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Conclusions and Recommendations

The stakes for economic prosperity, liberalization, and the international economic institutions arising from the global financial crisis are profound. The United States, other leading countries, and the international financial institutions are searching for solutions to the present crisis and mechanisms to prevent and contain future crises. Secretary Rubin has advocated designing a new international financial architecture that could lend greater stability to the international system. The ESF has been an important part of the financial architecture in the past and will remain critical in any new pattern of arrangements. Political disagreement within the United States over the role of the ESF, among other institutions and policies, weakens US influence over system reform.

This chapter summarizes the particularly important findings from the historical review and the analytical and financial sections in the preceding chapters. It then offers a set of recommendations on the Treasury's management and congressional oversight of the ESF.

Findings

First, the ESF has been at the disposal of the Secretary of the Treasury since its creation in 1934. Exclusive secretarial control has been justified by the nature of financial markets, the advantage of confidentiality, and the importance of acting quickly and on the basis of expertise when conducting foreign exchange intervention and extending credits to foreign governments. Some members of Congress have challenged the amount

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of discretion that the Secretary is given under the law. With the exception of the reaction to the Mexican operation of 1995, however, those challenges stemmed from the views of a distinct minority.

Second, the transparency of the ESF has evolved a great deal from the beginning, when the Secretary reported only to the President on the operations of the ESF. Soon after the creation of the ESF, the Secretary's reports were submitted to Congress as well, and then later they were made public. Since the 1970s the Treasury has reported to Congress on a monthly basis and to the public through the Federal Reserve on a quarterly basis. Each loan agreement with a foreign government has been reported to Congress under the Case Act. In a development consistent with this trend, the administrative expenses of the ESF were placed on the budget beginning in FY1980. Under the Omnibus Trade and Competitiveness Act of 1988, the Treasury is required to deliver semiannual reports on broader matters of international economic policy and exchange rates, on which the Secretary is to testify if called upon to do so, and in which policy matters pertaining to the ESF are discussed. These changes constituted responses in part to the evolving congressional desire for greater transparency of the ESF and accountability of the Secretary in past operations while also preserving confidentiality, flexibility, and speed in current operations. Thus, the present-day ESF in no way resembles a "slush fund."

Third, the ESF has also evolved in response to changes in the international monetary and financial systems. Since the 1930s Treasury Secretaries have both conducted foreign exchange intervention and extended international loans from the ESF. The formal objectives of the ESF shifted from stabilizing the dollar in a narrow sense in the early decades of the fund to promoting "orderly exchange arrangements" and "a stable system of exchange rates" after the end of the fixed-rate regime in the early 1970s. International capital flows to emerging markets increased dramatically in the 1990s, and when those flows reversed, the demand increased for distress financing, most dramatically in the case of Mexico in late 1994 and 1995. Those loan commitments as well as the lengthening terms of those commitments thus reflect the increased size, speed, and reversibility of modern private capital flows. Highly mobile capital could also easily produce large movements in the dollar exchange rate in the future, prompting an increase in the volume of currency intervention. The basic rationales for creating the ESF—imperfections in the currency and financial markets—very much apply to the present day.

Fourth, although the ESF was originally created by a Democratic Congress and President, the account and its placement at the disposal of the Treasury Secretary have had bipartisan support. Secretaries under both Democratic and Republican Presidents have used the account extensively and defended congressional delegation of authority to the executive. The second Reagan administration and the Bush administration made the

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greatest use of the account by far, each intervening to the tune of nearly $26 billion over their respective tenures. The Reagan and Bush administrations also signed the most credit arrangements and activated more of them—14 under President Bush and 12 during President Reagan's second term—than other administrations (see table 1). While the magnitude of the 1995 Mexican operation was unprecedented for a single credit arrangement, the extent of the Clinton administration's use of the ESF overall has been considerably less than that of its Republican predecessors.

