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Lending Policies

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here this morning to present several key findings in two reports that we are releasing today. We prepared these reports to address the mandate in the Omnibus Appropriations Act for 1999 that we report on (1) the conditions the International Monetary Fund (IMF) negotiates with its borrower countries[1] and (2) the trade policies of borrower countries. One report[2] describes how the IMF establishes and monitors financial arrangements with borrower countries and assesses how this process was used for six borrower countries—Argentina, Brazil, Indonesia, Korea, Russia, and Uganda. While we describe the conditions for financial assistance to these countries, evaluating whether these were the appropriate policies was beyond the scope of our work. The second report[3] identifies the trade policies of four IMF borrowers—Brazil, Indonesia, Korea, and Thailand--and the likely effects of their policies on certain U.S. industry sectors. We will be reporting separately on the IMF's financial condition this September.

First, looking at how the IMF establishes and monitors conditions, we concluded that:

- The IMF has a process for establishing and monitoring financial arrangements with member countries and it generally followed the process for the six countries in our study. The process encompasses data collection and analysis as well as judgment by the IMF Executive Board and staff, and gives the IMF wide latitude in assessing a country's initial request for assistance, negotiating terms and conditions for that assistance, and determining the country's continued access to IMF resources. Under its charter, the IMF limits financial assistance to

[1] With the exception of some financing for low-income countries, the IMF does not loan funds to a country, per se. Rather, the country "purchases" the currency it needs from the IMF with an equivalent amount of its own currency and then later "repurchases" its own currency according to the terms applicable to the IMF financing policy. For the purposes of this statement, we will use the terms "disbursement" and "loan" to refer to "purchases," and "repayments" to refer to "repurchases." In this statement, we use the term "arrangement" to describe the broad concept of IMF's financial assistance to countries and the associated conditions that are intended to address the underlying causes of the countries' need for assistance. We use the term "program" to describe the conditions that are the policy changes and reforms as outlined in the documents the countries prepare in the context of their IMF financial assistance.

[2] International Monetary Fund: Approach Used to Establish and Monitor Conditions for Financial Assistance (GAO/GGD/NSIAD-99-168, June 22, 1999).

[3] International Monetary Fund: Trade Polices of IMF Borrowers (GAO/NSIAD/GGD-99-174, June 22, 1999).

members with a balance-of-payments need; the IMF has broadly interpreted this to encompass a wide range of financial difficulties.

- The IMF has continued to make disbursements to a country that had not met all conditions when it decided that the country was making satisfactory progress; this decision was based on the IMF's analysis of data on the country's progress and the IMF's judgment.
- When the IMF determined that the country's progress in meeting key conditions was insufficient, disbursements have been delayed, and have not resumed unless or until satisfactory progress was achieved, in the IMF's judgment.

Second, our report on the trade policies of IMF borrowers concluded that:

- IMF financial arrangements in four borrower countries that are important trading partners of the United States focus primarily on macroeconomic and structural reforms rather than trade reform because restrictive trade policies were not major causes of the countries' financial problems leading to the request for IMF assistance, according to the U.S. Treasury Department and the IMF. Nevertheless Brazil, Indonesia, and Korea have undertaken some trade liberalization within the context of their most recent IMF arrangements. According to the Treasury Department, Thailand's recent IMF financial arrangements have had no trade liberalization commitments because trade policies were not the root causes of its financial crisis, and also because Thailand's trade system was more open than the other three countries' systems.
- The large macroeconomic changes in these four borrower countries caused by their recent financial crises have probably been a more important source of changes in their trade than trade policies. This greatly complicates the task of measuring the impact of the trade policies on the United States. The countries' trade policies can distort trade in specific sectors, however, which could contribute to import surges.

Background

The IMF's first purpose is promoting international monetary cooperation. Its Articles of Agreement, as amended, provide that it may make its resources available to members experiencing balance-of-payments problems; this is to be done under "adequate safeguards." The IMF's approach to alleviating a country's balance-of-payments problems has two main components—financing and conditionality—that are intended to address both the immediate crisis as well as the underlying factors that contributed to the difficulties. Although financing is designed to help alleviate the short-term balance-of-payments crisis by providing a country with needed reserves, it may also support the longer term reform efforts by providing needed funding.

