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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Committee on Foreign Relations

United States Senate

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Mr. Chairman, I appreciate the opportunity to appear before the Committee on behalf of the Federal Reserve Board in support of the legislation, S. 2271, currently before Congress to approve a 50 percent increase in the U.S. quota in the International Monetary Fund. Prompt passage of this legislation is in the interest of the United States and will help to maintain a smoothly functioning international financial system. Failure to act promptly would weaken both substantively and symbolically U.S. leadership in the international community.

An increase in the resources available to the IMF at this time is essential if the Fund is to continue to play a central role in dealing with the unprecedented scale of payments imbalances that its members are facing. The United States, with more than a fifth of the total quotas in the Fund, is the largest member of the IMF, and the Fund cannot continue to function effectively without commensurate U.S. participation in its financial operations.

The IMF is a broadly based international financial institution, including industrial and developing countries, oil-exporting and oil-importing countries, and even several centrally-planned economies in its membership. Its importance in facilitating the efficient functioning

of the international monetary system is growing. It has been assigned major new functions and responsibilities in recent years, including expanded surveillance of economic policies and exchange-rate practices of its members under the second amendment of the IMF Articles of Agreement. An IMF substitution account is currently under active consideration and negotiation; this would add further to the responsibilities of the Fund. The U.S. Government has been in the forefront in broadening the responsibilities of the Fund, and concrete support in the form of Congressional approval of the quota increase would position the Fund to handle an expanded role with a stronger financial position and with enhanced authority.

Active U.S. participation in the IMF is in the U.S. national interest. The United States benefits directly from a financially strong IMF because it may want to draw on the Fund in the future, as it did in 1978 as part of the November 1 package of anti-inflation actions. In an environment of increased international financial strains and increased sensitivity of the U.S. economy to developments abroad, the United States also benefits indirectly from the IMF's efforts to alleviate such strains. In many instances, without temporary financial assistance from the IMF, countries would be forced to take severe adjustment actions that could have a disruptive effect on the international economy.

With the introduction of new IMF facilities and changes in its operating procedures in recent years, potential access by members to the Fund's general resources has increased considerably and appropriately. More significantly, however, in view of the adverse impact of the higher oil prices on the external positions of many countries, the need for short-term balance-of-payments financing in coming years may well increase dramatically. The IMF should be in a position to meet substantially increased calls on its resources, and the proposed increase in IMF quotas would broaden the financial base of the Fund and help it to do so.

The Fund's resources have experienced a considerable erosion in relation to the growth of the world economy over the past 10-15 years. By 1977, when the most recent quota review began, total quotas in the Fund, for example, had declined to about 4 percent of the value of world imports compared with more than twice that proportion in the 1960's. Developments since 1977, especially the increase in countries' oil import bills and the general effect of inflation on the value of imports, have reduced the ratio of IMF quotas to world imports even further. Since an additional increase in IMF quotas is not now planned for another five years, the proposed 50 percent increase in quotas barely would maintain the current size of the Fund's resources in relation to the expected growth of world trade in the period ahead.

Because of recent disturbances to the international economy that had not been anticipated at the time the quota increase was negotiated in

1978, the proposed increase is a minimum step toward meeting the enlarged prospective financing needs of the IMF and its members. The world economy once again is confronted with the problem of dealing with the financial consequences of a huge OPEC current-account surplus and the accumulation of vast reserves by OPEC members, together with magnified current-account deficits for most oil-consuming countries. In a speech earlier this month, Chairman Volcker focussed on the implications of those financial flows -- often called the recycling process. He expressed the hope that the IMF would play a major role in the recycling process that lies ahead. With your permission, I would like to submit a copy of these remarks for the record. The observations on the recycling process should help to place the role of the IMF in the current situation in a somewhat broader perspective.

The strengthening of the financial position of the Fund resulting from the increase in Fund quotas is an essential element in preparing for the strains that may well develop on the international financial system in the next year or two. The role of the Fund under the current circumstances will not only be important because of its financial resources, but also because through the good offices of the IMF there is a better chance to achieve a better mix between adjustment and financing of the huge external imbalances the world economy faces.

Higher IMF quotas do not mean a reckless increase in liquidity that will be frittered away. Resources provided by the IMF typically have

been used constructively, and IMF members have an excellent repayment record. An encouraging development in recent years has been the increase in the number of countries adopting stabilization programs as part of stand-by credit arrangements with the Fund. Among developed countries, Great Britain and Italy benefitted from IMF-assisted stabilization programs in recent years, and an increasing number of developing countries can point to the successful turnaround of their economies in large part because of the stabilization programs that they implemented in conjunction with a stand-by arrangement with the Fund. At present, some 24 countries are covered by IMF credit arrangements that are conditioned upon their adherence to policy performance criteria. The Fund's leverage in continuing to encourage its members to introduce necessary adjustment actions in conjunction with drawings on IMF credit facilities will be heavily dependent on the Fund's possessing sufficient resources to continue providing such credits.

In recent years, the International Monetary Fund has been viewed by some as an aid institution offering long-term development loans. This is a mistaken view: the IMF is designed to provide short-term balance-of-payments financing assistance to all its members, developed countries as well as developing countries. When the Fund provides financial assistance, it must have a reasonable assurance that the associated adjustment programs will be successful in assuring repayment

and in enabling the IMF to maintain the "revolving fund" nature of its operations. Conditionality associated with drawings on the Fund that often are large in relation to a member's quota, therefore, are appropriate and necessary.

