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The International Monetary Fund's (IMF) Proposed Quota Increase: Issues for Congress

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Summary

The International Monetary Fund (IMF) is the international lender-of-last-resort. Each of the 182 members of the IMF have a "quota," which broadly reflects the size of its economy and its relative position in the world economy. Among other things, quotas determine the size of a country's contribution to the IMF's capital. Thus, they provide the funds out of which the IMF makes its loans.

Under the IMF's Articles of Agreement, a general review of the adequacy of the IMF's quota resources must be conducted at least every five years. The Eleventh General Quota Review has just been completed with a recommendation that quotas be increased by 45 percent. This would result in an SDR 66 billion increase (about $88 billion) in total IMF quotas, to SDR 212 billion ($283 billion).

The U.S. quota would increase by SDR 10.6 billion ($14.2 billion), to SDR 37.1 billion ($49.7 billion). The U.S. share of total quotas would drop from 18.1 percent to 17.5 percent. The United States, which would continue to have the largest quota, would retain its veto over major decisions in the IMF. Under the Bretton Woods Agreements Act, U.S. participation in the proposed quota increase must be authorized by Congress. In addition, under a compromise formula reached in 1980, the necessary funds must be appropriated.

Current proposals for funding the IMF — an increase in quotas and the "New Arrangements to Borrow" (NAB) — raise a variety of serious issues, including:

- **contagion**: how to prevent the spread of financial difficulties from one market and economy to others in an integrated world economy;

- **moral hazard**: whether "bailouts" and IMF financing, by sending the wrong signals, encourage precisely the type of economic behavior that they were meant to deter;

- **conditionality**: whether the economic policy changes and performance targets that the IMF requires of its borrowers in return for a loan are appropriate and effective;

- **transparency**: whether information on IMF program design, in particular, and government economic and financial information and data, in general, are accurate, timely, and widely available to the public, including investors, so as to allow for more accurate assessment and greater accountability; and, finally,

- **asymmetry**: the relative lack of leverage of the IMF over its non-borrowing members and the resulting limitation on its ability to prevent crises.

The crisis in Asia is eroding the IMF's financial base. Its "usable" resources are estimated to be not more than about $38.4 billion, with a liquidity ratio of 79.1%, and may be considerably less. Both are approaching historically low levels.

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The International Monetary Fund's (IMF) Proposed Quota Increase: Issues for Congress

The International Monetary Fund (IMF), founded in 1945, is the international lender-of-last resort. Its 182 member countries may borrow from it when they are experiencing economic and financial difficulties.

The IMF's loanable funds are derived from its capital subscriptions or "quotas." Under the IMF's Articles of Agreement,[1] the IMF must conduct a general review of the adequacy of its quotas every five years. If the IMF considers its financial resources to be inadequate to meet anticipated loan demand, it may, with the approval of its Executive Board, recommend an increase in its quotas. The IMF has recently recommended that its quotas be increased by 45 percent.

U.S. participation in this proposed 45 percent increase must be authorized and appropriated by Congress. The proposed quota increase is in addition to a proposal that the United States participate in the "New Arrangements to Borrow" (NAB), [2] an arrangement of medium-term credit lines that would provide supplemental financing to the IMF in the event of an international financial crisis. U.S. participation in the NAB is also currently under consideration by Congress.

The emergence of an international financial crisis in Asia in the late spring of 1997 has made both the quota increase and the NAB proposal extremely controversial. The Asian crisis has resulted in large financial assistance packages for Thailand, Indonesia, and South Korea. In the case of the latter two countries, these have included commitments by the United States to provide backup contingency financing. Moreover, the IMF's loan to South Korea is the largest loan ever extended by the IMF, exceeding that provided to Mexico in the wake of the peso crisis of December 1994, a crisis that in many important ways forms the backdrop for the current crisis.[3]

Past requests for increases in the U.S. quota have been the occasion for a rigorous examination of the IMF, its operations, and its loan programs. This report

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[1] Article III, Sec. 2 (a).

[2] For more details on the NAB, see U.S. Library of Congress. Congressional Reserach Service. *The International Monetary Fund's "New Arrangements to Borrow" (NAB)*, by Patricia A. Wertman. IB97038. Updated regularly.

[3] Details of the 1994 Mexican peso crisis and the response to it can be found in, U.S. Library of Congress. Congressional Research Service. *Mexico's 1995 Economic Program and the IMF*, CRS Report 95-428 E; *The Mexican Support Package: Overview and Analysis*, CRS Report 95-1006 E; and *Mexico: Chronology of a Financial Crisis*, CRS 95-1007 E, all by Patricia A. Wertman.

is intended to provide an overview of selected major issues related to the proposal to increase the IMF's quotas. Many of the issues raised here also pertain to the proposed NAB. The report is not intended to be comprehensive. The order of presentation does not imply any hierarchy of importance.

