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# TIME TO TERMINATE THE ESF AND THE IMF

by Anna J. Schwartz

## Executive Summary

The International Monetary Fund and the U.S. Treasury Department's Exchange Stabilization Fund are undemocratic institutions unaccountable for their actions. Their current functions have little to do with their original missions. The ESF is used by the executive branch to circumvent Congress in the provision of foreign aid. Its foreign exchange interventions have, in any event, always been wasteful and ineffective at controlling the relative price of the U.S. dollar. The IMF has also been used to provide massive bailouts in the cases of Mexico in 1995 and of Asian countries since 1997. Defenders of the IMF as an international lender of last resort are misinformed since the IMF does not and cannot serve that purpose. Both institutions should be abolished, not reformed, because they are not needed to resolve currency crises and they preclude superior solutions.

*Anna J. Schwartz is a research associate at the National Bureau of Economic Research.*

## Introduction

The U.S. Treasury Department's Exchange Stabilization Fund (ESF) and the International Monetary Fund (IMF), which are administered by unelected officials, are not accountable for their actions in extending foreign aid with U.S. tax dollars. In a democratic society those two institutions should have no right to exist. Both the ESF and the IMF have increased their level of activity, performing functions that go beyond their original missions. The ESF has been relied on by the executive branch to provide bilateral aid to Mexico following its 1994 currency crisis and to offer loan commitments to Asian countries facing financial turmoil over the past year. Likewise, since 1995, the IMF has been providing massive bailout funds to Mexico, Asian countries, and Russia to deal with disturbances in currency, bond, and equity markets and banking problems. Yet the IMF is thoroughly unsuited to serve as an international lender of last resort. Both institutions should be terminated because both are wasteful and unnecessary for resolving currency crises.

## Why Should There Be an ESF?

The Gold Reserve Act of January 31, 1934, established the Exchange Stabilization Fund. The ESF began operations in April 1934 with an initial capitalization of $2 billion of the $2.8 billion paper profit that the U.S. government realized from devaluation, that is, from raising the price of gold to $35 an ounce from $20.67. Only $200 million of the $2 billion capitalization was actually made available to the ESF, and in 1945 the United States used the remaining $1.8 billion to pay part of its subscription to the International Monetary Fund.

The ESF was conceived to operate in secrecy "under the exclusive control of the Secretary of the Treasury, with the approval of the President, whose decisions shall be final and not subject to review by any other officer of the United States."[1] The 1934 act authorized the ESF to deal in gold and foreign exchange in order to stabilize the exchange value of the dollar. The secrecy arrangement was intended to cloak foreign exchange market intervention. It promoted two objectives. The first objective was to conceal from the public and Congress the exchange rates at which foreign currencies were bought and sold, particularly if they involved losses. A second objective was to permit the Treasury, if it so desired, to conceal information about any other operations the ESF might undertake. The U.S. Treasury itself reported one example of the ESF's use for purposes

other its mandate. During fiscal year 1980, "the administrative expenses for international programs, formerly funded by the Exchange Stabilization Fund, became a separate international affairs appropriation."[2]

A review of the ESF's exchange market intervention shows that it is a futile exercise to attempt to control the relative price of the U.S. dollar, and that the ESF wastes resources in that attempt.[3] Whether the dollar is deemed strong or weak, intervention does not deal with the fundamental economic conditions that underlie medium-term changes in the exchange value of the dollar. The supposedly grossly overvalued dollar in 1981-85, for example, did not deindustrialize the U.S. economy and usher in a service economy of low-income occupations. Similarly, concern that a weak dollar would induce domestic inflation has not been substantiated.

In addition to its statutory authority to engage in exchange market intervention, the ESF has granted itself a mandate to negotiate stabilization loans to favored countries--a mandate not found in the statute creating the ESF. Since its establishment, the ESF has lent dollars to low-income countries to stabilize their currencies, clearly a form of foreign aid. As Alfred Hayes, then president of the Federal Reserve Bank of New York, remarked at a December 5, 1961, Federal Open Market Committee meeting, "The Stabilization Fund has been used for a number of purposes, such as shoring up weaker countries--which is almost a State Department activity."[4] Congress in effect has ceded to the executive branch the power to extend foreign aid without prior congressional approval.

Selecting countries to which the ESF makes loans is obviously a political decision. From 1936 to 1961, 10 Latin American countries at one time or another had exchange stabilization loans. The countries in that group were Argentina, Bolivia, Brazil, Chile, Cuba, Ecuador, Mexico, Nicaragua, Paraguay, and Peru. Mexico had the longest record of agreements, the initial ones motivated by the disturbing effects on Mexico's silver-based monetary system by the U.S. Silver Purchase Act of June 19, 1934, which led to a trebling of the market price of silver between 1933 and 1935.

