IMF and World Bank 2004

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Much of what the charters of the IMF and the World Bank say about purposes and objectives is out of date. The current mandate of the IMF should be to reduce global risk to an attainable minimum. The mandate of the World Bank should be to facilitate social and economic development as a means of reducing poverty.

How can the IMF reduce risk to an attainable minimum? The IMF has two principal functions that can improve the market’s operations in ordinary times and in crises. One function is to increase the quantity and improve the quality of information available to private lenders. The other function is to reduce the risk of financial crises in a given country and the spread of crises to other countries, as in Latin America in the 1980s and Asia in the 1990s.

Under pressure from its critics, the IMF has made much more information available about its activities, recommendations, and assessments. This information can be used by private lenders to improve their assessment of risks in a given country. This is particularly important for making judgments in the ordinary course of lending. Many problems in developing economies arise or are exacerbated by the volume of short-term renewable loans used to finance risky, longer-term assets. Timely release of information about a country’s debt structure and performance can reduce this type of lending.
Important as is the improvement of information, the most important function of the IMF is to reduce the risk of severe crises that spread internationally. Improved information contributes, but reform of IMF procedures is important also. Prodded by its critics and its new management over the last three years, the IMF improved its operations and recommendations in several ways. It now restricts the conditions attached to its loans to a small number of macroeconomic and financial measures or objectives. It appears less willing to make massive loans than in the 1990s. And it pays more attention to avoiding crises and to determinants of debt sustainability in developing countries.

The most important single change remains undone. The IMF should move from its “command and control” approach to one that relies on incentives.

Historically, the IMF has attached conditions to its loans. The country agrees to the conditions to get the loan, but it may be politically unpopular at home to enforce conditions such as expenditure reduction or tax increases. Or, growth may be less than anticipated, requiring additional painful adjustment. The IMF’s Independent Evaluation Office found that countries achieved about one-half of the proposed change in fiscal balance on average. About 60 percent of the programs under-performed.¹

This command and control approach has the unfortunate side effect of making the IMF appear responsible for imposing harsh measures under adverse circumstances. The country’s government, of course, agrees as a condition of the loan. This does not remove the IMF’s responsibility in the minds of the country’s electorate, the protestors at international meetings, and much of the public.

I believe that reform occurs when the country’s leaders, a majority of its citizens, or both, want reform. Reform cannot be imposed successfully by external technocrats without local

support. Local governments can, and do, frustrate reforms or ignore IMF (or World Bank) conditions. The reason Turkey, Brazil, Argentina, Ecuador, and others have repeated crises is that they do not reform enough to avoid them. They promise, but they do not reform. Command and control fails, as we expect it would.

The main reform needed at the IMF is development of an incentive system to replace command and control. Briefly, the IMF should establish a short list of policies or observable standards that countries should adopt to be assured of assistance in a crisis. It should use its surveillance to assure that a country meets the standards and publish the list of countries that do – and do not – get a guarantee of crisis assistance. The IMF would not help countries that do not meet the standard. To prevent crises from spreading, the IMF would assist countries that are victims of crises in their neighbors or trading partners.

Countries that adopt the standard would be subject to less risk. Hence, they could borrow more capital at a lower interest rate spread over U.S. Treasuries. Other countries would get less capital and pay a higher interest rate. This would give the government and the public considerable incentive to adopt stabilizing policies. The capital markets, not the IMF, would impose discipline.

The IMF itself is at risk. As my colleague Adam Lerrick has shown, that risk is a cost to the United States (and other countries) but does not appear in our budget. Lerrick estimates the hidden annual cost of the IMF to U.S. taxpayers currently as $1.5 to $2 billion. The principal component is the risk of default by one of the major debtors.

Four countries – Argentina, Brazil, Indonesia and Turkey – owe about 70 percent of the IMF’s outstanding debt. The IMF avoids default by lending more money or, as in the case of Argentina, by extending the maturity of the debt. As in the past, the IMF will come eventually to
the Congress for a quota increase either because of a default or because its resources are allocated to unpaid loans.

Reform of this system should be a priority. The administration, to its credit, has made considerable progress in getting collective action clauses into private debt contracts. Reform of debt repayment to international financial institutions and to lenders should be next on the agenda.