The Quota Increase Proposal: Some Background

Each IMF member country has a "quota," which broadly reflects the size of its economy and its relative importance in the world economy. Quotas determine the size of each country's capital contribution to the IMF, and, thus, represent the IMF's basic financial resource. Quotas also determine voting rights within the IMF, access to IMF loans, and shares in any distribution of "Special Drawing Rights" (SDRs).[4]

Under the IMF's Articles of Agreement, a general review of the adequacy of the IMF's quota resources must be conducted at least every five years. The Eleventh General Quota Review was scheduled to be completed not later than March 1998. In September 1997, it was agreed, after intense negotiations, that a quota increase of 45 percent would be recommended. As the Asian financial crisis accelerated, the IMF's financial base began to erode as it extended loans to the Philippines, Thailand, Indonesia, and Korea in quick succession. The IMF's Managing Director Michel Camdessus, revisiting an early position that the quota increase needed to be greater than 45 percent, then asked the IMF's Executive Board to increase quotas by 70-80 percent. This would have raised total IMF quotas in an amount ranging between SDR 101.7 billion and SDR 116.3 billion (then $137-157 billion), including a U.S. contribution that would have been increased by between SDR 18.6 billion and SDR 21.2 billion ($25-$29 billion). The U.S. and German governments quickly indicated their opposition to the request for an expansion of such a magnitude. On December 23, therefore, the Executive Board proceeded with the originally agreed recommendation to increase quotas by 45 percent.

The currently recommended quota increase would increase the IMF's total quotas from SDR 146 billion ($195.5 billion, as of January 15, 1998) to SDR 212 billion ($283.9 billion). The U.S. quota would rise from SDR 26,526.8 million ($35.5 billion) to SDR 37,149.3 million ($49.7 billion), an increase of SDR 10,622.5 million ($14.2 billion). The U.S. quota, therefore, would rise by 40.0 percent, 5 percent less than the target increase. This would be reflected in a decline in the U.S. share of total quotas, which would drop from 18.141 percent to 17.521 percent. The veto power of the United States over major IMF decisions would, therefore, be retained.

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[4] The SDR is an international reserve asset created by the IMF and used to denominate all IMF accounts. The value of the SDR fluctuates against the U.S. dollar on a daily basis. It has recently been agreed that the IMF should make a new allocation of SDR 21.4 billion. This would double the number of SDRs outstanding. The proposal to allocate SDRs, because it would require an amendment to the IMF's Articles of Agreement, would require congressional authorization. Because no U.S. funds would be involved, however, no appropriation would be required. For more details, see U.S. Library of Congress. Congressional Research Service. *The IMF's Proposed Special Drawing Rights' (SDRs) Allocation: A Background Paper*, Patricia A. Wertman. CRS Report 97-738 E.

Under Section 5 of the Bretton Woods Agreements Act of 1945 (P.L. 79-171; 22 USC 286), U.S. participation in any IMF quota increase must be approved by the U.S. Congress.

The IMF's Need for Resources

The Asian crisis has substantially reduced the IMF's financial resources. IMF loans are made from its pool of so-called "usable resources," that is, its holdings of hard currencies and SDRs. According to the IMF, "[i]n assessing the adequacy of the Fund's liquidity position, the stock of usable currencies and SDRs held in the GRA [General Resources Account, the financial account from which the IMF makes most of its loans] is reduced by the amount of resources *committed* under arrangements *and expected to be drawn*, and is reduced further to take account of the need to maintain working balances of currencies and of the possibility that the currencies of some members in relatively weaker external positions would have to be removed from the operational budget."[5] (Italics added.)

Near the end of November 1997, the IMF was reported has having $50 billion (SDR 36.5 billion) in usable currencies by the *Washington Post* (Nov. 22, 1997) and the *Wall Street Journal* (Nov. 25, 1997), a figure that was confirmed to CRS by the IMF. The statement quoted in the preceding paragraph from the IMF's annual report suggests that the SDR 15.5 billion ($21 billion) loan to Korea, announced on December 4, would have immediately reduced the IMF's **uncommitted** resources by the full amount, thereby reducing its usable resources to SDR 21 billion ($28.5 billion, figured in SDR terms, using the exchange rate prevailing as of December 4, that is, $1.35723 per SDR), less an undisclosed amount of working balances. This, in turn, reduced the IMF's estimated liquidity ratio to 57.9 percent, from 100.6 percent[6]

IMF Deputy Managing Director Stanley Fischer stated, in his press conference of December 5, 1997, that the IMF had $44 billion in usable resources *after the Korean loan*. The first installment of the Korean loan, paid out immediately, amounted to SDR 4.1 billion ($5.56 billion). Adding this amount to $44 billion results in a total near to the $50 billion reported in late November. In essence, the $44 billion appears to have represented money actually in the "till," that is, cash-in-hand, rather than reflecting the full amount of the IMF's loan package to Korea.