Many of the same countries that received stabilization loans before 1962 were again recipients in later years. There were some newcomers in Europe, Asia, and Africa, but the Latin American countries predominated. In the post-

World War II years, ESF loans were usually combined with loans from international or other U.S. agencies.

The country with the longest and most continuous record of ESF agreements is Mexico. In 1995 Mexico received the biggest loan the ESF has thus far granted, $12 billion. It was politically advantageous to have Mexico repay that loan in advance of the scheduled date. Mexico did so by borrowing longer term in Europe at higher interest rates than it paid on the ESF loans. Largely as a result, Mexico's current total public and total foreign debt exceeds its 1994 debt. The debt is in the form of long-term instead of short-term _tesobonos_ (Mexico's dollar-indexed bonds), but Mexico will be repaying its debt for many years to come. Intervention by the ESF and the IMF was not needed to achieve this transformation of Mexico's debt. In the absence of such intervention, Mexico and the investors who lent it money would have had no choice but to restructure the country's debt. Although the Treasury has proclaimed the Mexican bailout a great success, and much has been made of the resumption of high growth rates of output there, the level of real gross domestic product in 1997 barely surpassed its level in 1994.

The list of countries with stabilization loans raises doubts that the loans have resulted in stabilization. Repeatedly extending those loans has not helped those countries to achieve prolonged stabilization of their currencies. The message of the loan package appears to be that mismanaged countries have a friend in the ESF, which will arrange a rescue. Servicing and amortizing the loans seem to add to the borrowers' problems. Loans may be a fruitless policy for countries that have yet to develop an institutional framework that discourages imprudent borrowing of foreign currencies at short term.

Despite its record, the ESF's secrecy has enabled it to survive and expand. The act creating the ESF excluded it from the congressional appropriations process once its initial capitalization was in place. The ESF was intended to be self-financing and was not required to seek annual congressional funding for its operations. The self-financing arrangement contributed to the secrecy of ESF actions, because the fund did not have to justify its expenditures during annual appeals to Congress for appropriations. Modifications have been made regarding the secrecy in which the ESF was designed to operate, but no change has occurred in the status of the secretary of the treasury's decisions as final and not subject to review.

Congress has recently been disposed to require the president to disclose information about ESF transactions. The response of the Republican Congress to the president's authorization of the ESF offer of $20 billion in medium-term loans to Mexico, less any outstanding short-term loans and securities guarantees, in January 1995 was to pass the Mexican Debt Disclosure Act of April 5, 1995. Congress directed the administration to provide a broad range of documents, some of them classified, about the bailout, before Mexico could obtain more money from the ESF. For the first time, the ESF reported the interest rate on the loans to Mexico. A notable omission in the ESF's published reports on earlier stabilization loans was any reference to the interest rate charged, widely believed to be less than the market would charge. The provisions of the Mexican Disclosure Act, however, expired in November 1997.[5]

No challenge to the constitutionality of the ESF seems possible, since ordinary citizens have no standing. The ESF, designed originally as a creature of the executive branch and immune from legislative oversight, breaches the separation of powers. It is hard to believe that a fund with similar powers would win legislative approval today. In 1934, New Deal legislation by and large was initiated by the administration, and Congress rubber stamped what was put before it.

The secretary of the treasury has promised $1.7 billion, increased to $5 billion in December 1997, to South Korea as backup for an IMF loan; $3 billion for Indonesia; and $250 million for Thailand. Only the South Korean loan has been activated. The fundamental question regarding the ESF is why an institution should exist from which the unelected secretary of the treasury and his deputy can draw and lend, at their discretion, funds on the basis of scare scenarios. It is telling that U.S. bank exposure to the Southeast Asian countries in crisis is far lower than the exposure of Japanese and European banks. Yet we have not been subjected to a barrage of arguments from Japanese and European banks that the stability of the world will be undermined if we do not prop up the troubled Asian economies. One might be led to surmise that the ESF exists only for the self-glorification of U.S. officials who see themselves as saviors of the world. We do not need the ESF. The power to extend foreign aid should be restored to Congress.