The World Bank

In the past few years, the administration and the Congress have insisted on some of the reforms advocated by the majority report of the International Financial Institution Advisory Commission. Monitored grants replaced some of the lending to the poorest countries. The administration has worked to set explicit conditions that can be monitored and has introduced incentives for countries to meet those conditions. In its most recent budget, Congress required an independent performance audit of some IDA programs and insisted on greater transparency at the World Bank.

These steps are a good start, but only a start. The central issue about the World Bank with its many programs is: It spends or lends about $20 billion a year but neither we nor they know which programs are effective and warrant expansion or retention, and which are ineffective and inefficient and should be abandoned. The monitoring that Congress insisted upon for part of IDA should be extended to the entire bank and its affiliates.

There are two ways to gain the needed information. One is an independent performance audit by an outside agency. Another is development of an independent, internal group similar to the GAO or the IMF’s Independent Evaluation Office. The current arrangement does not meet this standard.
An example will bring out the problem. We have considerable evidence that poverty has declined dramatically measured by the number of people living on $1 per day or less. The decline is most striking in Asia especially in China and India. Market opening, private investment, protection of property rights, and the like contributed much to the improvement. Where these spurs to growth and development are largely absent, as in Sub-Saharan Africa, poverty has increased. Did World Bank programs contribute to the reduction of poverty in Asia? Did these programs ameliorate worsening prospects in Africa? The Congress should require answers to these questions.

Further, the Bank should concentrate on the hard cases, the impoverished countries. The Bank should have an explicit program for graduation. Countries that can borrow in the capital markets with investment grade ratings should not receive subsidized loans. Those loans can be better used to provide potable water, sanitary sewers, disease control in the poorest countries and to encourage countries to adopt institutional reforms that have been effective in spurring development. These include the rule of law, open trading arrangements, and protection of property rights and individual rights.

Finally, we should insist that the IMF and the Bank eliminate overlapping responsibilities. The World Bank should become a more effective development bank. The Bank has estimated that $1 trillion a year is paid in bribes in all countries. A large part is in the developing countries. Ridding the system of corruption is a major challenge. The IMF’s responsibility should remain the maintenance of global financial stability. As a result of experience in the Asian crisis, many Asian countries have accumulated substantial reserves to protect them against crises and to avoid being put under IMF supervision. They have also
established a regional lending system outside the IMF. This, too, opens questions about the future role of the IMF.

New leadership at the IMF and the end of James Wolfensohn's term at the Bank in 2005 provides an opportunity for new leadership, new approaches, and much needed reform.
Leadership and Progress under

The Pax Americana

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The David Horowitz Lecture,

Jerusalem, January 5, 2004
Leadership and Progress under the Pax Americana

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It is almost sixty years since the end of World War II, the effective beginning of the Pax Americana, a great experiment to reshape the world's institutional structure, to prevent reoccurrence of major wars and economic depression and to extend liberty to places and people where it had never been known. Sixty years is a long time in the life of a nation, more than a quarter of U.S. history, and sufficient time to assess the main domestic and international achievements and failures of U.S. leadership. If we listen to the critics, we might conclude that the gains have been modest, the failures large, and the future clouded by environmental degradation, population explosion, nuclear proliferation, rising anti-Americanism and anti-globalization. This is a one-sided conclusion.

Looking back a century in the United States, the average person earned less than $500 a year, a dentist $2500, a mechanical engineer about $5000. Pneumonia was the leading cause of death. In the next century the United States moved from one among many countries to a position of pre-eminence. At the end of World War II, it could design the institutions that shaped the postwar economic order.

* An earlier version was presented as the First Irving Kristol lecture of the American Enterprise Institute, February 25, 2003 and published in World Economics, 4 (July – September), 2003, 15-26. I am grateful to Christopher DeMuth for helpful comments.
The late economist, Jacob Viner, writing in 1944, described United States’ objectives for international economic relations embodied in legislation ratifying the General Agreement on Tariffs and Trade, and the Bretton Woods Agreement establishing the International Monetary Fund and the World Bank. "Trade barriers will be as moderate and nondiscriminating as government and peoples...can be persuaded to make them;...currencies will be freely convertible into each other;...long-term capital will move from capital-rich to capital-poor countries;...abundant scope will be preserved for the exercise in the international field of competitive enterprise." Viner (1944, 53) The world achieved much of that program.