The difference between the two numbers might, therefore, revolve around a definitional or operational determination of what constitutes committed resources. The IMF's commitment of funds might occur only after the IMF decides to disburse a loan installment (usually quarterly) following its review of borrower performance,

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[5] IMF. *Annual Report, 1997*, p. 125.

[6] The IMF's liquidity ratio consists of the ratio of its usable resources to its liquid liabilities. The Fund's liquid liabilities are comprised of its members' reserve tranches and thus, are equal to one-fourth of total quotas or SDR 36.3 billion. The reserve tranche is considered to be part of a country's international reserves and may be drawn automatically and unconditionally upon request. The liquidity ratio is, thus, a measure of the IMF's ability to lend.

rather than when a loan package is agreed, as the language of the annual report suggests to the outside analyst. Statistically, IMF loan arrangements are reported showing both disbursed and undisbursed amounts of the total loan package, again suggesting that the total package is committed up front.

The Korea loan is, in any case, being rapidly disbursed. The second installment, amounting to SDR 2.6 billion ($3.58 billion), was disbursed on December 18, followed by an emergency $2.0 billion that was announced on December 24 and disbursed in early January. *Considering **only** disbursements under the Korean loan and starting with the $44 billion figure for usable resources*, this would leave the IMF with an estimated balance of cash-in-hand of not more than $38.42 billion, also less an undisclosed amount of working balances. The IMF's liquidity ratio would then be about 79.1 percent (using the SDR exchange rate of January 15.). IMF resources and liquidity, thus, are falling rapidly by either definition.

By historical standards, the Asian crisis is reducing IMF liquidity to relatively low levels. Since 1983, the IMF's liquidity position has ranged between 71.0% and 167.6% at the end of each of its fiscal years, which end on April 30. At the end of April 1992, that is, immediately prior to the last quota increase, which became effective on November 11, 1992, the IMF's liquidity ration was 81.6%. The Fund's liquidity ratio has not fallen below 80% since 1986, in the midst of the international debt crisis of the 1980s. Since 1978, the year that the United States made a reserve tranche drawing, the IMF's liquidity ratio has been below 60% in only three years — 1978, 1979, and 1982.[7]

The resource needs of financially troubled countries always exceed what the IMF is able or willing to provide. The IMF's role is to rebuild confidence, to be a "catalyst" to private funding. It is only because the current packages have so far largely failed to stem the current "run" that the adequacy of the IMF's resources is even an issue.

"Contagion"

Occurring as a major financial crisis continues to wash over the economies of Asia, the proposed quota increase raises a number of serious issues. Among these is the issue of "contagion." Contagion is, simply, the spread of a financial crisis from one financial market or country to another. It raises the prospect that economies that are mostly healthy can be dragged down by economies with serious financial and economic problems. Ironically, it is the very success of Bretton Woods, specifically, the increasing freedom with which trade and capital flows move around the world, that allows for the emergence of this issue. It was a major concern of policymakers as the late 1994 Mexican crisis unfolded, [8] a concern that proved to be justified as the impact spread from Mexico to Argentina and Brazil and then to other emerging

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[7] IMF. *Annual Report*, 1994, p. 133.

[8] In the end, Mexico drew on its $17.8 billion IMF loan and a maximum of $12.5 billion of its $20 billion credit line from the United States.

markets in Asia. Nevertheless, within 3-4 months the Mexican crisis had largely been contained.

The current crisis has sequentially rippled through Asia, beginning in Thailand in late spring and spreading rapidly to Indonesia, the Philippines, Malaysia, Hong Kong, Taiwan, and South Korea. The duration of the current crisis, the number of countries involved, and the amount of funding and back-up lines committed — an estimated $115 billion — are well beyond those experienced just two years ago.

Concerns about contagion as a characteristic of financial crises, thus, have been heightened by the current crisis. Financial markets are demonstrably integated and are likely to become more so in the 21st century. Enormous amounts of short-term cash move at the tap of a computer key. The question is, therefore, raised as to just what it takes to prevent the spread of financial crises. How much cash? What kind(s) of response by the international community? Are current mechanisms adequate to do the job? Would the crisis have unfolded differently if the "New Arrangement to Borrow" (NAB) had been in place and activated?

"Moral Hazard"

A "moral hazard" is any action that encourages the very behavior that the action seeks to prevent. Broadly, the question is whether "bailouts" *per se* reduce or increase systemic risk. In terms of the current discussion, the moral hazard issue may conveniently be divided into two parts: that applied to countries and that applied to investors. With regard to countries, it is argued that governments engage in bad economic management precisely because they know that they will be bailed out. In the event, as the Mexican crisis of 1994-1995 demonstrated, countries are not spared the consequences of imprudent economic policies. The real economies of financially troubled countries and the people who inhabit them suffer the pain of a forced economic adjustment. The public policy issue here is whether that pain is to be somewhat mitigated by the provision of external financial support, especially because concerns arise regarding contagion and because broader foreign policy and security issues might well also arise, as they have with regard to both Mexico and Asia.

