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COMMENT ON THE CONSENSUS

by Allan H. Meltzer

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John Williamson's paper is a commendable effort to summarize the policy consensus in Washington about the reforms required to bring Latin America toward stable, non-inflationary growth. Any effort of this kind runs the risk that some of the participants will decide to disagree after seeing that they are part of a consensus.

Williamson lists ten principles or policy rules. The list is remarkable as much for what is included as for what is omitted. A decade or more ago, I believe, there would have been much more about policy activism, discretionary judgment on a case-by-case basis, trade-offs between inflation and unemployment, and development planning. Earlier, a vociferous group would have favored import substitution. I am not a Washington "insider", so I do not know whether Williamson has captured the consensus. If he has, the Washington policy community has come a long way toward rules, private property, reliance on the market system, avoidance of deficits and inflation, and an open economy operating in a competitive world market place.

Before commenting on some of the specific proposals and suggesting alternatives, I digress to mention some of the rhetoric and an omission. I wish there were fewer references to unnamed right wing deviationists. The audience would be better served if the paper stayed on the issues. Also, I was surprised to see no references to the left wing deviationists and the more rabid environmentalists. Are these groups inconsequential, with no effect on the consensus and no relevant alternatives? I find that difficult to believe, particularly about the environmental activists.

Let me return to substance and offer my, perhaps idiosyncratic, view of what should be prescribed. John hints at a preference for cyclically balanced budget, but he thinks the consensus favors a balanced budget or small deficits. I would have preferred to combine the budget proposal with spending priorities to emphasize the use of resources and the method of financing.
Budget deficits are not wrong or harmful if they finance spending that increases efficiency, have a real return in excess of the resource cost, and are not financed by inflation. A rule that keeps the debt/GNP ratio fixed or balances the budget annually or cyclically pays no attention to resource use.

Of course, the government may use resources badly, turning productive opportunities into wasteful projects, or increasing corruption. In that case it is not the deficit but privatization that is required to improve efficiency. Here, I join the Washington consensus. I would restate and combine budget policy, spending priorities and some of the other items to emphasize efficiency. The rule would be: Allow the government to spend only where the spending does not reduce the efficiency of resource use. Finance the spending in a non-inflationary way.

Missing from the consensus is any explicit statements about price controls and other interventions that distort relative prices. Deregulation may be too broad a term to cover these distortions. The efficiency rule serves this purpose as well as others.

The Washington consensus would like real interest rates to be positive and moderate. The last term is vague and raises a question about how policy can change real interest rates. One way is to reduce risk and uncertainty toward the minimum inherent in nature. Credible rules, stable medium-term policies, secure property rights, a commercial code, a legal framework and an accounting system lower risks and reduce risk premiums in real rates. I would, therefore, state the rule in terms of actions to reduce risk and eliminate avoidable uncertainty.

This brings me to the exchange rate. I understand the case for fixed exchange rates and the case for flexible exchange rates and domestic price stability. I don't understand the rationale for the in between cases that are so prevalent in the world.

My solution for Latin America would be to replace the central banks with currency boards. The currency boards would not be permitted to monetize debt or change the exchange rate. The exchange rate would be fixed. The currency board would issue money in exchange for convertible currencies and would be required to keep the shares of its portfolio equal to the trade weights of its exports and imports.

Central banks have provided no net benefit to Latin American countries. Inflation, much of the capital flight, and high real risk premiums in interest
rates are part of the cost. Currency boards have worked well in Hong Kong and Singapore and contributed far more to the welfare of the citizens of those countries than the central banks of Latin America to theirs.

My proposal is: (1) fix the exchange rate and (2) replace the central bank with a monetary authority or currency board. This proposal if adopted would promptly lower real rates, by reducing risk premiums, therefore lower internal debt service costs, and reduce budget expenditure. Further, abolishing the central bank would enhance credibility and encourage a return of "flight capital."¹

I don't believe either that my proposal is part of the Washington consensus or that it will be soon. I offer it to suggest that consensus has not thought very deeply about ways of institutionalizing reform to increase credibility. Institutional reform does not guarantee that the public will believe the policymaker, but it works to reduce the lag between policy announcements and beneficial results.

I agree with most of the points about commercial policy. I would add a proposal to join GATT, as some have done. Also, I have advocated debt for equity swaps if accompanied by privatization since 1982, so I am glad to see the consensus form. And, no one will be surprised to learn that I favor secure property rights where these promote efficiency, as they usually do. I would add, as mentioned above, the desirability of a legal framework, a commercial code and removal of exchange controls.

To sum up, my list would be shorter and would differ in a few places. I would have:

One, promote efficient use of resources and avoid distortions.
Two, reduce risk to a minimum; avoid policies that redistribute risks.
Three, abolish the central bank, establish a currency board or monetary authority, and fix the exchange rate.
Four, establish property rights, a commercial code and a legal framework.

With the possible exception of the currency board, this would be a good list for any country, the Soviet Union, Poland, Argentina and, yes, the U.S.

¹Inflation is not the only way to tax assets. Fear of confiscatory taxation and outright confiscation would remain as reasons for capital flight.
Where I suspect John and I disagree most is on implementation. He talks about finding the fundamental equilibrium exchange rate, or using counter cyclical fiscal policy, or maintaining moderate interest rates, presumably by judgment or possibly policy mix. I prefer rules or medium term objectives to lower risk and reduce uncertainty.

A further problem of implementation is the serious problem of getting the Washington consensus applied. Public choice considerations exclude a goodwill theory of government. We have to take the next step and ask about the incentives required to get the consensus adopted and implemented. Years of experience with conditional lending suggests that this is not an easy problem or one that we know how to solve. Does John Williamson agree that there should be no aid, no assistance unless countries implement rules like those in the consensus? How do we monitor compliance?

Recent research considers these questions as part of the problem of establishing credibility. Credibility is a stock that, once built up, speeds the adjustment to policy changes. For most of Latin America, the credibility stock has been depleted. Some concern for rebuilding credibility is a necessary part of implementation.

One purpose in describing the consensus is to put restrictions or conditions on aid. This raises some questions. Is there evidence that foreign aid helps the recipients? What kind of aid? Do the benefits to the recipients outweigh the costs to the donors? Or, is aid a type of charity?

A common answer is that aid encourages adjustments that local governments would not do on their own. If so, we must face the problem of implementation, enforcing the rules. Otherwise, the aid is likely to provide resources that permit countries to maintain the policies that the consensus wants to eliminate.

Finally, it might be useful to recall that the consensus in 1983 favored additional lending after the initial crises had been overcome. Let me suggest that we would be nearer to a solution if, instead, the debtors and creditors had been encouraged to work out a solution. The Washington consensus did not help then. Would it help now? Or, would all parties gain if Washington stood aside and let the debtors and creditors work out the solution?