Soon after these new rules of the Pax Americana were in place, the beginning of the cold war required military preparedness, heavy expenditures for developing and producing armaments, maintenance of a large standing army and a system of alliances to share some of the costs and to mark the geographical limits beyond which Soviet expansion would risk war.

Only a few years before the Soviet Union collapsed, some analysts and historians saw only failure. Two years before the Soviet system collapsed, a popular book by historian Paul Kennedy (1987) warned that the Reagan tax cuts and "imperial overstretch" caused budget deficits that would destroy American power and end American influence. In the same year, a well-known foreign policy expert, Walter Russell Mead, wrote: "The foreign position of the United States decayed rapidly during Reagan’s tenure, reflecting a continuing erosion of the economic structure of the American Empire." Mead (1987, 200) Mead added: "It was unlikely that future British prime ministers, of any party, would court political disaster by cooperating too closely with the United States." (202) At home, Mead found "the record was even more dismal." (202)
Within less than a decade after these books appeared, the complaint had changed. America was now to be feared as the hyper-power militarily, economically and in producing popular culture. It is well to recall that French complaints began before there was a Bush administration or a war in Iraq.

The well-known analysts who made these forecasts looked at foreign and domestic events through the filter of an inappropriate and invalid set of ideas that led them into error. They overlooked the significant differences that made the postwar years very different from the interwar years. They disregarded very relevant facts that could have corrected their errors. One of the principal facts of the postwar years was well known long before they wrote. These years saw an enormous change in living standards and extraordinary economic and social progress around the world. In the United States, since 1945 per capita income in constant dollars tripled from a level about equal to current Portugal or Ireland to $25,000. A sustained annual rate of increase of less than 2% that produced this progress compares to an annual average of nearly 5.5% in Hong Kong and Singapore in the 1980s and 8 percent in Japan during its high growth period.

We need not look only to Asia for remarkable economic progress. Israel’s growth rate of 9.2% compounded from 1950 to 1968 is second only to Japan, but Japan did not have to spend—indeed was barred from spending—large amounts for defense. And it did not have to fight wars, as Israel did. While Israel’s early growth rate could not be maintained, rapid growth resumed in the early 1990s. Despite six wars and two intifadas, Israel has achieved the status of a rich country with per capita income of $20,000, truly a remarkable achievement in the presence of continuing hostility.
The Pax Americana worked extremely well for many countries. During the postwar years, more people in more countries increased their living standards by larger amounts than in any period in recorded history. Progress was not limited to incomes. Standards of health, education, and life expectancy improved. Infant mortality declined. Popularly elected governments took root in countries that had never experienced popular sovereignty. Freedom and liberty expanded as never before. This impressive performance owes much to the aspirations and efforts of the multitudes struggling out of poverty and tyranny. Those aspirations seem to exist everywhere. They were not discovered in the postwar years or missing in the interwar years. In the United States, Canada, Western Europe and Australia people have struggled for two centuries to improve their own and their children's lives and to extend liberty.

Two institutional changes, working together, explain much of the difference between postwar and previous experience. One is the spread of capitalism, joining the market system to property rights and the rule of law. The other is the Pax Americana. Let’s consider the role of each.

Capitalism and the Market System

Until the nineteenth century, growth was slow and for long periods non-existent. It was only after the beginning of modern capitalism, democratic capitalism, that growth in living standards, increased longevity, improved health care and education could be purchased with the proceeds of economic development. Social and economic progress came to be the norm, the expected result. But this expectation became the norm only where countries accepted capitalist methods, property rights and open trading arrangements.
Postwar experience offers many comparisons between countries that adopted capitalism and the market system and those that did not. Three provide experimental evidence that is as good as we are likely to find in the social sciences. We can hold constant the history, culture, and traditions and observe the outcome after thirty, forty or fifty years of capitalism or socialism in the two Germanys, the two Koreas, and in China and the Chinese diaspora in Taiwan, Hong Kong, and Singapore.

In each of these comparisons, culture, language, and traditions are the same. Outcomes are markedly different. The countries with capitalist institutions and the market system grew richer; the others faltered or went backward. A South Korean now lives on an average income about equal to average incomes in the United States in 1945. His North Korean cousins, if they manage to survive, exist by eating roots and grass. Many of the Hong Kong Chinese escaped from mainland China. By the mid 1990s, the average income in Hong Kong was more than 30 times the income on the mainland and this a decade after the Chinese government accepted a limited market system and began to grow.