Many of the imprudent policies undertaken by governments occur in an electoral environment or result from long-standing institutional or cultural arrangements or out-moded developmental models. In these circumstances, outside suggestions that a different course might be "wiser" are not likely to be well-received until a crisis brings the point painfully home. Even after a crisis, "conditionality" attached to a financial rescue package may well be viewed as an infringement of sovereignty. A related policy question that arises here, thus, concerns how to put "teeth" in preventive measures, notably, surveillance, data dissemination, and transparency, which are discussed in somewhat more detail below.

Moral hazard also arises with regard to investors. Does the possibility of a bailout encourage private investors to take on risks that they might otherwise shun in an attempt to reap greater financial returns? At the time of the 1994 Mexican crisis, private investors were made whole as result of the bailout. This, in essence, let the

private sector retain gains, but distributed the losses to the public sector. Policymakers viewed this as an unfortunate by-product of a necessary policy action.

Many fear that the Mexican crisis set an undesirable precedent that is being reinforced by the current crisis, where it appears that some countries are "too big to fail." Additionally, it encouraged private investors to believe that similar support would be available in the event future crises. As long as the profits rolled in, investors, therefore, failed to undertake, or ignored, "hard-headed" internal analyses of what represented a prudent risk — a view strongly suggested by the yields on much emerging market debt prior to the current crisis. The policy question here is how to restore market incentives to prudent risk-taking. Some believe that the only way to do so is to stop providing bailouts to countries that get themselves in financial trouble — whatever the cost to the domestic or international economy. In short, that investors need to be aware or beware. From this perspective, the IMF would cease its role as lender-of-last resort. In a totally different view, some suggest that some form of capital controls, at least on an interim basis, might be appropriate. Finally, still others argue that national security, foreign policy risks, and the threat to the international trade and financial system outweigh concerns about moral hazard.

IMF "Conditionality"

The issue of "conditionality" arises only after a bailout is already in progress. Conditionality consists of the economic policy changes and the economic performance targets that are attached as conditions (hence the term "conditionality") for receiving IMF loans. It is probably safe to say that IMF conditionality has been an issue almost from its first loan and has become more controversial as the years have passed. This is, undoubtedly, due, at least in part, to the fact that the IMF's conditionality has become more comprehensive and more intrusive over the years. Much of this shift, in turn, may be attributable to a shift in the IMF's loan clientelle. Initially, under the Bretton Woods fixed-exchange-rate system, the IMF's loans were largely to the major industrial countries, including the United States. The remedy for a balance-of-payments or liquidity problem was then largely limited to macroeconomic policy changes, that is, changes in fiscal, monetary, and, sometimes, exchange rate policy. Structural reforms were limited to those directly related to macroeconomic policy, for example, tax reform.

Now, with the recent exception of South Korea, the IMF's loans are exclusively to developing countries and to the "transitional" economies of Eastern Europe and the former Soviet Union. At least since the announcement of the so-called "Baker Plan" in 1985, at the height of the Third World debt crisis, therefore, the solutions to external debt and liquidity problems have included structural (microeconomic) issues, as well as macroeconomic issues. This tendency to focus on microeconomic issues, along with the macroeconomic issues, has been considerably amplified by the need to assist the formerly Communist economies. Issues, such as privatization, trade, and financial liberalization, are now almost routinely a key part of IMF conditionality, with the IMF often operating to harmonize its recommendations to the requirements of other international bodies, such as the World Trade Organization (WTO) or the World Bank. Most recently, the IMF, like the World Bank, has broadened its

concerns to what is essentially a political issue, the issue of good governence, including corruption. While this makes good economic sense, it is also a major departure in terms of the nature of conditionality.

The U.S. Congress has played an active role in the evolution of IMF conditionality. Not infrequently it has instructed the U.S. Executive Director in the IMF to use the "voice and vote" of the United States to bring about specific changes in IMF policy, most especially including conditionality. Over the years, these instructions have included, for example, encouraging the formulation of adjustment programs that would foster sustained economic growth, not bailout banks, eliminate the adverse impact on the poor and on the environment, work toward the elimination of predatory agricultural practices, promote fair trade and the elimination of trade restrictions, increase productive participation of the poor in the economy, reduce military spending, and promote improvement in conditions for workers.