Fifth, the Mexican financial rescue was quite successful. The operation smoothed the balance of payments adjustment that Mexico underwent and thus limited the drop in growth and incomes that might have occurred otherwise. Mexican access to international capital markets was restored in short order. Most important from the US standpoint, the loan prevented an even larger adverse shift in the bilateral trade balance, and the ESF was repaid within two years. US economic and political relations with Mexico, as embodied in the NAFTA agreement, thus remain essentially intact as a result of the financial operation of 1995.

Sixth, it is clear from the debate prompted by the Mexican rescue that the operation was legal under the discretion provided to the Secretary of the Treasury by the ESF statute. The statute, its legislative history, and decades of practice with congressional oversight establish the legality of ESF loans. Although the President must report and justify to Congress loans with terms exceeding six months, neither the statute nor the legislative history imposes any limitation on the term over which funds can be lent from the account. Apart from the two years during which the D'Amato amendment was in effect, there has been and remains no legal bar to offering medium-term loans to countries stricken by financial crises.

Seventh, the political unpopularity of the Mexico operation, however, produced serious de jure and de facto constraints on the Secretary's ability to draw on the ESF for international lending during fiscal years 1996 and 1997. The United States took a lower profile in the Thai rescue during the summer of 1997 than might otherwise have been the case, arguably weakening the effectiveness of the IMF package as well as creating a vacuum that the Japanese attempted to fill with the proposed Asian monetary fund. Constructive Japanese diplomacy should of course be welcomed, but the profound domestic macroeconomic and banking problems afflicting Japan at the time could well have tempted the Japanese government to skew the terms of regional financial rescues in favor of moral hazard-creating bailouts. The inability of the Japanese government to address its domestic economic problems satisfactorily augured poorly for its ability to lead regional arrangements effectively. This episode suggests that it is very much in the interest of the United States to provide leadership and to support the leading role of the IMF in negotiating financial rescues. The episode also strongly suggests that constraining the use of the ESF undermines that leadership.

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The United States and the international community require a capacity to act in international finance, even if this capacity is usually held in reserve and is used infrequently. Abandoning such a capacity would not only invite greater international financial instability but also risk backsliding on external financial liberalization around the world. Although countries struck by the recent crisis have generally maintained market-friendly policies, governments could not be expected to remain fully exposed to the shifting and sometimes fickle flows of international finance, particularly in light of the large costs that the present crisis is imposing on stricken countries. In the absence of a cushion in the form of official lending—an international financial safety net—governments can be expected to retrench, reinstituting various forms of capital controls and trade barriers, and jettisoning outward-oriented economic strategies. (Witness the measures introduced in Russia and Malaysia.)

Multilateral facilities such as the IMF must be a cornerstone for this capacity. Participating in multilateral institutions provides many advantages to the United States. Those institutions leverage the resources that the United States provides, have greater international legitimacy than the United States acting alone, can take the political heat for politically unpopular policy reforms in borrowing countries, and provide economic and financial analysis that is less encumbered by national political agendas. But it would be unwise for the United States to rely *solely* on the IMF for international financial diplomacy. The United States should retain a *unilateral* capacity to act. This was recognized when the IMF was first created. When acting alone, the United States can respond more quickly and in ways that advance its own interests more effectively than can multilateral institutions. Maintaining a US capacity for financial rescues is all the more important when the resources of the international financial institutions are limited, as they were before the recent quota increase of the IMF. Constraints on the resources of multilateral institutions gave rise to the ''bilateral'' contributions of leading governments through the parallel and the second lines of defense. Finally, a unilateral facility can conduct foreign exchange intervention, whereas the IMF cannot.

It is therefore the basic conclusion of this study that Congress should leave the ESF alone. The ESF should remain under the exclusive control of the Secretary of the Treasury. The availability of the ESF for both foreign exchange intervention and credits to foreign governments should be maintained. Congress, in particular, should not impose any new constraints on the use of the ESF for international financial rescues, including for medium-term credits when those might be necessary. However, although recent progress on transparency is impressive, reporting requirements and mechanisms for ensuring accountability, primarily through congressional oversight, could be strengthened (see below).

