government purchases of bank preferred stock for a short period (say, five years). Those purchases would occur on a matching basis with arms-length public offerings of new common stock. To qualify banks would have to agree to other provisions, including the suspension of dividend payments on common stock during the period in which the government holds preferred shares. The one-time recapitalization subsidy is designed automatically to target assistance toward the relatively strong, and to help make subordinated debt requirements feasible.

The World Bank, and other development banks, could help during the transition process in two ways: by providing financial assistance to encourage countries to implement credible market discipline (and thereby qualify for IMF membership), and by offering advice on how to structure complementary institutions and laws (including commercial laws, accounting codes, and bankruptcy laws). Too often World Bank loans have crowded out private lending and removed incentives for countries to adopt the fundamental reforms of property rights on which private lending depends. World Bank loans to China are the clearest example of such misdirected lending. But in some cases the World Bank successfully has targeted its assistance to encourage privatization of financial institutions and the creation of credible market discipline. Its loan subsidies to Argentina to help pay for the privatization of provincial banks are an example. The World Bank and other development banks could help ensure broad based membership in the new IMF by redirecting loan subsidies toward government programs that restructure banking systems to encourage adherence to market discipline.

Large Macroeconomic Shocks

No matter what the stated commitment to market discipline, time inconsistency problems will tempt governments to provide assistance to banks during severe macroeconomic downturns. Banking systems that respond properly to market discipline will necessarily magnify recessions by curtailing the supply of loanable funds when they experience losses on their loan portfolios. Governments will be tempted to relax market discipline to prevent the aggravation of cyclical downturns.

A better approach is to maintain market discipline through the subordinated debt requirement, but subsidize private bank recapitalization (using the preferred stock matching subsidy described above) to counteract especially severe economic downturns. I am not arguing that bank recapitalization is desirable economically; rather, I am arguing that if government intervention into the banking system is politically inevitable, it is better to intervene to help banks meet the standards of market discipline, rather than simply repealing those standards.

It is also crucial that other forms of bank bailouts be forsworn. In particular, central banks of IMF member countries should not be permitted to operate discount windows that implicitly bail out banks. In the presence of deposit insurance, a private interbank market for reserves, and IMF liquidity assistance there is no need for a domestic discount window to implement monetary policy (Goodfriend and King 1988, Bordo 1990). If central banks insist on operating a discount window, they should be required to restrict potential abuse by employing in their domestic discount window lending the same Bagehotian principles advocated here for the IMF window.

V. The Political Economy of Financial Reform

Politics poses challenges for any attempt to bring economic reason and market discipline to bear on the regulation of the global financial system. Politicians and regulators are jealous of their power, tend to prefer systems that rely on discretion rather than rules, and are more comfortable managing cryptic decision making processes (the proverbial smoke-filled rooms in which IMF policies are determined today) than engaging opponents openly in public fora.

Thus the reforms I advocate – the abolition of the Exchange Stabilization Fund and a sweeping reform of the IMF – will likely not be very welcome in Washington or in the treasury departments or finance ministries of many nations. That does not mean that reform is impossible, but it certainly will be an uphill battle.

Consider, for example, the problem this proposal poses for the U.S. Treasury Department. It has frequently used the Exchange Stabilization Fund (Schwartz 1997, 1998) and the IMF as means to provide foreign aid under the guise of liquidity assistance. These mechanisms have the advantage that they avoid the unpleasant and inconvenient requirement of seeking Congressional approval for such aid. The recent IMF assistance programs for Mexico in 1994-1995, and for Russia in 1998, were among the most unseemly recent examples of pushiness by the U.S. administration.

The political obstacles to rationalizing the current system are formidable. But the distortions in decision making created by those obstacles also are motivating a redoubling of effort in some quarters to reform the system. Simplifying the IMF's role and decision making process by setting simple, meaningful, and publicly observable membership criteria, and placing strict bounds on how and when the IMF provides assistance, would be a welcome means of reducing politically motivated distortions from the process of providing necessary liquidity assistance. These reforms would also remove the IMF from the uncomfortable position of dictating the details of macroeconomic and microeconomic policy to its member nations (see Feldstein 1998). Aside from IMF membership criteria, according to my proposal, no conditions would be attached to IMF liquidity assistance.

The prospect of a world where the power to allocate risk would be less abused, and where political puppeteers would find the strings of the financial system beyond their reach, fires the imagination and invites the effort to see such a project through. The recent failings of IMF-U.S. Treasury policies in Mexico, Asia, and Russia, and the chorus of criticism facing the IMF and the Treasury, provide a window of opportunity for reform. Congress is now poised – for the first time in U.S. history – to thoroughly evaluate the process of decision making within the IMF.

Yet, a deeper question remains unanswered. Assuming that something like this plan did succeed in being passed, and that it would perform as advertised, would the policies be politically credible? The key to credibility is the willingness to enforce market discipline in the banking system – which ensures that first-tranche losses from financial collapse are borne privately by subordinated debt holders. Will member governments do so, and will the IMF be willing to eject members that fail to impose those losses?

It is not possible to predict political processes very exactly. At the same time, the subordinated debt plan has been designed to maximize the probability of political survival. Subordinated debt is a very thin sliver of private loss (2% of risk-weighted assets), and would be held (preferably, outside of the country of issue) by large, diversified international financial institutions for whom that sliver of loss should not be devastating. The vast majority of claims on banks are protected from loss by deposit insurance. Subordinated debt also is specifically earmarked ex ante for loss, and governments that do not bail out subordinated debt holders can point to IMF membership requirements that prohibit bailing them out. Furthermore, allowing for stock recapitalization during the most severe macroeconomic crises removes one of the main threats that might otherwise relax market discipline.