In the current crisis, the specific issue with regard to IMF conditionality is whether the programs for Thailand, Indonesia, and South Korea are too austere. The charge of too much austerity (or too little) in IMF programs, that they are "cookie cutter" programs, has been a recurrent charge for many years. What gives this charge resonance now is that, unlike Latin America in the 1980s, the Asian governments with which the IMF has recently negotiated programs cannot be accused of fiscal profligacy. According to the IMF's published numbers, Thailand had a projected public sector deficit of -1.6% of GDP (1997); Indonesia, a projected central government surplus of +1.2% of GDP (1996/1997); and South Korea, a central government deficit of -0.5% of GDP (1997).[9] In 1998, the IMF is asking that Thailand achieve a public sector surplus equal to +1.0 % of GDP; Indonesia, +0.8% (1997/1998) and +1.0% of GDP (1998/1999); and South Korea, +0.2% of GDP. These represent significant shifts in the fiscal balance of countries that have followed prudent policies.

In designing the economic programs for Asia, it appears that the IMF was concerned about staunching the financial outflow, inflationary pressures stemming from currency depreciation, the likely enormous costs of cleaning up severe structural problems in the financial systems of the borrowing countries, and the decline in tax revenues resulting from a slowdown in economic growth. As a result, it recommended fiscal and monetary tightening, including increased interest rates, tax increases, and budget cuts. Finally, the IMF maintains that its fundamental focus in Asia is on structural reform, particularly in the banking sector.

Critics, including the IMF's sister-institution,[10] the World Bank, which undoubtedly has the relevant IMF documents that provide detail on IMF conditionality, fear that the resulting slowdown in economic growth will significantly worsen the problem by forcing more companies into bankruptcy, further worsening bank balance sheets, and increasing unemployment. Since balance-sheet problems in both the corporate and the financial sectors have been politely overlooked for years

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[9] IMF Press Releases No. 97/37, No. 97/50, and No. 97/55.

[10] Davis, Bob and David Wessel. World Bank, IMF at Odds Over Asian Austerity. *Wall Street Journal*, January 8, 1998, p. A5, A6.

in these "crony-capitalist" societies, this is almost certainly an accurate assessment. The issue is whether the IMF's fiscal, in particular, and monetary targets will unduly aggrevate the problem, bringing about a debt-induced deflation, making it harder for these countries to restart economic growth. Oddly enough, prior to the leaking of the IMF's own confidential assessment, compared to the level of criticism toward IMF austerity, there had been relatively little public criticism of the IMF's requirement to close weak banks, an action that the IMF now acknowledges as having worsened Indonesia's difficulties.[11]

The Asian crisis has made the, often, sterile debate over IMF conditionality into a debate of historic significance with serious consequences. Whether the fiscal and monetary adjustments are too much or too little is likely to depend upon both the extent to which the policies are actually implemented and on market perceptions. One lies in the realm of politics; the other, in the realm of psychology. These are inherently somewhat unpredictable. Running macroeconomic models may be beside the point. Nevertheless, the IMF's competence and its credibility are being tested. The risks of a miscalculation are, after all, substantial. Ultimately, a vigorous debate on IMF conditionality in Asia is likely to result in better programs.

Economic reform is always a process, not an event. In particular, the fast flow of events in the early stages of a crisis is likely to work against well-designed programs. The speed with which market forces now move may simply outpace the relative slowness of the political process, with the result that governments everywhere and anywhere, inevitably, are likely to find it difficult to respond in a timely manner with appropriate policies. Initial conditionality is, therefore, certain to be altered; current programs are works-in-progress. Recommendations for a tight macroeconomic stance are already being eased.

Adjustment and finance are inversely related: the more finance that is available, the less the required economic adjustment; conversely, the less finance, the greater the required adjustment. Assumptions about the size of a particular financing package and, hence, the needed degree of economic adjustment, therefore, are tied to assumptions about the availability and structure of external finance, especially private finance. This includes, for example, an issue that has been particularly critical in the Asian crisis, namely, the rolling over of short-term loans, including trade credit. Market psychology, therefore, must be accurately gauged. Will investors hold or fold? This requires a very difficult assessment that rests in the realm of uncertainty rather than probability. It would appear certain that all concerned, including the IMF, misjudged market sentiment. Certainly, this is the inescapable conclusion with regard to South Korea, where an acceleration of the original "bailout" package was announced on December 24. Political factors appear to have played a key role in this failure.