The access to and disbursement of IMF financial assistance are conditioned upon the adoption and pursuit of economic and structural policy measures the IMF and recipient countries negotiate. This IMF "conditionality" aims to alleviate the underlying economic difficulty that led to the country's balance-of-payments problem and ensure repayment to the IMF. As the reasons for and magnitude of countries' balance-of-payments problems have expanded (due, in part, to the growing importance of external financing and changes in the international monetary system since the 1970s), conditionality has also expanded. According to the IMF, conditionality has moved beyond the traditional focus of reducing aggregate demand, which was appropriate for relieving temporary balance-of-payments difficulties, typically in industrial economies. Structural policies—such as reducing the role of government in the economy and opening the economy to outside competition—that take longer to implement and are aimed at increasing the capacity for economic growth—became an important part of conditionality. More recently, the financial crises in Mexico (1994-95) and in Asia and Russia (1997-99) have resulted in an increased focus on strengthening countries' financial sectors and the gradual opening of their economies to international capital flows.

Approach Used To Establish And Monitor Financial Arrangements

Over time, the IMF has developed a broad framework for establishing and monitoring financial assistance arrangements that is applied on a case-by-case basis considering each country's circumstances. This process, based on the IMF's analysis of country data and projections of future economic performance, gives the IMF wide latitude in establishing an actual or potential balance-of-payments need, the amount and timing of resource disbursements, and the conditions for disbursements; and in monitoring and, in some cases, modifying the arrangements.

Its Process for Establishing and Monitoring Programs Gives IMF Latitude

Under its Articles of Agreement, as amended, the IMF provides financial assistance only to those countries with a balance-of-payments need. Under these Articles, the IMF primarily considers actual or potential difficulties in either the country's balance of payments or its reserve position to be a basis for providing financial assistance. This framework has provided the IMF with wide latitude to consider countries' individual circumstances and changes in the international monetary system in its financial assistance decisions.

The specific conditions that the IMF and the country authorities negotiate are intended to address the immediate and underlying problems that contributed to the country's balance-of-payments difficulty, while ensuring repayment to the IMF. These conditions are intended to be clear indicators of a country's progress toward the overall program goals, such as strengthening the country's balance of payments or reducing inflation. These conditions can include a variety of changes in a country's fiscal, monetary, or structural policies. Fiscal policy conditions may call for countries to reduce budget deficits; Brazil's program, for instance, called for limits on public sector debt. Monetary policy conditions seek to, among other things, rebuild international reserves to promote financial stability; Uganda's program set a minimum level for its net international reserves. Changes in structural policies may include revisions to financial market regulation or tax policies; Korea's program called for restructuring its financial supervisory system. Political constraints and economic uncertainty can make these negotiations sensitive and difficult. After a country fulfills any early IMF requirements, known as "prior actions," and the IMF Executive Board approves the financial arrangement, the program is to take effect and the country is eligible to receive its first disbursement of funds.

Korea and Argentina exemplify the differences that can exist between countries' financial arrangements with the IMF. Korea's program provided substantial funding at the earliest stage of the program to counter an ongoing balance-of-payments crisis in late 1997 resulting from substantial losses in Korea's foreign currency reserves and the depreciation of the won, Korea's currency. The country faced balance-of-payments problems primarily due to significant capital outflows. Korean banks had a large amount of short-term external debt that needed frequent refinancing. As market confidence fell, the willingness of external creditors to "roll over" or refinance these loans declined rapidly. The government's attempt to support the exchange rate rapidly depleted official reserves of foreign currencies. The main goals for the program's monetary policy were to limit the depreciation of the won and contain inflation.

In contrast, Argentina's 1998 program was designed as a precaution against a potential balance-of-payments problem that could result from external economic shocks. Although Argentina enjoyed good access to capital markets and had employed a strategy to lengthen the maturity of its debt and borrow when interest rates were low, it faced an uncertain future due to deteriorating conditions in the international financial environment and the effect this likely would have on its future access to capital markets. Argentina agreed to access IMF resources only if external conditions made access necessary. The program was principally concerned with maintaining fiscal discipline and enacting labor market and tax reforms that were intended to maintain investor confidence and strengthen the economy's competitiveness.

The process of monitoring a country's progress toward overall program goals and compliance with program conditions involves both the borrower country and the IMF. The approach is designed to incorporate data on a country's economic performance as well as the judgment of the IMF Executive Board and staff. IMF staff reviews a member's economic performance and implementation of policy changes that were negotiated as conditions of the financial assistance. The staff then reports to the Executive Board at regularly scheduled intervals for each assistance program. In situations where conditions have not been met, the staff formally or informally advises the Executive Board. The staff may recommend that the Board grant a waiver for the nonobservance of the unmet conditions. Typically waivers can be recommended if the nonobservance is minor and program implementation is otherwise "on track." If there is no waiver, additional financial assistance is not to be made available to the country and the program is effectively suspended until there is an agreement between the IMF and the country that is approved by the IMF Executive Board. This agreement may mandate policy changes before any further assistance is granted and change the conditions for future assistance.

