IMF Briefing for Senate Republican Staffers

by Bert Ely

January 14, 1998

I -- Two basic premises regarding national economies:

- Countries, like businesses and individuals, are unlikely to get into financial difficulty if they follow sound, prudent economic and financial policies.
  - Economic success is not an accident -- it is the product of numerous sound public policies.
  - Financial crises in developed as well as developing countries are largely banking crises.
- Market-determined prices, including interest rates and currency exchange rates, constantly provide important information to all concerned, however painful or unpleasant that information might be.

II -- A basic principle regarding international financial assistance:

- International financial assistance should be provided only to those countries that have followed sound economic and financial policies.

III -- Sound economic and financial policies include the following:

- Legal contracts and property rights are enforced by an honest, independent judiciary.
- The financial markets set <u>all</u> interest rates without any central bank or other government guidance or decree.
- A floating exchange rate.
  - Fixed exchange rates, dirty floats, and currency boards distort or muffle important price information which in turn distort's the country's banking system and credit markets.
- A sound banking system and transparent, competitive credit markets.
  - Foreign-headquartered financial institutions are treated in the same manner as domestic financial institutions.

    - The domestic capital markets are open on a non-discriminatory basis to foreign investors.

    - The financial markets are sufficiently transparent to all investors.

    - Banks and financial markets are able to properly price credit without government distortions.

    - The government does not otherwise interfere in the credit allocation process; no crony capitalism.

    - The depositor protection process does not encourage <u>un</u>sound banking.

- Government deficits are financed in credit markets at market rates of interest and not with currency forced into circulation through the government bill-paying process.

    - To ensure that deficits are not financed with currency people do not want to hold, a government's currency should always be convertible into the government's interest-bearing debt at the market value of that debt.

- Minimal corruption.

IV -- The IMF, as now structured, is part of the problem, not part of the solution:

- The IMF lacks strong <u>ex</u> <u>ante</u> or before-the-fact membership standards. Therefore, its members can engage in unsound economic and financial policies with the confidence that if their policies backfire, they can obtain liquidity assistance or other aid from the IMF.

    - It is the lack of rigorously enforced <u>ex</u> <u>ante</u> standards which has created the IMF moral hazard that has become so evident in the aftermath of the Mexican bailout. In effect, the IMF provides to its members an unpriced safety net or liquidity guarantee that does not discourage unwise economic and financial policies.

- The IMF's moral hazard will grow as its financial resources and employee headcount grow.

V -- What should be done to rectify the IMF problem:

- Recognize that a large IMF that has to ride to the rescue frequently is an organization that has failed its mission.

    - After-the-fact fire-fighting, as is now occurring in Asia, is not a sign of success.

    - Success should be measured by how few IMF rescues there are, not how many.

- Recognize that because, quite properly, the IMF lacks an army, police force, and courts, it cannot rely upon the police power of the nation-state to enforce its will upon its members.

- The only practical way the IMF can enforce its will is through the power of exclusion.

    - Nation-states should be permitted to belong to the IMF only as long as they exhibit good behavior; that is, they are following sound economic and financial policies.

    - The IMF should be a club to which nations aspire to join, but countries should be admitted to the club only if they qualify. Presumably, international lenders would avoid lending in countries that do not belong to the IMF.

- Therefore, the IMF should set membership standards to which every member country must adhere at all times.

    - These standards are sound economic and financial policies, as summarized above in section III.

    - No country should automatically be entitled to membership in the IMF; no country should be exempt from expulsion.

    - The IMF should be barred from organizing or participating in the financial rescue of non-members.

VI -- A fundamental restructuring of the IMF should be attached as a condition of any future IMF funding authority that Congress enacts:

- Congress should use the IMF funding process to force an overdue restructuring and downsizing of the IMF, and specifically its employee headcount.

- A time limit should be put on any increase in the United States' contribution to the IMF.

VII -- Additional thoughts:

- The Asian financial mess is largely water-over-the dam.

- The public policy focus today should be on quickly reducing the IMF's moral hazard, thereby preventing future Asian-like situations.

- At this time, Korea is a special case, for national security reasons. However, Korea must go through the necessary restructuring and opening up of its financial system.

- Any country that reneges on a previous commitment to the IMF should be cut off from future funding and immediately be kicked out of the IMF, even if the country is as large as Indonesia.

- Japan is a disaster financially, but as the world's largest creditor nation, it should not need any IMF assistance.

    - It is unlikely that Japan will rectify its problems in the near future.

- The long-term objective should be the abolition of the IMF, but since that cannot be achieved overnight, the IMF should be restructured in the meantime.

Appended to this outline is a paper that I presented at the 1997 Cato Monetary Policy Conference, titled "**Market Forces: The Best Regulator of Global Capital Flows**," which describes the numerous public policy failures underlying all financial crises. The appendix of the paper describes twenty different sets of public policies that contribute to these crises.

Other articles and papers on monetary policy and banking structure issues are located on the Ely & Company website, **http://www.cais.com/ely**.