In the end, the IMF has found, over the years, that those programs most likely to be successful are those that the country "owns," rather than those to which the country has reluctantly agreed. Ultimately, all liquidity crises are crises of confidence

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[11] For information on the IMF's report, see Sanger, David E. I.M.F. Now Admits Tactics in Indonesia Deepened the Crisis. *New York Times*, January 14, 1998, A1, D11.

that can only be reversed by implementing sound and credible economic policies. No amount of conditionality can compensate for a failure of political leadership. Countries are free to alter policies at any time — without IMF prodding — and work toward restoring market confidence on their own. Indeed, as one writer has suggested, conditionality is an attempt to make countries be wise in their own behalf, but, if countries were wise in their own behalf, there would be no need for conditionality.[12]

IMF Conditionality and U.S. Trade

Within the United States, there is a specific concern regarding the conditionality of current IMF programs in Asia and its potential impact on the U.S. trade deficit. To examine this, it is first important to note the relationship between capital flows and trade flows.

The balance-of-payments is a statistical statement that summarizes a country's transactions with the rest of the world during a given time period, usually one year. It is a form of double-entry bookkeeping whose balance is always "0." By mathematical definition, therefore, the two largest components of the balance-of-payments — the current account, which consists largely of the trade balance, and the capital account — are equal (with an allowance for errors and omissions). They are mirror images. For that reason, if a country has a surplus on its capital account, it will have a deficit on its current account and vice versa. Also, by mathematical definition, then, a large outflow of capital, such as is now occurring in Asia, will result in either the reduction of an existing current account deficit or the emergence of a current account surplus. This is brought about through changes in the exchange rate or in income levels. This adjustment in a country's external balance will occur as a consequence of the capital outflow, regardless of whether the government undertakes any policy changes, including (perhaps especially including) whether or not it agrees to an IMF program. Thus, as a direct result of the exodus of capital, Asian exports will increase and Asian imports will decrease. U.S. companies are certain to face greater competition both in the U.S. domestic market and abroad.

Beyond the autonomous shifts in external balances that are inevitable, the impact of the present IMF programs in Asia is likely to have several contradictory effects, reflecting both the fact of the program and trade-offs made in designing the program. These are likely to be as follows:

- As noted previously, finance and adjustment are inversely related. The financial support provided as part of the "bailout" packages, in and of itself, will lessen the severity of the external adjustment that has to occur in the wake of the capital outflows from Asia. In other words, the financially troubled countries of Asia will have to increase exports and decrease imports to a lesser extent than they otherwise would have had to in the absence of the financing provided by the IMF and others, including the United States.

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[12] The author believes that the original source of this thought was Leonard Silk, writing in the *New York Times*.

- IMF programs have tightened monetary policy with the intention that raising interest rates would induce investors, both foreign and domestic, to hold local currency assets. The IMF was also concerned about the inflationary effects of currency depreciation. To the extent that this strategy is successful — and, at present, it is not clear that the strategy is succeeding — it encourages capital inflows, reduces capital outflows, reduces pressures on the international value of the local currency, and reduces the degree of adjustment needed in the current account. This again implies a reduction in pressures to export and less constraint on imports.

- In addition to tightening monetary policy, the IMF has also asked for budget cuts to cover the costs of recapitalizing and restructuring the financial sector. This fiscal tightening will slow domestic economic growth, having an impact that moves counter to the those discussed immediately above. Specifically, slowed domestic growth is certain to increase the incentive for Asian producers to seek markets abroad aggressively. A reduction in demand by Asian consumers is also likely to reduce the import of foreign goods and services.

- IMF programs are also seeking financial liberalization and trade liberalization. Trade reforms are to be consistent with the rules of the World Trade Organization (WTO). Both are likely to result in increasingly open markets, leading to an inflow of both capital and goods. These changes will occur over the long-run, however, in contrast to the more immediate effects that have been discussed above.

Thus, it is perhaps accurate to say that the IMF is "working both sides of the street" on trade issues. The mere provision of money eases trade adjustments that must, by definition, follow a massive outflow on capital account. Indeed, this is one of the primary purposes of the IMF.[13] At the same time, in the short-term, this is likely to be offset, at least partially, by the fiscal and monetary austerity that most IMF programs, including those in Asia, involve. Long-term liberalization efforts, on the other hand, are likely to be much more positive. Above all, it is important to note the the size of the U.S. trade deficit, as opposed to its country composition, is a function of U.S. macroeconomic policies and capital flows.

[13] Art. I, sec. v and vi.

The IMF and "Good Governance:" The Corruption Issue

At their annual meetings in September 1996, the World Bank and the IMF adopted a declaration, the "Partnership for Sustainable Gowth." It identified the importance of good governance as an essential element in promoting economic growth, including "ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption." The IMF's involvement, through both its policy advice and it technical assistance, is limited specifically to economic aspects that are in the IMF's traditional purview and expertise. Thus, the IMF is concerned with:

- **institutional reforms** of the treasury, budget preparation and approval procedures, tax administration, accounting, and audit mechanism, central bank operations, and the official statistical function;

- **market reforms**, focusing primaily on the mechanisms of the exchange, trade, and price systems, and aspects of the financial system; and

- **regulatory and legal reforms**, including taxation and the tax code, banking sector laws and regulations, and the establishment of free and fair market entry (the commercial code).[14]

The key consideration for the IMF is whether poor governance would have "a significant current or potential impact on macroeconomic performance in the short and medium term, and on the ability of the government credibly to pursue policies aimed at external viability and sustainable growth."[15] In the case of corruption, the issue is to be raised if the macroeconomic implications are significant — even if they are not precisely measurable. Even when this threshold standard is not crossed, corruption may be addressed as part of the IMF's efforts to promote greater transparency and remove unnecessary regulations and opportunities for economic rent seeking. The IMF is not, however, an investigative agency.

