APPLYING GREECE

A modest proposal for 2010

IMF takeover of California not too far out

By Swaminathan S. Anklesaria Aiyar

The following is a top-secret letter from an International Monetary Fund (IMF) economist to the IMF managing director:

Dear Managing Director:

Allow me to make a modest proposal (with apologies to Jonathan Swift) to expand IMF operations to places once regarded as unthinkable. I refer, of course, to California.

The world has been transformed in recent times, offering completely new opportunities. Today the IMF is rescuing not only low- and middle-income countries, but rich eurozone members like Greece. Hopefully, we will soon expand into Portugal and Spain, too. This will mean bigger budgets and staff, the two unstated aims of any bureaucracy.

Greece has a fiscal problem but no balance-of-payments problem. Nitpickers say this violates the IMF charter, which binds the IMF to lend only for balance-of-payments needs. But politicians have brushed aside these legalities: They view the IMF loan to Greece as not merely permissible but essential. They need the IMF as a tough cop and source of funds.

Having established that we can now lend for fiscal support, we should broaden our horizons. We must consider other entities with fiscal problems but no balance-of-payments problems. The biggest, of course, is California. With 37 million people and a gross domestic product (GDP) of $1.8 trillion, it is far larger than Greece (11.2 million people, GDP of $350 billion).

The IMF historically has lent to central banks, not governments. Its loans historically have gone into the foreign-exchange reserves of countries, not their budgets. The Bretton Woods agreement of 1944 envisaged a division of work: The World Bank would provide fiscal support to governments, and the IMF would provide hard currency to central banks.

That division of work has blurred over the past two decades. Politicians found it convenient to use the combined resources of the World Bank and IMF to assist ex-communist countries at the start of the 1990s and countries hit by the Asian financial crisis in 1997 through 2000. IMF loans entered the budgets of countries for the first time.

Still, those loans were primarily for balance-of-payments needs: Fiscal support was merely a bonus. With the Greek loan, we are in new territory. We can now lend where there is a pure fiscal issue and no balance-of-payments issue. Indeed, we need no longer lend to central banks. Greece has no central bank: Along with fellow Europeans, it is part of a currency union called the eurozone and uses euros issued by the European Central Bank.

The analogy with California is compelling. California, too, is part of a currency union with other American states, all of which use dollars issued by the Fed. Our loan to Greece will go straight into the Greek budget, not the European Central Bank. Similarly, an IMF loan to California would go straight into its budget, not the Fed. Just what politicians want.

Many Californians will strongly resist an IMF loan as being politically and financially humiliating. Yet this initially was true of Greece, too, and eventually, resistance changed to acceptance, if not quite a welcome. Trade unions and others took to the streets in Greece and will do so in California, too. No problem: Such protests are essential safety vents for dissent in any democracy.

California is a state, not a country. This is a hurdle, but hopefully not an insuperable one. The IMF and World Bank can lend only to national governments, not state governments. However, the World Bank got around that by lending to state governments with guarantees from national governments. The IMF has never taken this route. But now that it can lend purely for fiscal support, it should consider lending to states (like California) with guarantees from national governments.

National governments may not always agree to such deals. Yet, as we have discovered in the past 65 years, politicians dislike imposing tough structural reforms and may prefer to let the IMF take the political heat.