That said, it must be admitted that no economic plan is foolproof, and that much will depend on how the IMF reacts to attempts by members to undermine market discipline. The more economists and policy makers worry about this issue in advance, the better.

Other details of the plan must also be addressed to make it more politically survivable. Non-bank banks (intermediaries that operate as banks, but do not call themselves banks) and similar evasions of the spirit of the membership requirements must be guarded against. Small banks, who will find it hard to access global subordinated debt markets, and who may possess the political power to block regulatory reform, must be compensated as well. The easiest way to proceed might be to allow small banks (defined, say, as banks with less than $1 billion in assets) to issue their subordinated debt in the form of interbank deposits held by large local banks.

A final political obstacle to reform might be called the "one world syndrome." I propose that the IMF charter prohibit loans to non-member countries. Because membership criteria will not be met by everyone, that implies that some countries will be excluded (by their own actions) from IMF protection. For some, it will be awkward to devise a global safety net and an international lender that excludes countries from membership and protection. But this is necessary for two reasons.

First, restricting access to the IMF helps taxpayers worldwide to limit their own governments' abuse of IMF lending in support of bailouts that transfer resources to influential oligarchs. Policy markers should recognize that without the core institutions of a successful market economy – clear and credible private property rights, competition, and adherence to market discipline to ensure appropriate incentives toward risk taking – quasi privatization of banks and liberalization of capital flows builds a house of cards that will inevitably topple. It is counterproductive for the IMF to assist such economies or to encourage them to enter global capital markets. Helping oligarchs to preserve their power and status at the expense of local taxpayers only makes it harder for economies to build the foundations of successful liberalization.

Second, IMF membership rules are necessary to prevent member countries from abusing the protection offered by other members. As in all successful private and public arrangements that provide liquidity protection, regulations are necessary to prevent free riding. For a mutually beneficial liquidity insurance system to work, membership criteria must be meaningful and membership must be valuable, otherwise the ability to free ride will undermine the willingness to reform domestic banking systems and other policies.

Of course, the U.S. government, and others, would still be able to provide foreign aid to non-member countries for strategic or humanitarian reasons. But that assistance would not flow through the IMF or the ESF.

VI. Conclusion

A global financial architecture can be defined as the set of institutions, contracts, and incentives that determine how financial risks are taken and how losses and gains from taking those risks are allocated. This paper offers an ecumenical proposal for reforming that architecture. As a working assumption, I have assumed that there is some truth in virtually every argument that is made about the problems facing the global financial system, and have argued that it is possible to design a global safety net that properly allocates risk, eliminates (or at least significantly reduces) problems of moral hazard, and still provides protection against illiquidity problems. I have argued that the imagined system would be simple to operate, and would be more credible politically (more "time consistent") than many alternatives. It would also permit the IMF to provide elastic liquidity assistance to help members defend their exchange rates from unwarranted attacks.

The proposed changes would also avoid IMF micro-management in the midst of crises, which has been criticized as an abuse of power (Feldstein 1998), an ineffectual means of financial system reform, and counterproductive to the provision of rapid liquidity assistance. Focusing the IMF's mission on true liquidity assistance would transform it from an agency that balances political interests to one that solves well defined economic problems, which would do much to rebuild the shattered reputation of the Fund.

Others, no doubt, will find ways to improve this proposal. By being concrete – drafting "blueprints" rather than just outlining broad principles – I do not mean to suggest that mine is the only imaginable way to proceed, but rather I hope to have stimulated *specific* discussions, and to have pointed to the need to combine economic logic with political pragmatism when designing the rules that govern the global financial system.

Offering a plan for reform does not constitute an unconditional argument for keeping the IMF. Schwartz (1998) is right, in my view, to argue that in its current form the IMF does more harm than good. Abolishing the IMF may be the right policy to pursue if it turns out that the path to reform, including credible IMF enforcement of meaningful membership criteria that limit safety net abuse, is blocked by those with vested interests in preserving the status quo.

Table 1

Elements of the Reform Plan

Membership Criteria for the IMF

Bank regulations:
- Basle standards (but without restrictions on subordinated debt/tier 2 capital)
- 2% subordinated debt requirement (with rules on maturities, holders, and yields)
- 20% cash reserve requirement
- 20% "global securities" requirement
- Free entry by domestic and foreign investors into banking
- Bank recapitalizations are permitted, but strict guidelines must be met (and must follow pre-established rules, as in preferred stock matching program)
- Domestic lenders of last resort avoid bank bailouts by following Bagehotian principles

Other membership criteria:
- Limits on short-term government securities issues
- If fixed exchange rate, 25% minimum central bank reserve requirement
- If fixed exchange rate, banks offer accounts in domestic and foreign currencies

IMF Lending Rules

- Loans are provided only to members in good standing (those following above rules)
- If a member defaults, it may not borrow for 5 years, and then only after arrears paid
- Loans are for 90 days
- Supernumerary majority of members required to roll over loans for another 90 days
- Loans are collateralized by 125% of value of loan in government securities
- 25% of the 125% collateral must be in foreign government securities
- The interest rate on the loan is set at 2% above the value-weighted yield on the collateral observed one week prior to the loan request
- The IMF reserves the right to refuse a loan to a member
- No conditions are attached to IMF loans

IMF Funding

- The IMF borrows from the discount windows of the Fed and other central banks
- IMF borrowings from central banks are 100% collateralized by government securities issued by the government of the lending central bank
- Government securities that serve as collateral for IMF borrowings from central banks are lent to the IMF by its member countries

Other Emergency Lending

- IMF, World Bank, IDB, and others would make no other emergency lending available
- The Exchange Stabilization Fund would be abolished

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