The IMF Has Disbursed Funds on the Basis of Sufficient Overall Progress

In monitoring compliance, IMF missions to each country documented a country's progress in satisfying conditions. In some cases, the IMF determined the countries had made sufficient overall progress in meeting program conditions so that additional funds could be made available, even when the countries had not satisfied some key conditions.

For example, in response to the Argentine government's request, the IMF staff recommended, and the Executive Board approved, a waiver on the basis of the IMF's judgment that there was sufficient overall progress in implementing the program and that the deviation from meeting the required condition was minor. In March 1999, the IMF Board approved a waiver when Argentina's fiscal deficit (1.1 percent of gross domestic product) slightly exceeded its target of 1 percent. Access to funding was not delayed.

Similarly, in April 1998, the IMF Board approved a waiver when the Ugandan government experienced a temporary shortfall in its checking account balances, causing it to miss a required condition. According to the IMF staff, this shortfall happened because the government made payments sooner than expected. The staff viewed this as a minor, technical issue and recommended the waiver.

The IMF and borrower countries may also negotiate changes in conditions to respond to unanticipated developments. For example:

- The IMF and Korea revised Korea's program several times during its first 2 months. The IMF acknowledged that the initial program was "overly optimistic" as economic conditions worsened; Korea continued to have access to financial assistance during these renegotiations.
- Brazil's program was modified due to adverse events. The maintenance of the exchange rate regime was an objective of Brazil's IMF program. Brazil turned to the IMF for assistance in September 1998, when its currency came under pressure as a result of the Russian crisis, and it experienced a significant loss of reserves. This reserve loss decelerated after the negotiations began; but, according to Brazilian officials, Brazil's currency came under additional pressure after its IMF program had started. The reasons for this included the defeat in Brazil's congress of two tax measures deemed crucial to the fiscal adjustment program and the reluctance of a number of Brazilian state governors to fulfill their financial obligations to the government. To try to stem the additional loss of reserves, the Brazilian government found it necessary to devalue and then float the currency. The IMF program was then revised to reflect the new economic situation and currency regime.

Disbursements Have Been Delayed Until Satisfactory Progress Occurred

In some cases, the IMF determined that the countries had not made sufficient overall progress in meeting program conditions. In these cases, no additional funds were made available until, in the IMF's judgment, satisfactory progress had been achieved.

The IMF delayed disbursements to Indonesia at various points during its current program until the IMF determined that the country had made sufficient overall progress in meeting the program requirements. For example, the IMF delayed Indonesia's disbursements from mid-March 1998 to early in May 1998 due to the IMF staff's determination that Indonesia had made insufficient progress in carrying out its program. The first review was completed in May 1998. Indonesia met none of the required conditions addressing macroeconomic components of the program and one of the key conditions for structural economic changes. IMF staff recommended that the Board grant Indonesia's request for waivers of these conditions on the basis of actions taken by the government. (For example, the government had established a new comprehensive bank-restructuring program in January 1998 to be implemented by a new agency, the Indonesian Bank Restructuring Agency.) Following the Board's approval, Indonesia received its next disbursement. At this time, the IMF moved from quarterly to monthly reviews of Indonesia's program. Disbursements were also delayed in the process of completing several subsequent reviews.

The IMF faced continued problems in Russia's implementation of its IMF program. Over time, the IMF delayed disbursements and program approval, reduced the amount of the disbursement, and ultimately suspended the program. According to the IMF, it delayed disbursements because of Russia's poor tax collections, reflecting a lack of government resolve to collect taxes. However, throughout Russia's program the IMF staff expressed the view that Russia's key senior authorities were committed to the program and should be supported; therefore, the IMF Board continued to approve disbursements. Events in 1998 particularly illustrate this. The delayed approval of the 1998 program, due to cabinet changes and difficulty in meeting the revenue package, meant that Russia received no funds between January and June 1998. The program was finally approved in June 1998, on the basis of implementation of prior actions. In July 1998, the IMF approved additional funds to Russia but reduced the amount of the disbursement from $5.6 billion to $4.8 billion due to delays in getting two measures passed in the Duma. The IMF was scheduled to release the next disbursement in September 1998, but Russia had deviated so far from the program that the IMF made no further disbursements. In March 1999, Russia requested that the program be terminated. In April 1999, the IMF and Russia announced they had reached agreement on a new arrangement. To date, the IMF Board has not approved the new arrangement.

