

**REFORM OF THE
INTERNATIONAL MONETARY FUND**

HEARING
BEFORE THE
SUBCOMMITTEE ON
INTERNATIONAL TRADE AND FINANCE
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED SIXTH CONGRESS
SECOND SESSION

ON

THE EXAMINATION OF THE FINDINGS OF THE INTERNATIONAL FINAN-
CIAL INSTITUTION ADVISORY COMMISSION REGARDING REFORM OF
THE INTERNATIONAL MONETARY FUND

APRIL 27, 2000

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The Commission's recommendations regarding the IMF's function and methods of assistance attempt to remedy these shortcomings. These measures would allow the Fund to play a valuable role in promoting the stability and prosperity of the global economy.

Finally, the Under Secretary made certain references to the role of the development banks and the Commission's recommendations. I understand this hearing wishes to focus on the IMF. However, if you have any questions regarding the development banks and the Under Secretary's comments, I would be happy to answer them.

Senator CRAPO. Thank you, Mr. Lerrick.

Mr. Hanke.

**OPENING STATEMENT OF STEVE H. HANKE
PROFESSOR OF APPLIED ECONOMICS
THE JOHNS HOPKINS UNIVERSITY**

Mr. HANKE. Thank you very much, Mr. Chairman and Members of the Subcommittee. I appreciate this opportunity to express my views concerning the findings of the International Financial Institution Advisory Commission, as they relate to the International Monetary Fund.

Let me begin by characterizing the Commission's report, as I read it. The findings are that the IMF has expanded its scope and scale in a very opportunistic way over time. It has engaged in misguided policies that have helped spawn currency crises and banking panics. These, of course, have led to a great deal of hardship in the client countries. I agree with the Commission's diagnosis, as I have characterized it.

As far as the recommendations go, I agree with the thrust of the recommendations. The thrust is to dramatically reduce the scope and scale of the IMF, to rein it in, if you will. In fact, the core function that you're left with in the Commission's report is to act as a short-term crisis management unit that is engaged in lender-of-last-resort or liquidity assistance on a short-term basis at a penalty rate if a client can put up good collateral.

Now, my point here is that the private market is perfectly willing to do this and the emerging-market countries are engaged in receiving credit. They are either tapping into credit lines or options on credit lines. Argentina and Mexico are two of the countries that have used the private market and wouldn't need this lender-of-last-resort facility. I believe, logically, and given the diagnosis of the Commission's own report, that the IMF should be shut down and it should be shut down entirely and permanently!

That leads to the question: Well, what kind of a world would we face with the IMF being completely shut down, rather than even having this shell of an activity recommended in the report, which the markets can perfectly take care of? I believe the core of the problem that we have to look at is what ultimately causes these banking and currency crises. The nub of the problem is central banking in emerging-market countries having a weak rule of law.

Central banking is something very new. In 1900, there were only 18 central banks in the world. In 1940, there were only 40 central banks in the world. We have had an explosion of central banking since World War II, largely at the encouragement of the IMF, of course, because this has meant jobs for the boys. After all, if you

set up a new central bank, you need lots of technical assistance and other things. This has been most unfortunate. I should indicate that now, we have 173 central banks operating.

I believe that we have to rein in the central banks if we are ultimately going to solve the problems created by crises that erupt in these emerging-market countries. It gets back to what Senator Bennett was saying about sound money. Monetary authorities or central banks can create base money. They can extend credit to the fiscal authorities to state-owned enterprises and anyone else they care to. We have to put a hard budget constraint on these central banks by, in effect, putting them out of business.

The easiest way to do this is to do something that Senator Mack has been championing. That is, to dollarize the emerging-market countries. If you dollarize an emerging-market country, you don't have a central bank, number one, and number two, you don't have an exchange rate. If you don't have an exchange rate, how can you have an exchange rate crisis? You eliminate that automatically. Orthodox currency boards, incidentally, would do roughly the same thing.

The second issue is you still have credit in the system. Although you do not have a central bank which can create base money, you do have fractional reserve commercial banking systems which can create bank money. In order to solve that problem, you should go to 100 percent-reserve banking so that any bank accepting deposits would have to have full 100-percent coverage for those liabilities.

The third issue, then, is if you can't extend base money credit and you don't have bank money credit, how do you get credit in the economy? You go back to the old setup of merchant banking and investment banking.

Much like a three-legged stool, the remedy rests firmly on three closely-linked reforms. That is what is required if you really want a sound money and banking system in emerging-market countries. That would eliminate any of the problems that we think we need the IMF and other international institutions to help us fix from time to time.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you very much, Mr. Hanke.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman. I have just one question that I would like to ask all of our panelists.

I don't see an inconsistency between Mr. Meltzer's proposal that we have a set of high financial standards that countries could meet and in the process be preapproved for IMF liquidity assistance, and having conditionality for loans on the people who had not met the very conditions that would become the conditionality for those that didn't meet the preconditions.

As I understand it, in listening to Mr. Meltzer, the things that he's talking about as part of the preconditions are the very things that any reasonable or rational policy would ask a country to do in return for getting the liquidity loan.

In reality, I view these loans as having two objectives. The first is to provide some liquidity assistance. The second is to provide both a prod and a shield for political leaders to do what they know