The IMF is to address issues of governance in both its lending programs and in its routine annual review of members' economic policies and performance (Art. IV consultations.) With regard to its loan programs, issues of weak governance are to be addressed early. More importantly, IMF loans may be suspended or delayed on account of poor governance if the issue meets the test of having significant macroeconomic implications and puts the successful implementation of the program or the purpose for using IMF resources in doubt.

Based on press reports, this policy appears to have been applied just three times since its inception in 1997. The IMF suspended a loan to Cambodia for six months when revenues from logging concessions somehow did not show up in the budget.

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[14] IMF. *The Role of the IMF in Governance Issues — Guidance Note*. Electronic version.

[15] *Ibid*.

In Kenya, the IMF suspended a loan when court proceedings in a major scam involving fictious gold and diamond exports collapsed and the country's top customs official, who had a reputation for fighting corruption, was removed. The $220 million in funds for Kenya that were delayed have still not been disbursed and will be the subject of negotiation in February 1998. The IMF also persuaded Romania to cancel a $1 billion purchase of 96 Cobra attack helicopters from Bell Helicopter, a U.S. firm. The helicopters were intended to expedite Romania's entry into NATO, but would have worsened Romania's budget and its external debt position. All three of these countries are relatively small. The application of the corruption guidelines in Asia would present a much greater challenge for the IMF.

"Transparency" and "Asymmetry:" IMF Programs, Country Data, and Crisis Prevention

In addition to concerns about the substance of IMF policies, critics also charge that a lack of transparency regarding the details of the IMF's programs have made them difficult to evaluate, adding to market uncertainties about their likelihood of success, and, thus, delaying the return of capital that has fled the region. In recent years, the IMF, has, in fact, moved toward providing greater information about its programs to the general public. Press releases announcing IMF loans used to be not much more than a paragraph in length. Now they average about 2-3 pages and are available on the IMF's web site (http://www.imf.org.) This allows some assessment of the general thrust of IMF programs. Details, however, are not available from the IMF, making a thorough-going review by outside experts impossible.

Countries themselves are free to and often do release details of their programs, including letters-of-intent and memoranda-of-understanding that set out both policy changes and performance targets. IMF staff assessments of a country's adherence to its program are not made available by the IMF, but, as was recently the case with South Korea, are on rare occasions leaked, sometimes selectively, from somewhere in the member government. The yearly evaluation that the IMF makes of all its members, the so-called Article IV consultations, which were formerly unavailable, are now released, in an abbreviated and sanitized version, including on the IMF's web site, if, and only if, the member country gives the IMF permission to do so. Some of the reluctance to provide greater information, thus, can be traced as much to IMF members as to IMF staff. The issue is perhaps best viewed as a subset of the broader issue of transparency. The U.S. government has, as a matter of policy, pushed for greater transparency both within the IMF and elsewhere.

A much more serious problem is the relatively widespread failure of the IMF and others, including other international financial institutions, investors, banks, and credit-rating agencies, to foresee the likelihood of a crisis, such as the current crisis in Asia. Some of this may have been an unwillingness to see problems with the "Asian miracle" as long as profits continued to roll in. The failure to accurately evaluate the state of the Asian economies is more serious in the case of the IMF, the other international financial institutions, and the private credit agencies. The IMF's focus on macroeconomic performance may have caused it to overlook or underestimate

fundamental structural problems. A lack of transparency may again have been a contributing factor.

The failure of the Mexican government to release timely data on its international reserve holdings in the months immediately preceding its late 1994 crisis was considered a major factor in blinding investors to the potential for a crisis. This omission led to a move to require more timely data from countries borrowing in international capital markets, culminating in the IMF's "Special Data Dissemination Standard (SDDS) and the Dissemination Standards Bulletin Board (DSBB). The former are standards on the timely publication of economic and financial data. The SDDS is aimed at countries that have, or seek, access to international capital markets. Participation is voluntary. As of July 31, 1997, 42 countries or territories had subscribed to the standard. There is a transition period for full compliance that lasts until the end of 1998. The DSBB is the IMF's electronic bulletin board for the SDDR (http://dssbb.imf.org). Countries participating in the DSBB are encouraged to establish links (hyperlinks) to national sites for economic and financial data. Lastly, the IMF has established a general data dissemination system (GDDS), which is aimed at all IMF members and intended to be a "good-practices" standard for data systems and dissemination. All of these are in the very early stages.