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Six Principles

While maintaining a capacity for action through the ESF, the Secretary of the Treasury should nonetheless respect six key principles when conducting international financial rescues. These principles derive in part from the classical doctrine of financial crisis stabilization most commonly associated with Walter Bagehot (1873) and further developed by a number of contemporary analysts.[1]

First, loans from the ESF should be issued sparingly. The Treasury should make the account available only after borrowers have exhausted their access to the private financial markets and, preferably, other official creditors. The account should be a lender of last, not early, recourse.

Second, loans should naturally be conditioned upon policy reforms in borrowing countries to correct economic problems and facilitate international adjustment. Such reforms help to ensure that ESF funds are used appropriately and that the Treasury will be repaid.

Third, large medium-term loans should usually be made in parallel with programs administered by the IMF, which should continue to take the lead in the negotiation of policy conditions. With greater personnel resources and detailed country expertise spanning the globe, the IMF is often better positioned to determine conditionality. As a multilateral agency in which the borrower is also a member, the IMF might well also have greater legitimacy than the US government in insisting on policy reform.

Fourth, ESF loans should be backed by a reasonably assured source of repayment and generally receive an interest-rate premium, relative to the precrisis market rate, to induce the borrower to return to the private markets quickly. The assurance of repayment could take the form of an interest in financial or real assets similar to collateral, an earmarking of foreign currency reserves, new loans coming from other parties, a currency swap, or, when justified, the ''full faith and credit'' of the borrowing government.

Fifth, loans from the ESF should be effectively senior to the borrower's obligations to previous creditors. Legal issues complicate the formal subordination of loans from private and official financial institutions to loans from the US Treasury. Nonetheless, owing to the political and economic stature of the United States, the US Treasury is in practice a highly preferred creditor. Failure to repay the Treasury, like the failure to repay the IMF, would severely limit and possibly cut off access to private markets and would draw potentially far-reaching political consequences—which the Treasury's informal dealings with borrowers should of course emphasize.

1. For recent reviews, see Capie (1998) and Fischer (1999).

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Sixth, private lenders and investors should also contribute to the rescue package—through some combination of debt relief, rescheduling, and new money—so that official financing does not simply substitute for private finance. This principle will be the most difficult of the six to apply, because private creditors are more diverse and decentralized than they were, for example, in the debt crisis of the 1980s (Henning 1996). ''Bailing in'' the private banks and investors should be a principal objective of the new international financial architecture currently being debated and negotiated.

These principles are designed to maximize the likelihood that an ESF financial operation will effectively stabilize markets, assure repayment of the Treasury, encourage an early return to private capital markets, and minimize the moral hazard effects of official lending. They cannot be imposed rigidly on the credit activities of the ESF; the principles require artful application in light of prevailing economic and perhaps political circumstances. The first five of these principles were observed in the successful Mexican operation. Bailing in the private sector was probably not possible under the circumstances prevailing in early 1995, and proved not to be necessary. Requiring that a loan be placed in reserves, to offer another illustration of the partial substitutability of these precepts, is similar to making reserves collateral for the credit. By strengthening the basis for repayment, other conditions might also substitute for collateral. Nevertheless, the Secretary must respect the spirit of these principles and follow a conservative approach when using the ESF.

Oversight and Transparency

Because discretion and flexibility are critical to the successful use of the ESF, Congress would be better served by exercising oversight rather than legislating these six principles. Congress, and the banking committees in particular, has access to numerous Treasury reports and has multiple opportunities to question the Secretary and other Treasury officials privately and publicly, and thus possesses all of the tools necessary to exercise such oversight effectively. In overseeing ESF operations, members of Congress should ensure that these principles are respected; the Treasury should offer, and Congress should insist on receiving, an explanation for any deviation from them. The authority delegated to the Treasury under the ESF law remains retrievable: If Congress were to find that these principles had been violated, it could resort to legislation in the future.