This region, the Middle East, shows how much can be achieved by a determined people operating with secure property rights under the rule of law and democratic accountability. Despite living in an insecure and often violent region, with little in the way of major exportable resources, Israel has prospered while absorbing multitudes from abroad. These requisites of growth are missing in most of its neighbors. Despite considerable foreign aid, most of these authoritarian states have grown much less.

For those who choose to see, there is much to see. Going south to Mexico a few miles from San Diego California also shows the remarkable difference between the outcomes produced
under democratic capitalism, the market system, and the rule of law. Many of the same families
live on both sides of that border. What a contrast in living standards and opportunity!

Within the United States, we see that success is not limited to one ethnic group, one
culture, one race, or one sex. Instead of the decline predicted by Paul Kennedy, Walter Mead
and many others, the United States economy after 1982 experienced two of the longest periods of
sustained growth in its history punctuated by two mild recessions. Per capita income increased
50 percent from 1980 to 2001. For the first time since the early 1950s, the gap widened between
U.S. average income and average incomes in Western Europe and Japan. It was no longer true
that the Europeans could have their welfare system and narrow the gap in per capita income with
the United States as they chose to do from the 1950s to the 1980s. Now they have to choose
between redistribution and higher living standards. They have started to wrestle with that
challenge. The outcome is unclear.

Critics point out that the spread of capitalism benefits many, but some are left behind.
This claim has now become the roar of the anti-globalists and the demonstrators at international
meetings. A glaring problem with such comparisons is that many countries are not part of the
global system. They do not adopt capitalist methods and are not open to trade. It is a mistake to
blame globalization for the poverty found in countries that do not join the global system.

Robert Barro and Xavier Sala-i-Martin (1993) studied convergence of countries' living
standards. Countries that open their economies and educate their children grow faster than
developed countries. They close the gap in living standards.

One recent study finds that poor countries that open to trade have grown twice as fast as
rich countries for the past twenty years. As a result poverty has fallen and global income
inequality is at the lowest level in a century. Bhalla, (2002 as quoted in IMF 2002, 335)
Another study finds that income inequality across countries has fallen since about 1980 and is now below the 1950 level. Williamson (2002, 7). Openness to trade is a principal reason for the rapid growth and declining poverty of developing countries, (ibid., 9). Dollar and Kraay (2000) showed that in countries with fiscal discipline, the rule of law, and low inflation, the benefit of growth for the poor is most certain.

The commitment to freer trade in the Pax Americana gave developing countries the opportunity to realize these gains. Many of the poorest countries are in the Middle East and Sub-Saharan Africa, areas that have not joined the global market by opening their economies to trade and to new technologies and opportunities. These countries have 70% of all major conflicts and casualties and slower growth than most other regions. The UN’s recent Arab Development Report attributes these failings to lack of freedom and the low quality of education in Arab schools. Greater freedom would contribute to higher living standards by opening the economy, strengthening the market system and the rule of law.

Not everyone benefits, and all benefits are not immediate. But democratic capitalism, the market system, and an economy open to trade and exchange give opportunities to individuals. Boris Yeltsin expressed this well:

“A great power is a self-reliant and talented people with initiative. ... And the sole measure of the greatness of our Motherland is the extent to which each citizen of Russia is free, healthy, educated and happy.” (Quoted in Aron 2002, 8)

The Pax Americana

Not all market economies prosper. The difference between countries or periods depends greatly on the presence or absence of internal and external institutions that produce stability and
the willingness of countries to join the international system and make the internal reforms that permit the market to function well. Accepting the rule of law, fiscal discipline, openness to trade, and private property are key elements.

Countries acting alone cannot produce global stability. The Pax Americana offered global political stability, the defense of common interests, rules for trade and payments, and a general disposition to rely on markets and market processes to allocate resources and to establish a system of human rights and liberty.

This system was not perfect. United States leadership was not always wise or well thought out. Sometimes avoidably, sometimes unavoidably, mistakes were made by the United States, by its adversaries and its allies. Nevertheless, the United States took the lead in providing political stability, rules for freer trade, and international financial stability. It organized many countries into alliances and encouraged its allies and others to gain from trade by adopting rules and peaceful mechanisms for resolving disputes. These arrangements provided benefits to all who joined. Economists call arrangements of this kind public goods because, unlike private goods, the benefits are not limited to the producer or a single user. Many can share.