The IMF, however, has come under increased criticism by some who claim that it has been too harsh in its policy advice. It is true that IMF-sponsored stabilization programs often require substantial economic retrenchment by borrowing countries, involving at times political and social costs for such countries. Restrictive adjustment measures in most instances, however, are necessary in order to correct the underlying imbalances that have led to the need for balance-of-payments assistance in the first place. The need for such corrections does not come from the actions of the Fund, but rather from those actions inside and outside the country that bring about the unsustainable external deficits. Some of the difficulties associated with such stabilization programs could be eased if resort to the Fund came earlier, before the situation has worsened to the point where drastic action is required. However, in order to encourage members to come to the IMF, the Fund's resources must be ample, and the terms of conditional credits must be otherwise attractive.

Although the IMF will be expected to assume an expanded role in the recycling process ahead, the actual amount of resources provided by the IMF will remain small in relation to total financial needs. Inter-

national credit markets, and especially credits from private commercial banks, have played an important role in recent years in channelling funds from countries in surplus to countries in deficit. We have every reason to expect that these markets will continue to play a major role in providing credits to finance external deficits in the period ahead. At the same time, the IMF should play a strategic role in helping create the economic conditions in borrowing countries to attract private capital flows and maintain access to credits from banks.

One potential danger in the recycling process that must be avoided, however, is the overloading of the commercial banking system. Ratios of loans to developing countries to banks' capital or assets of U.S. banks have declined slightly over the past two years. For foreign banks, loan ratios have risen, but based on the latest available information they remain lower than for U.S. banks. Thus, in the aggregate, it would appear that there remains some leeway for prudent increases in loans to developing countries by U.S. and foreign banks without raising their exposure ratios to excessive levels, particularly since the capital and assets of banks also would be expected to increase. The capacity and willingness of the banking system to provide additional financing to developing countries, however, will vary greatly from bank to bank and will continue to depend on the condition of individual borrowers and the terms of the loans. Emerging problems seem likely, as in the past,

to remain limited to a small number of countries. In response to increased risks, lending spreads may well widen and maturities may shorten.

Given the expected increased demands for balance-of-payments financing, as well as the large external indebtedness that many countries already have with commercial banks, the IMF should be in a position to meet a larger proportion of the immediate financing needs of its members in the coming years than it has assumed recently. A strengthening of the Fund's financial position by the increase in members' quotas would increase the likelihood that more countries would come under the Fund's conditional-lending umbrella. Such a development, in turn, would promote greater complementarity between IMF financing, other official financing, and private bank lending to such countries. At the same time, the increased capacity of the Fund to finance payments imbalances of its members does not in any way relieve public and private borrowers and lenders from their responsibilities -- on the one hand for servicing outstanding loans and on the other for care and informed judgment in deciding on new commitments.

It would be desirable that when authorities in borrowing countries see trouble ahead that they consult with the IMF promptly to develop a program that will maintain their creditworthiness. It also would be helpful if commercial banks, when they recognize that a liquidity

problem is developing in one of the countries borrowing from them, would urge the country to seek the advice of the Fund, as well as the Fund's assistance in working out a smooth transition to a more viable rate of external financing. The constructive role of the IMF also could be reinforced if commercial banks were to structure their lending policies so as to support the Fund's role in the adjustment process.

In sum, in light of the serious problems that the international economy is facing, it is essential that we equip ourselves adequately to meet the challenges ahead. We will have to work on a number of fronts simultaneously, particularly pursuing sound macro-economic policies that succeed in curbing inflationary pressures, adopting effective energy policies, improving international cooperation and consultations, and strengthening international institutions such as the International Monetary Fund.

At this time, about 29 percent of the IMF membership, with nearly a quarter of the total quotas in the Fund, already has given parliamentary approval to the increase in IMF quotas from about SDR 39 billion (about \$50 billion) to about SDR 58 billion (about \$75 billion). For the proposed increase in quotas to take effect, members with three fourths of the Fund quotas must give their approval by November 1, 1980. Without U.S. participation, therefore, there is little likelihood that the quota increase could be implemented. Prompt approval by Congress of the

legislation increasing the U.S. quota in the IMF would spur other countries to consent to increases in their quotas. An increase in the U.S. quota from SDR 8.4 billion (about \$10.9 billion) to SDR 12.6 billion (about \$16.3 billion) would reaffirm the U.S. commitment to an open international financial system and to the key role of the International Monetary Fund in fostering the smooth operation of that system. In view of the important attention that is being directed at reducing the size of the United States budget deficit, I would add that under the alternative budgetary treatment approaches that the Treasury currently is discussing with interested Congressional committees, U.S. payments on its quota subscription would not affect net budgetary outlays or, therefore, the Federal budget deficit.

Enlarging the financial capacity of the Fund at this time by putting in place the proposed increase in IMF quotas will strengthen the Fund's influence in promoting over time balance-of-payments adjustments by those members that are facing increased external financial difficulties. Access to ample Fund resources and associated financing by developing countries, in particular, should help these countries to avoid having to make large and abrupt reductions in their growth rates and imports. If these countries are compelled to cut imports sharply, the United States and other industrial countries will feel the economic effects. Moreover, financing by the IMF would reduce temptations by countries to adopt

protectionist measures to deal with their external payments problems, a step that would be contrary to their own longer-term best interests and to the interests of their trading partners, including the United States.

The proposed IMF quota increase, thus, will benefit both the United States and the international financial system. The Federal Reserve Board, therefore, urges prompt approval by Congress of the legislation increasing the U.S. quota in the International Monetary Fund.