Making the IMF More Effective

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Follow this and additional works at: http://repository.cmu.edu/tepper
Part of the Economic Policy Commons, and the Industrial Organization Commons
Making the IMF More Effective

by Allan H. Meltzer

Carnegie Mellon University

and American Enterprise Institute

It is a privilege to appear before the Senate Subcommittee on International Trade and Finance to discuss the report of the International Financial Institution Advisory Commission (IFIAC). Given the Subcommittee's jurisdiction, I will begin with international trade.

As you know, the United States will again run a current account deficit of between 3 and 4% of GDP. This is a large deficit for a mature economy like ours, and it follows a similar current account deficit last year. The size of the deficit shows the willingness of foreigners to invest in our dynamic economy and America's opportunity -- both households and businesses -- to buy quality products at competitive prices abroad.

By running deficits, the United States helped the global economy to recover from the Asian crisis. This was the proper economic policy for the United States to follow. It is my judgment that this policy was far more important for the recovery of the Asian and world economy than any actions taken by the International Monetary Fund (IMF) or other international financial institutions. Critics of the IFIAC report often point to the recovery in Asia as evidence of the effectiveness of IMF programs. I believe they should not neglect the important role of U.S. trade policy. Countries like Malaysia, that did not follow IMF recommendations, recovered also because they too benefited from the opportunity to export under the trade rules that the United States has pioneered.
While I applaud our policy and recognize that a more restrictive policy would have been detrimental to us and others, I recognize also that some individuals, companies, and regions have been hurt by the flood of additional imports that we absorbed. Fortunately, our economy was in the midst of a long boom, so the dislocations were less costly than if they had occurred in a U.S. recession.

The lesson that I draw is that the U.S. has a special interest in reforming the international financial system to make the system more stable, less subject to the type of severe contractions that affected Latin America in the 1980s, Mexico in the mid-1990s, and Asia, Russia, Brazil and others most recently. A more stable international financial system would not require the large increases in imports experienced in 1998 and 1999 and at other crisis periods.

Making the system less prone to crises, and making crises less severe, requires changes in IMF practices. IFIAC identified three major reasons that financial crises are frequent, severe, and widespread:

(1) collapse of a country's pegged exchange rates;

(2) collapse of a country's financial system; and

(3) the time required to negotiate conditions on IMF loans.

The Commission's bipartisan majority found solutions to these three problems. Countries would have five years to reform their financial systems by providing adequate capital to protect against large withdrawals, by permitting foreign competition in home country financial markets, and in other ways. Countries would be urged to avoid pegged exchange rates. A country meeting the pre-conditions would get assistance at once, not after a delay of several months.

Critics have claimed that the Commission's proposals would eliminate assistance for countries that did not satisfy the pre-conditions. This criticism misses the point. Countries
would have a strong incentive to meet the pre-conditions because capital markets would lend mainly to countries that meet the pre-conditions. Other countries would pay a higher interest rate and would receive less capital, so they would be less affected by withdrawal of foreign lenders. They would be known as more risky countries. Lenders to these countries should expect to take losses if problems arose. By lending to countries that do not pre-qualify for assistance, the lender assumes a risk of default and should not be rescued by taxpayers or international financial institutions.

The Commission proposed that, in the event of a crisis that threatened to spread, loans should be made at a super penalty rate to prevent the spread even if the crisis country did not qualify. If feasible, the loans would be offered to neighboring countries, not to the country that failed to meet financial standards. If necessary to prevent crises from spreading, restrictions would be waived.

Other reforms of the IMF are desirable also. The world economy now depends mainly on private capital flows. The IMF has a major responsibility for increasing the quantity, timeliness, and quality of information to provide lenders with more accurate information. It should release Article 4 reports, improve the transparency of its own accounts, and record votes. It should focus its efforts on crisis avoidance and improving market information, leaving long-term lending and poverty assistance to the development banks.

Several of these recommendations were endorsed at the recent IMF meeting. Mr. Chairman, my time is limited. I will be happy to answer questions about what the Congress can do to make the IMF more effective and more accountable.