Defense is an example. The European countries acting alone could not expect to defend themselves against an attack by the Soviet Union. The United States could mount a credible defense that gained strength from European support. The United States invested heavily not just in mounting defense but in developing military technology. Europeans knowing that they would be defended could give less than proportional effort. They were the classic free riders. They did not shirk responsibility, but they limited their commitment to a smaller share than the United States of total spending on military weapons, manpower, and the development of weapons systems and technology.
Israelis have experienced the effects of European free riding on the Pax Americana. When Israel was attacked in 1973, President Nixon supported Israel with arms and armaments. When the Arab states responded by threatening an oil embargo, the NATO countries refused to join any peacekeeping effort. They chose to free ride on Israeli and American efforts.

U.S. military expenditures and the willingness to use force or the threat of force in Greece, Turkey, and Iran initially, in Korea and Vietnam later, and at other times and places made the commitment credible. Scholars can debate whether all these actions were necessary, wise, or well thought out. That they contributed to decades of political stability is not debatable. And by the late 1980s, they helped to end the cold war. The principal adversary and all but a few of its satraps gave up the conflict. Many former adversaries joined the market system and, acknowledging the superiority of democratic capitalism, began to establish political and economic systems and institutions modeled on western norms.

The trade and financial arrangements created under American leadership contributed to growth and economic expansion. Trade rules permitted countries to choose a strategy of export led growth. That strategy remains feasible only if other countries permit import led consumption. To get this system started, the United States led the way to more open markets for imports and permitted countries to discriminate against its exports. Later, it promoted a system of trade preferences — the General System of Preferences — that continues to offer considerable advantage to developing countries. Still later, it began to offer free trade agreements with several developing economies including Israel.

Political stability permitted many new or developing countries to curtail spending on defense and devote their resources to investment, economic growth, and raising living standards.
Political stability also meant that merchants could travel more freely to many parts of the world, a benefit that wars and terrorism vitiate.

The third key element is financial stability. The initial effort to establish a dollar-based system of fixed exchange rates could not survive the inflationary policies that the United States used to finance the Vietnam War abroad and the Great Society at home. More than a decade of inflation and disinflation followed in the major developed countries and many developing countries. The Bretton Woods system failed to achieve financial or price stability. Nevertheless, the market economies avoided the disastrous experience of the interwar period.

The United States did not organize these successful institutions on its own. It exercised leadership both in organizing the postwar world and in adjusting to changing political and economic events. It did not always act alone. It led several successful coalitions. It paid a price in lives, resources, and money, but it achieved unparalleled success for itself, its allies, developing countries that joined the market system and friends of liberty everywhere.

The reader of today’s newspapers and journals of opinion must find strange this story of remarkable achievement, of sacrifice by the American public to defeat the adversaries of liberty and to increase living standards for all who chose to participate in its global system. The regular fare of the writers of these journals is criticism of globalization. United States policy is called unilateral, and the United States is castigated for pursuing its interests and promoting liberty in its own way.

**Unilateralism**

What should one make of the recent charge of American unilateralism? The word suggests different purposes, that what the United States sees as its policy interest, broadly or
narrowly defined, differs from what others see as in their interest. There is some truth to this claim of different purposes, but stopping there misses the source of these differences and how they are likely to evolve. Stopping with a complaint about unilateralism also misleads the public into thinking that, if the U.S. would change to a more multilateral policy, tensions between Europe and the United States would greatly diminish or even vanish. That seems unlikely.

An example shows how facile is the claim that United States policy pursues its own, narrowly defined, unilateral interest. The confrontation with Iraq protects Europe as it does the United States. The United States does not gather all the gains from successful confrontation, though it pays the largest share of the costs. U.S. policy creates a classic public good. A more peaceful world benefits the Europeans, including those governments who complain most about U.S. actions and policies.

I believe that free riding is one reason for reluctance in several European countries to participate. Europe is not monolithic. It is not even united on these issues. Several countries support U.S. policies and actions but can offer little more than token assistance. They are free riders. Others could offer assistance but want to exercise control. France is the leader of this group. Then there is Britain, willing to help supply public goods.