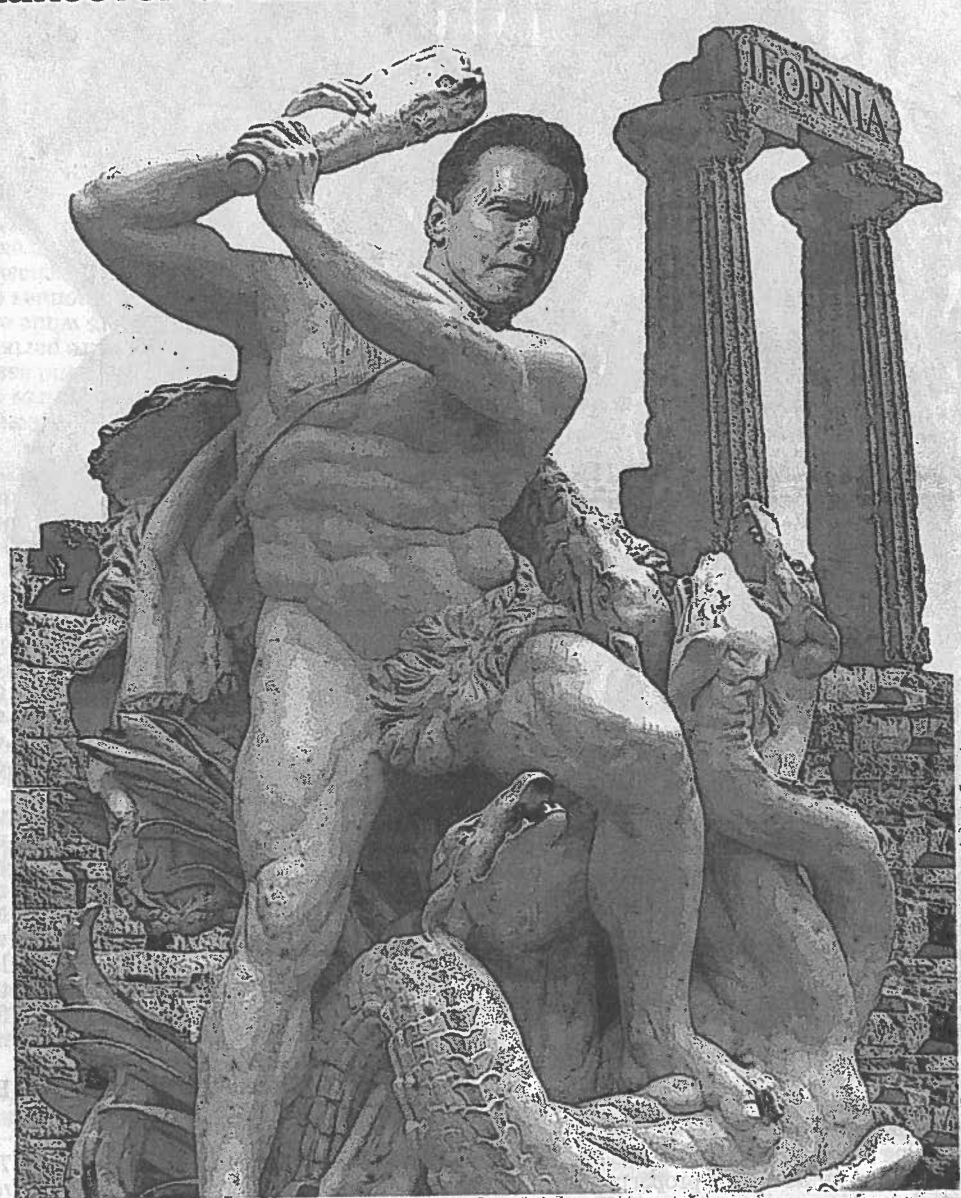

ILLUSTRATION BY HUNTER

Germany and France were initially opposed to our assistance to Greece, but they eventually agreed. They decided they needed the IMF, not just as a financier, but as a tough cop.

Both President Obama and Gov. Arnold Schwarznegger initially will resist an IMF loan to California. But as the California crisis deepens, they eventually may find it politically convenient. Mr. Schwarznegger wants $7 billion from Washington. Mr. Obama might prefer to guarantee an IMF loan of this size rather than ask Congress for the money.

Once politicians agree, we can start the formidable task of drafting new covenants and procedures for loans to state governments (like California) across the world. That will mean, I am delighted to say, more staff and larger budgets.

Sincerely,

(Name redacted)

Swaminathan S. Anklesaria Aiyar is a research fellow at the Cato Institute's Center for Global Liberty and Prosperity in Washington.

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