**Why Should the IMF Exist?**

When the IMF was created by the Bretton Woods Conference in 1944, it had a well-defined purpose. It was to enforce the rules in a fixed exchange rate system about altering a country's exchange rate when fundamental adjustment was needed, as well as to provide temporary resources to deal with a country's balance-of-payments problems. With the collapse of the Bretton Woods system in 1971, the IMF lost its purpose. The switch to floating exchange rates eliminated its exchange-rate regulatory role and changed the character of balance-of-payments problems. Since the early 1970s, the IMF has been seeking to reinvent itself. Until the 1995 Mexican bailout, it had pretty much decided that it would promote its purpose as providing advice and information to its members, which number over 180 countries. That, however, proved to be only an interim stop on the road to acquiring a new identity.

The IMF's supplementation of the ESF's role in the 1995 Mexican bailout planted the idea that the IMF should serve as an international lender of last resort. Endowing the IMF with the function of an international lender of last resort has become a rallying cry for its supporters in the current drive to provide it with an emergency infusion of cash. The problem with this program is that its advocates have little understanding of the meaning of a lender of last resort.

Central banks have the capacity to serve as their banks' lenders of last resort. They can create high-powered base money (currency in circulation plus reserves), they can act quickly, and they can decisively stem a banking panic. The IMF lacks each of those features. It cannot create high-powered money. It can issue Special Drawing Rights (SDRs) to central banks that can monetize the SDRs in their national currencies. But the IMF cannot issue SDRs without authorization by its membership. It cannot act quickly. The decisions of its executive board are subject to the votes of executive directors who consult their national authorities. To provide money to a borrowing country, the IMF first engages in lengthy negotiations of a reform program. A national central bank can promptly provide liquidity to the money market without prior external approval. Moreover, a national lender of last resort rescues solvent banks temporarily short of liquidity. It does not rescue insolvent institutions. The IMF has no such inhibition.

The IMF reinvented itself again after the Mexican bailout in 1995. The lesson the IMF took from the bailout was that it needed a stockpile of money if it was to act as

a lender of last resort in the next financial crisis, given that it lacks the capacity to create high-powered money. In early 1997 the IMF announced a plan to raise cash to rescue a country in distress. It proposed to reach an agreement, known as the New Arrangements to Borrow (NAB), with two dozen countries to borrow from them as much as $28 billion for this purpose. By 1998 the line of credit from 25 official creditors, on which the IMF could draw, was increased to $47 billion. In addition, the IMF decided to increase the quota that each member contributes. For the United States, the total contribution to the NAB and the quota increase amounts to $18 billion. That amount is what the administration is now asking Congress to appropriate. Since mid-1997, the appeal to Congress to allocate funds to the IMF has been based on the plight of the Asian countries that have experienced large declines in stock market valuations and the exchange market valuations of their currencies that were pegged to the dollar.

Opponents of the funding increase for the IMF are found in and outside Congress. Outside observers note that the size of the bailout proposed for the Asian countries is a multiple of the Mexican bailout, $118 billion versus $30 billion, that the bailout indemnifies the foreign bank lenders who suffer little or no loss on their claims denominated in hard currencies, and that the bailout creates a moral hazard, encouraging lenders to repeat imprudent lending practices.[6] Short-term renewable loans denominated in foreign currencies were the undoing of Mexico in 1994; yet the Asian countries welcomed the same form of credits two years later, and the lenders came off scot-free in 1995 as the banks will probably in 1998, because of the IMF. A big pot of IMF money is clearly the wrong response, especially in today's world of deep capital markets that are ready to lend to liquidity-constrained countries at interest rates that reflect credit risk.

Within Congress the IMF faces two groups of opponents: liberals who seek labor and environmental reforms in the countries to which the IMF is prepared to lend as a quid pro quo for supporting the increase in funding, and conservatives who seek concessions related to abortion legislation, the ESF, or the way in which the IMF operates. Congress has been advised by one witness to accept the IMF funding increase only if the Asian countries adopt currency boards.[7] The congressional opponents of whatever stripe should not demand a quid pro quo but should reject the increase in IMF funding on principle.

Secrecy is a characteristic of the IMF as well as of the ESF. The IMF's dealings with its client states are not open. How does the IMF determine the size of its loan offers? It does not reveal that information. Some specific obligations that it imposes on the borrowers may be leaked to the media, but typically not the full text of the agreement. That text is often confidential, as are internal IMF records on policy recommendations, economic evaluations, and the IMF's own performance. Are the borrowers authorized to use IMF funds to pay the debts of private-sector companies? U.S. taxpayers assume the burden of their share of IMF loans without full knowledge of the fine points of the deal.[8]

The countries in Asia that are experiencing financial problems will either adopt measures to reform their banking systems, to eliminate political domination of credit allocation, and to earn restoration of their creditworthiness in international capital markets, or they will not. To do so requires political resolve, not the IMF. Not to do so means those countries will fail to grow out of their problems. The world financial system will not be undermined if the IMF does not bail out those countries. Low-income countries have gotten into trouble financially many times in the past two centuries. Investors who lost money in ventures in those countries were hurt, and the countries involved had setbacks. The world did not collapse. The boom in Mexican and South American mining shares on the London Stock Exchange in 1822-25, their collapse early in 1825, and the default by nine U.S. states in 1841-42 on their bonds held in Britain are a few examples of many other such past financial crises without fatal consequences worldwide.