A frequent explanation attributes many of the differences to values. It is certainly true that many European journalists and politicians are disturbed by the moral certitude with which some U.S. presidents have condemned their adversaries as evil. Differences in values are not new. They existed during the cold war, so they cannot explain the increased hostility that recently characterized relations with France and Germany. I will offer three reasons that I believe are more relevant.
First, like all public goods, defense invites free riders who can gain the common benefit without sharing in the cost. Once the threat of Soviet tanks and troops pouring through the Fulda gap disappeared, European interest in common defense weakened. Military spending, troop strength, weapons systems, and preparedness declined. Germany spends on defense about half of what the U.S. spends relative to GDP. The United States spends more on defense than the next ten largest spenders. This spending protects others as well as its own citizens, a message that does not require elaboration here.

Britain is the outlier that requires explanation. Others are willing to depend on U.S. defense forces to protect them, while carping that the United States is too belligerent, too passive, too warlike, or lacking in strategic vision. All of these complaints, and others, were voiced before the Kosovo engagement, when Europeans showed themselves incapable of agreeing on and executing a policy to defend their region from renewed tyranny. They behaved as free riders do, waiting for the United States to supply the public good.

Britain and France took polar positions. Even before the end of the cold war, French policy aimed at creating a distinctly European policy led by France and supported by Germany. British governments have opposed as best they can a European system dominated by France and Germany, free riding on American defense and foreign policy efforts outside of Europe. It has not been averse to rewarding itself by pursuing its commercial interests even if they support hostile governments. British governments have opposed the French vision and supported a strong U.S. influence in Nato and in Europe to counter it.

Second, the Middle East poses a special problem for principal European countries. A large and growing part of the population in France and Germany recently came from the Middle East or North Africa. They have friends and relatives in Muslim countries. Their presence in
these countries makes a small voting bloc, and a noisy non-voting bloc, which regards assistance
to Palestinians and other Muslims as a high priority issue. Further, Germany and France have
not developed arrangements for integrating recent immigrants as full participants in their
economic and political life. Many are restless, chafing at their status. Without major changes,
this problem will grow over time as the Muslim proportion of the European population rises.
This is a problem we in the United States know well from our own past experience.

Third for the French government and some others, the attractive alternative is not to
match U.S. spending on defense but to control the way in which that spending is used. By
demanding a large role for the U.N. Security Council in reaching decisions, France and Russia
increase their role relative to ours. If the United States is going to defend them, along with itself,
they want to control the conditions. If the U.S. resists, it is accused of unilateralism, a claim that
gains in importance because of the vocal support it receives in the United States. These tactics
are not limited to defense. France, particularly, has used international pressure to impose large
costs on the United States.

Those who call for an end to American unilateralism hark back to an earlier period in
which unilateralism was absent. When would that have been? Lord Skidelsky’s biography of
Lord Keynes describes the negotiations in the 1940s over the start of the postwar order. “Britain
would accept the obligations of multilateralism only if guaranteed a large credit line to the
United States.” Skidelsky (2001, 383) In August 1945, President Truman shocked the British,
French, and others by canceling lend lease shipments without prior warning. In 1962, Germany
and France threatened to convert their dollars into gold to pressure President Kennedy into
changing his policy toward Europe. Kennedy threatened to remove U.S. troops from Europe in
response. This occurred at a time when the United States not only defended these countries but
permitted them to discriminate in trade against U.S. exports. In the 1960s, before the Bretton Woods System of fixed exchange rates collapsed, the countries of Western Europe complained about the U.S. payments deficit while maintaining restrictions against U.S. agricultural exports. They maintained bilateral agreements with Mediterranean and African countries on some of the products they resisted buying from the United States. And they discriminated against Japanese exports to such a degree that all of western Europe took 7 percent of Japanese exports against 30 percent for the U.S. At the time, they paid only $800 million of the $1.7 billion annual cost of stationing U.S. troops in Europe. There are many other examples including French withdrawal of its troops from NATO.