Recent experience with South Korean data on short-term debt show that there is still substantial work to be done in the area of data accessability. Borrowing countries themselves may be "behind the curve" or, possibly, duplicitous about their financial data. Neither is unprecedented. Under these circumstances, program design is severely hampered and investors are either ill-informed or misinformed.

In the end, even first-rate data and an accurate economic assessment may not be sufficient to permit the IMF to prevent a crisis. Reportedly, both the IMF and the U.S. Treasury warned Mexico about the possible consequences of its economic policies in 1994. The IMF has little leverage with non-borrowing members, with whom it is limited to "jaw-boning." This problem — its "asymmetrical" treatment of borrowers and non-borrowers — has been recognized virtually since the establishment of the IMF. While there have been improvements in "surveillance," that is, oversight, of non-borrowers, the IMF has no preventative "teeth."

U.S. Budgetary Treatment in Brief[16]

Under current budgetary practice, U.S. quota contributions to the IMF:

- are considered an exchange of equal and offsetting financial assets,
- do not result in a **net** budgetary outlay,
- have no **net** effect on the budget deficit, but

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[16] For a detailed examination of the budgetary treatment of U.S. participation in the IMF, see U.S. Library of Congress. Congressional Research. *U.S. Budgetary Treatment of the International Monetary Fund*, by Patricia A. Wertman. CRS Report 96-279 E.

- require an appropriation, and
- have been provided for by an allowed adjustment to the budget's discretionary spending limits under Title X of P.L. 105-33, the "Balanced Budget Act of 1997."

Treatment of U.S. contributions to the IMF as an exchange of assets would normally mean that no appropriation is required. Congressional practice since 1980, however, has been to appropriate any funding intended for the IMF. This approach was decided upon in order to meet congressional concerns about "back-door" financing in an environment of rising budget deficits. The same budgetary treatment applies to the "New Arrangements to Borrow" (NAB).

Conclusions

The IMF is requesting a major increase of 45 percent of its quotas, or capital contributions, in the midst of massive financial crisis in Asia. This is not the first time that a quota increase has been requested at an historic moment. The 1983 increase occurred in the wake of the Latin American debt crisis; the 1992 increase, following the emergence of Eastern Europe and the break-up of the Soviet Union. While quota increases always trigger vigorous oversight by the U.S. Congress, those occurring in a crisis environment ensure controversy.

Perhaps the three most prominent issues are "moral hazard", "contagion," and "conditionality." Moral hazard suggests that bailouts, by distorting market signals, may increase the risk of the very behavior that they are meant to deter. Investors have not been forced to sustain losses. Instead, the costs have been moved into the public sector and, by extension, to taxpayers. A desire to punish investors and, perhaps, policymakers in the bailout recipient, is, however, pitted against concerns about economic growth; international trade; and political, foreign policy, and security interests. The integrated nature of financial markets, giving rise to contagion of financial difficulties between markets and economies, suggests that the United States is unlikely to be unscathed by the current crisis.

The IMF's competence and credibility are also on-the-line. By the time a country reaches the IMF, there are no easy choices, only trade-offs. Seldom, however, has the debate over IMF "conditionality" been so acrimonious. The very vigor of the current debate may reflect a somewhat greater degree of openness by the IMF regarding the design of its programs. In turn, it might also suggest that even greater transparency would lead both to more criticism from informed analysts and to better program design, in essence, greater accountability — an opportunity, not a risk.

The chief charge against IMF conditionality is that it is worsening the Asian crisis by imposing too much austerity on countries that were already in a strong macroeconomic position. In fact, IMF conditionality, particularly at the early stages of this rapidly moving and widespread crisis, is not "chiseled in stone." The fiscal and monetary austerity initially recommended in Asia, and so strongly opposed by IMF

critics, is already being eased somewhat. Economic reform is always a process, not an event. Above all, in the end, market confidence can only be restored by a political leadership that is willing and able to implement sound and credible economic policies — with or without support from the IMF. In essence, the crisis begins and ends at the top. This also implies that there will be other crises because some government somewhere will make a policy miscalculation.

IMF resources alone are never sufficient. They do, however, act as a catalyst to call forth other financing, particularly private financing. This is because IMF programs have generally been viewed as the international financial equivalent to the "Good Housekeeping Seal of Approval." By increasing the availability of external finance, the IMF mitigates the pain of a forced economic adjustment, easing the impact on economic growth and jobs, both domestically and internationally. This is, in fact, one of the major purposes of the IMF. The current crisis is seriously eroding IMF resources and liquidity. Its ability to undertake even routine lending in the future is diminishing.