The United States does not need the IMF to determine which countries it will extend foreign aid to, should it choose to do so. The power to make loans to foreign governments belongs to Congress. That power should not be shifted to the executive branch or to an international organization.

## Misinformed Defenses of the IMF

The Internet has been the site of recent exchanges between C. Fred Bergsten of the Institute for International Economics and Jeffrey Sachs of Harvard University on the performance of the IMF.[9] They agree on the importance of the basic purposes of the IMF and the urgency of its funding needs, premised on the belief that a renewed crisis would engulf other countries in Asia and spread well beyond it. They also agree on the need for fundamental reforms of the IMF. Sachs, in particular, assails its policies, while

Bergsten is more forgiving. They disagree on the timing of the reforms that the IMF should implement. Sachs insists that the reforms must be made before the IMF wins financial support from Congress. Bergsten wants to save the IMF from the intense assault launched by its opponents and to speed the adoption of the legislation before Congress.

The basic question neither answers is what evidence supports the notion that a crisis will spread from one country to another unless the IMF is there to check it. It is not contagion that makes countries vulnerable to a financial crisis. They are vulnerable because of their home-grown economic problems. The solution is not IMF loans but changing the incentives of financial institutions and the dominance of government intervention in credit allocation. In Asian countries financial institutions in the present environment are not prudent lenders.

Columbia University professor Charles Calomiris argues that the IMF does not qualify as a lender of last resort because it is not engaged in rescuing Asia from a financial panic. Far from protecting sound but illiquid banks, it is bailing out bankrupt ones. That action is contrary to the precepts of a lender of last resort whose mandate is to provide panic assistance to sound banks, not to lend to insolvent banks.[10]

University of California professor Bradford DeLong claims that the lesson of history is that we tried a private-sector solution that did not turn out well in 1873 without a domestic lender of last resort and in the 1930s without an international lender of last resort.[11] To counter the 1873 case, one can cite the failure of the Federal Reserve to act as a lender of last resort in 1930-33. The private-sector solution that was relied on to deal with financial panics from 1873 until 1907 would have been superior to the ineptness of the Federal Reserve in the Great Depression.[12] The private-sector solution before the founding of the Federal Reserve was the issue of clearing-house loan certificates by the private-sector clearing-houses.

The problem in the 1930s was not the absence of an international lender. DeLong cites the collapse of the Austrian Credit-Anstalt in 1931 to prove the need for an IMF lender of last resort. The Credit-Anstalt was Austria's largest deposit bank. Its financial condition worsened after 1929. In May 1931 the bank's losses for the preceding year, which wiped out its official capital, became known. The Credit-Anstalt was insolvent. No lender should have rescued it. If Austria had shut it, withdrawals would have

ended. Austria could then have negotiated a settlement with the bank's creditors. The Austrian government instead injected funds into the bank. Suspicion that its losses were greater than disclosed led to large withdrawals by domestic and foreign depositors. Capital flight followed as news of the bank's difficulties spread, hamstringing efforts to arrange foreign credits for Austria. Rather than abandon the gold parity of the schilling, Austria adopted exchange controls. By abandoning the gold standard after the Credit-Anstalt debacle, Britain helped herself. If the Federal Reserve was not ready to act as lender of last resort in the summer of 1931, the United States could also have abandoned the standard at that juncture and saved the country 18 further months of severe contraction. DeLong's contention that the policies of the 1930s were private-sector failures is questionable at best.

Finally, consider Massachusetts Institute of Technology professor Paul Krugman's brief for the "indispensable" IMF.[13] He trivializes the charge by opponents that IMF loans to troubled countries create a moral hazard. Krugman likens the safety net available to creditors to the moral hazard that the Federal Reserve creates by providing liquidity to solvent banks in financial panics because the incentive for depositors to monitor their banks is weakened. Krugman fails to recognize the difference between the term, object, and magnitude of the IMF's lending and the Federal Reserve's lender-of-last-resort operations. The Federal Reserve does not bail out the insolvent. Its assistance during a panic lasts weeks or a month. The amounts of Federal Reserve assistance are soon withdrawn. IMF loan assistance is available to insolvent institutions, and years may go by before the loan is repaid.