There is nothing new about countries placing their own interest first. After returning from negotiations in Europe in 1962, Board of Governors Chairman William McChesney Martin wrote to President Kennedy: “This is a tough, rough mean gang. And there is very little altruism.” (Kennedy 2001, 469) In the past, U.S. leadership was often the force that drove the alliance together. What has changed most is not the discovery of self-interest or unilateral actions; it is that with the end of the cold war, European governments have greater opportunity to be free riders and a reduced need to accept U.S. leadership and U.S. response to the change. This has reshaped the alliance, and it will continue to do so, thereby changing a main building block of political stability or even ending the alliance. The United States should try to work with them but should expect continued friction.
Trade and Finance

The two remaining pillars of the Pax Americana were rules for trade and finance. The challenge here is to reshape the system in a way that recognizes the progress that has been made and the changed relations after the end of the cold war.

Although criticized regularly by anti-globalization activists, the benefits of tariff reduction and rules for trade are well and repeatedly documented. As many have noted, one need only compare changes in living standards in countries that opened their economies to those that have not. Barro (1991), Barro and Sala-i-Martin (1993), Dollar and Kraay (2000) inter alia. The greater challenges now are to reduce the remaining tariffs, including developed country tariffs on textiles and foodstuffs, bring the many separate trading blocs into a global trading system, find more effective means of identifying and reducing non-tariff barriers, and develop incentives that encourage corrupt, oligarchic governments to open their economies and permit development to occur. The command and control system at the blundering World Bank just will not do. If the major countries want to encourage economic development in the poorest countries, they will reduce their tariffs on agriculture and textile imports and reform or replace the World Bank.

The central issues about the future of the World Trade Organization are whether the current system has provided most of the benefits it is likely to bring and whether the costs of additional agreements now exceed potential benefits. Both GATT and WTO found it impossible to reduce remaining tariffs on raw material and agricultural exports from emerging countries. Negotiations affecting service industries often involve performance standards that are very difficult to negotiate, even more difficult to make precise, and therefore unlikely to be enforced effectively. WTO judgments may override local law or require changes that countries are
reluctant to enforce. It seems right to ask whether the large benefits that have been achieved exhausted the net benefits likely to be obtained in the future. A new strategy is needed.

The use of sanctions to compensate for violations of trade rules is a lesser, but not unimportant, problem. Under current rules, countries can impose tariffs on imports as compensation for a foreign government’s trade restrictions. This allows the injured country to reduce selected imports by raising the prices paid by domestic users. Surely there is a better way to enforce rules than to penalize others by penalizing oneself.

A major challenge is to find a new role for the International Monetary Fund (IMF) and the World Bank that provides net social benefits. Two decades of intermittent crises in Latin America, Mexico, East Asia, Brazil, Argentina, Russia, and elsewhere raise doubts about the ability of present arrangements to maintain stability and growth. A long history of reduced living standards in client countries and a high failure rate of World Bank programs in poor countries suggest that the World Bank has failed the test. It is costly, bureaucratic and, much too often, ineffective.

In principle the IMF could provide two public goods if properly restructured. It could reduce the risk of global financial crises, provide information and accounting and financial standards that reduce costs of learning about countries’ prospects. Better information improves markets by permitting transactors to make more informed choices. One possible benefit would be reduced herd-like behavior by lenders to these countries.

The IMF has an advantage in obtaining information because it has programs in many countries and issues regular reports on problems and prospects. The IMF has made significant improvements in the quality and quantity of information it releases, but much more could be done to improve the quality and timeliness of country data. Congressman Saxton of the U.S.
Congressional Joint Economic Committee has taken a leading role in demanding better information and reform of IMF practices. He should continue to do so.

The IMF's most important tasks are crisis prevention and amelioration. In the past it has interpreted this responsibility broadly to include requiring policy decisions in many areas unrelated to economic stability. Its achievements have been limited. Crises have become larger and more frequent. Countries promise much but often change very little. Governments understand that the IMF continues to lend at subsidized rates even if the country fails to meet agreed conditions. Governments recognize that the IMF's management has in the past been more reluctant than the borrowing government to acknowledge that a program failed to achieve its objectives.

The United States has not helped the IMF to restructure its activities. Instead of lending to all countries with problems, it should limit its role to preventing crises from spreading to neighboring countries, trading partners, and innocent bystanders. Instead of lengthy negotiations to extract promises of reform, it should not lend to countries that have not adopted and maintained a small number of specific, verifiable policies that enhance stability. If there is a threat of a spreading crisis, the IMF should help potential victims, not the culprit.