Trade Policies of IMF Borrowers

Although all borrowers restrict trade to some extent, only a few of the 98 current IMF borrowers are traders large enough to affect the U.S. economy. Trade policies were not the major focus of IMF conditions for structural reform in the four borrowers we studied that are important U.S. trade partners. The IMF did seek to promote trade liberalization in these countries, however, and Brazil, Indonesia, and Korea undertook some actions to liberalize their trade regimes. Also, although U.S. imports from some of these countries have grown in some sectors, the effect of trade policy changes on U.S. imports has probably been of lesser magnitude than the effect of the substantial macroeconomic changes that these countries experienced.

IMF Conditions Did Not Focus on Trade Policies of Brazil, Indonesia, Korea, And Thailand

In its programs with four important U.S. trade partners, the IMF focused primarily on macroeconomic and structural reforms other than trade reforms. As we noted earlier, the IMF seeks to address the immediate and underlying problems that contributed to a country's balance-of-payments problem; restrictive trade policies were not major factors contributing to the countries' needs for IMF assistance.

Nevertheless, the IMF sought to promote trade liberalization in the countries, as it deemed appropriate. Part of the IMF's mission, as embodied in its Articles of Agreement, is to facilitate the expansion and balanced growth of world trade. As such, countries that have borrowed from the IMF sometimes have liberalized their trade systems within the context of their financial arrangements. Borrowers have eliminated or reduced tariffs or nontariff barriers to imports[4] and have ended or altered export policies, such as subsidies and export restrictions.

Brazil, Indonesia, and Korea have undertaken some trade liberalization within the context of their recent IMF financial arrangements. Nevertheless, their overall conditionality has focused primarily on macroeconomic and structural reforms other than trade reform because restrictive trade policies per se were not major causes of their balance-of-payments difficulties, according to the Treasury Department and the IMF. Reflecting this, only one of the trade liberalization measures taken was a required condition—the requirement that Indonesia reduce export taxes on logs and sawn timber. Further, although some of the import and export policies to be eliminated or modified under their IMF arrangements have been of concern to the United States and other countries, the stated purpose of these measures is not to benefit the three countries' trading partners. Rather, the purpose is to help resolve the countries' balance-of-payments problems and address the underlying causes of these problems by promoting greater efficiency in their economic systems.

Korea has eliminated four export subsidies, reduced some import barriers, and made improvements to the transparency of its subsidy programs. Indonesia has made many changes to its trade policies in the context of its IMF financial arrangements, including reducing or eliminating some import tariffs and export restrictions. Indonesia has committed to phase out most remaining nontariff import barriers and export restrictions by the time its IMF program ends in the year 2000. Brazil has committed to limit the scope

[4] Nontariff import barriers include quantitative restrictions, state trade monopolies, restrictive foreign exchange practices that affect a country's trade system, and quality controls and customs procedures that act as trade restrictions.

of its interest equalization export subsidy program to capital goods and has suspended for 1999 a tax rebate given to exporters. Further, according to the IMF, Brazil has kept its pledge not to impose any new trade restrictions that hinder regional integration, are inconsistent with the World Trade Organization, or that are for balance-of-payments purposes.

Some U.S. Imports From the Four Countries Have Increased Markedly in the Past Year, but Impact Is Difficult to Measure

The large macroeconomic changes in these four countries caused by their recent financial crises greatly complicate predicting and measuring the trade policies' impact on the United States. Our analysis of 1997-98 trade data reveals that overall U.S. imports from Brazil, Indonesia, Korea, and Thailand rose moderately in 1998. However, there have been substantial increases in U.S. imports from these countries in certain sectors. For example, imports of one category of flat-rolled steel from Korea rose by 36 percent to $355.8 million, and paper and paperboard imports from Indonesia were up by 284 percent to $40.8 million. Under U.S. law, there are procedures to investigate and remedy situations, such as steel import surges, where U.S. industry believes rising imports are attributable to foreign government policy and harm its economic interests.

In some sectors, rising imports may be due to other factors besides government policies. For example, market factors, such as increasing U.S. coffee consumption and the need for more natural rubber for the larger tires being used in U.S. motor vehicles, may be the reason for some of the import surges. Also, chemical imports are causing price pressures on U.S. producers in the United States, but the import increases are partly due to depressed demand within Asia that has led to increased shipments to the United States.

Mr. Chairman, this concludes our statement this morning. My colleagues and I would be pleased to answer any questions you or members of the subcommittee may have.

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