Krugman then trivializes a point advanced by former treasury secretaries George Shultz and William Simon and former Citicorp/Citibank chairman and CEO Walter Wriston.[14] They propose that the Asian financial problems be resolved by the private parties most involved, not the IMF. Krugman likens this proposal to the suggestion that banks and their depositors in a panic situation "work it out themselves," without the provision of liquidity by the Federal Reserve. The analogy is false. Whether the IMF is involved or not, the private parties most involved in international defaults are the only ones who can revise the original terms of a loan when the borrower cannot service it. That is what happened in the Latin American defaults in the 1980s, and is in process now. Korean banks have already renegotiated the terms of their foreign loans. Indonesia, until the political turmoil interfered, had begun the process. The borrow-

ers and creditors in the Asian country crises are not faced with liquidity problems. The problem is insolvency. At most, the IMF can provide a bridge loan. It cannot deal with the underlying insolvency problem. In the case of a domestic financial panic, the solution is for a lender of last resort to inject liquidity and to restore depositor confidence in the safety of funds in solvent banks. No loan contracts need to be rewritten.

Krugman sees the IMF as an international lender of last resort, perhaps flawed, but "all that we have, and it is a lot better than nothing at all." The IMF cannot be an international lender of last resort. Its services have only lately been promoted as qualifying it for that role. Essentially, its supporters have no solid economic evidence to back up their claims.

## Conclusion

The ESF and the IMF are secretive institutions that are being used for purposes other than those for which they were created. Mexican-style currency crises have provided an opportunity for the ESF and the IMF to expand their influence, yet the world needs neither institution to resolve those financial crises, and both funds preclude more effective market solutions. The scare scenarios that U.S. Treasury and IMF officials advance should not impress Congress. In the interest of a more stable and free international economy, the ESF and the IMF should be abolished, not reformed.

## Notes

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1. Gold Reserve Act of 1934, Public Law 73-87, sec. 10 (b).

2. U.S. Department of the Treasury, Annual Report of the Secretary of the Treasury on the State of the Finances, Fiscal Year 1980 (Washington: Government Printing Office, 1981), p. 105.

3. See Anna J. Schwartz, "From Obscurity to Notoriety: A Biography of the Exchange Stabilization Fund," Journal of Money, Credit and Banking, May 1997, pp. 135-53.

4. Minutes of Federal Open Market Committee Meeting, December 5, 1961, p. 74.

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5.  A bill to restrict the ESF to loans of only $250 million without congressional approval was introduced in the Senate in December 1997.

6.  See, for example, Lawrence B. Lindsey, "The Bad News about Bailouts," New York Times, January 6, 1998, p. A21; Rudi Dornbusch, "A Bailout Won't Do the Trick in Korea," Business Week, December 8, 1997, p. 26; and James Glassman, "Who Needs the IMF?" Washington Post, December 9, 1997, p. A25.

7.  Steve H. Hanke, Testimony before the House Committee on Banking and Financial Services, January 30, 1998.

8.  A bill introduced in the House of Representatives (H.R. 3331), the IMF Transparency and Efficiency Act of 1998, requires the IMF to divulge its secret workings.  At present there is no indication that the bill will be enacted.

9.  Jeffrey Sachs, Slate, at http://www.slate.com/Code/DDD/DDD.asp?IMSG=1&FILE=IMF& (version current on February 2, 1998); C. Fred Bergsten, Slate, at http://www.slate.com/Code/DDD/DDD.asp?file=IMF&iMsg=2 (version current on March 4, 1998); Jeffrey Sachs, Slate, at http://www.slate.com/Code/DDD/DDD.asp?file=IMF&iMsg=3 (version current on March 12, 1998); C. Fred Bergsten, Slate, at http://www.slate.com/Code/DDD/DDD.asp?file=IMF&iMsg=4 (version current on March 19, 1998).

10. Charles W. Calomiris, "The IMF's Imprudent Role as Lender of Last Resort," Cato Journal 17, no. 3 (Winter 1998): 275-94.

11. J. Bradford DeLong, "Crash and Learn," Washington Post, February 12, 1998, p. A23.

12. For a full discussion, see Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960 (Princeton, N.J.: Princeton University Press, 1963), pp. 407-19.

13. Paul Krugman, "The Indispensable IMF," New York Times, May 15, 1998.

14. George Shultz, William Simon, and Walter Wriston, "Who Needs the IMF?" Wall Street Journal, February 3, 1998.