In its management of the ESF, the Treasury Department should accommodate the evolving international norms of transparency exemplified by the 1998 working group report of the G-22. Those norms are changing quickly, and the Treasury, at the forefront of this movement among governments, has already enhanced disclosure, for example, by posting the

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US reserve asset position on the Internet, as mentioned earlier. The Department plans to publish the liability positions of the ESF as well. Pending agreement within the G-7, we can expect timely and more frequent release of other international financial information from the leading countries. The G-7 has a compelling reason to make progress on transparency: by leading by example, the group hopes to exert political and market pressure on the governments of emerging market countries to adopt higher standards of disclosure, thereby improving the information available to markets and mitigating financial crises in the future. The Treasury has enhanced ESF disclosure to the point where remaining problems of transparency tend to be related to the formatting and timing of the multiple reports rather than the availability of information per se. Information related to the ESF, to the external monetary position of the United States, and to financial agreements with foreign governments appears in many different sources—the *Treasury Bulletin,* semiannual reports on exchange rate policy, Federal Reserve quarterly reports, ESF annual reports, monthly reports to the congressional banking committees, and occasional Case Act reports to the international relations committees. A strong case could be made for consolidating these reports. Streamlining the reporting process would economize on the time expended by the Treasury staff and provide ''one-stop shopping'' for Congress and the public. However, doing so would require amending each of the several statutes that require the existing reports.

Second, it would be desirable for the Treasury to release ESF balance sheet information more frequently. The weekly publication of reserve statistics and the planned publication of information about ESF liabilities constitute progress in this direction. The department could go further by releasing monthly balance sheets with a few months' lag. Third, credit agreements with foreign countries, such as the 1998 agreement with Brazil, should clearly be released to the public. Such agreements are often classified out of deference to other creditors or to the borrower. Our partners in Europe and Japan should be put on notice that the United States intends to make the bilateral portion of future agreements public. Doing so should be part of the transparency agenda of the finance G-7 and other international bodies. One vehicle for such a release would be for the international relations committees of the Congress, with Treasury's consent, to disclose the Case Act reports that contain these agreements. In lieu of public disclosure, the agreements should be made available to the banking committees, which have oversight responsibilities, at the same time that they are transmitted to the international relations committees. These measures would naturally facilitate congressional oversight.

All actors should of course be mindful of the need to protect the flexibility and effectiveness of current and future ESF operations. There should be a presumption in favor of prompt and thorough disclosure within this

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constraint, however, as Treasury has acknowledged. Such disclosure, at least to the Congress, is part and parcel of the broad delegation of authority to the Treasury to manage the ESF. But Capitol Hill must also recognize the substantial costs in staff time of reporting to the Congress and of strengthening transparency in general, and budgetary appropriations for the administrative expenses of the Treasury should provide for additional resources.

As was acknowledged at the creation of the ESF, institutional arrangements require an investment of trust in the Secretary of the Treasury. That trust may have been abused on a couple of occasions in the distant past. But since Congress registered its objections on those isolated occasions, placed the ESF's administrative expenses on budget, and reinforced reporting requirements in the mid-1970s, that trust has been upheld. Basic integrity and good judgment in the use of the ESF should, among other things, be the subject of Senate questioning and discussion during its confirmation of the Secretary. Congress has the tools to verify that the trust placed in the Secretary has been upheld; if that trust were ever violated in the future, Congress could and should press for removal of the Secretary.

Without the ESF, the United States would be hamstrung in responding to international financial crises. The executive would have to rely on a mix of instruments that would be inadequate in emergencies. It could ask the Federal Reserve to make loans to countries under financial stress, but the Federal Reserve would insist on limiting these in size and duration. The executive could cobble together loans from the Export–Import Bank, the Commodity Credit Corporation, the Overseas Private Investment Corporation, and related agencies, as it has been done occasionally in the past. But such lending distorts these programs and comes with strings attached that often are inappropriate for the borrower. The executive could also ask Congress to appropriate funds for such loans. But, as members of Congress themselves observe, the rescue could then become embroiled in the politics of the moment in Washington, tied to a host of issues, both relevant and irrelevant. Congressional appropriation would probably come slowly, and it would require decisions by members with considerably less expertise than officials of the Treasury. Congress has historically and rightly preferred to delegate such decisions to the executive and to oversee the Secretary's actions. The intensification of international financial instability in recent years requires that this delegation of authority be maintained rather than rescinded. If it did not now exist, the ESF, or something like it, would have to be created.

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