Instituting these changes would replace the command and control system, based on a Washington consensus, with incentives for the country to choose and adopt stabilizing policies. Governments could explain to voters and legislators that reforms would reduce country risk, lowering interest rates. Reformed borrowers would obtain more credit from the market at lower cost, facilitating economic and social development. The IMF would be free to set standards and allow countries to implement the standards in their own way. Lenders would know the countries that adopted the standards and those that did not. They would know also that if they lent to
countries that had not reformed, they should expect to lose in a crisis. IMF loans would not bail them out.

Some of these steps are in process. The new management at the IMF has responded to criticism with less command and control and more attention to local control. Alas, less has been done to narrow the IMF's focus from managing many developing countries to the more urgent task of preventing multilateral crises by giving countries greater incentives to reform.

The World Bank poses a more difficult problem because, in practice, the nature of the public good it provides is less clear. Originally one of the Bank's main purposes was to offset a claimed market reluctance to lend to developing countries. For the past twenty years or longer, many of the problems in developing countries arose because the country and its residents attracted not too little but too much foreign lending, especially too much short-term, renewable lending. The development banks and the IMF paid too little attention to the risky situations they helped to create, and lenders learned to expect bailouts or support when problems developed, so they continued this unstable system.

If the World Bank were less bureaucratic, more focused, and had a better record of accomplishment; it might be possible to learn what it does more efficiently than the private sector. An independent performance evaluation should be mandatory. Some small steps in this direction are underway. Based on that review, the Bank should be reorganized and told to limit its activities to programs where it can provide what the market does not provide. I believe that four activities would remain.

First, the Bank's staff are experts on many technical problems faced by developing countries. The Bank should rent this expertise to countries at a subsidized price.
Second, the development banks can support programs to improve the quality of life for people in poor countries with inefficient or corrupt governments. Providing potable water and sanitation or improving health care are examples. The Congressionally appointed International Financial Institution Advisory Commission proposed monitored grants in place of loans to improve prospects that the benefits would be achieved. The U.S. Treasury succeeded after much effort to get agreement from the Bank and other countries to shift part of its subsidized loans to monitored grants. If the program is implemented correctly, it will improve the lot of the poorest among us.

Third, the Bank can get countries in a region to agree on and implement joint, regional environmental safeguards, disease eradication or reduction and similar regional programs with larger social benefits than the costs of providing them. Malaria, aids, measles, and other diseases are examples.

Fourth, the most difficult of all is to develop incentives within countries for sustained structural reforms, including rule of law, protection of private property, reduced corruption, economic stability, democratic accountability, and openness to trade. These reforms cannot be made overnight. They require persistent efforts to develop institutions and habit patterns that differ markedly from traditional ways. Sustained growth depends on these reforms, but the reforms depend on sustained commitment by country governments. A workable set of incentives to internalize responsibility for developing and maintaining structural reforms is badly needed.

**Conclusion**

When World War II ended, the United States offered to provide rules for trade, an international financial system, development aid, and later political stability enforced by military
power. These arrangements permitted much of the world to concentrate on economic and social
development with unparalleled success. U.S. leadership promoted postwar progress in many
countries, while maintaining peace and eventually overcoming its adversaries.

Against this record of unparalleled achievements in market economies is the record of
failure by the many experiments that pursued development outside the global system. These
failures are not limited to the Soviet Union and its satraps but include much of Africa, India
before its reforms, Alan Garcia’s Peru, Castro’s Cuba, the Sandanista’s Nicaragua, and many
others.

The end of the cold war weakened the bonds of alliance, permitted governments to
become more independent of the United States and weakened the global system. This is clearest
in Western Europe, but the change is visible in Japan, Korea, and South America.

With the end of the cold war, increased wealth and the spread of democratic government,
new arrangements are called for to provide the public goods that progress requires. All countries
have a stake in that progress and in developing or supporting institutions that give incentives for
progress. A new Pax Americana, like the old, requires military strength, new rules for trade, and
arrangements to maintain financial stability and economic well being. Success would continue
the remarkable progress of the last sixty years. Failure would likely slow this long period of
global growth, increased liberty, and human progress. Developing these new arrangements is the
major challenge to U.S. leadership as the engine of world progress in the new century.
References


