Reforming the International Financial Institutions: A Plan for Financial Stability and Economic Development

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Published In
Economic Perspectives, 6, 1.
Reforming the International Financial Institutions:  
A Plan for Financial Stability and Economic Development

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The U.S. Congress in November 1998, as part of an $18,000 million funding package for the International Monetary Fund (IMF), authorized the establishment of the International Financial Institution Advisory Commission. The commission's task: to review the effectiveness of the international financial institutions (IFIs), which include the IMF, the World Bank, and the regional development banks.

The commission was chaired by Allan H. Meltzer, an economics professor at Carnegie Mellon University and visiting scholar at the American Enterprise Institute. In March 2000, the commission sent to the Congress a report — approved by Meltzer and the majority of the commission members — sharply criticizing the IFIs and offering proposals for far-reaching structural changes in these institutions. Here, Meltzer outlines the commission’s majority conclusions and proposals.

The world economy and the international financial system are now very different from what was envisioned at the Bretton Woods conference in 1944, when the International Monetary Fund and the World Bank were established. These principal international financial institutions have responded to the many changes and crises in recent decades by expanding their mandates and adding new lending facilities and programs. New regional institutions, such as the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank, have opened to serve the needs of regional populations, but many of the activities of these agencies overlap with those of the World Bank.

In addition, two major changes have occurred in the international financial environment that require changes in the responsibilities of the international financial institutions. First, the fixed but adjustable exchange rate system adopted at Bretton Woods ended almost 30 years ago. Second, private financial institutions, corporations, and individuals in the industrial countries now supply the largest part of the capital flows to the developing world. The international financial institutions' share is now less than 5 percent of the total. Many of the poorest countries, however, remain dependent on the IFIs.

Major problems in the international financial system have followed these changes. Some countries have grown to rely excessively on short-term private capital inflows to finance long-term development, a very risky approach that has caused crises throughout history. Financial systems in developing countries too often have been
used to subsidize favored industries or individuals, weakening the financial institutions, eroding their capital, and increasing risks of crises and failures. Pegged exchange rates in many developing countries have made them vulnerable to speculative attacks. All these factors have helped create financial systems subject to frequent, severe crises.

Further, while the IFIs lend to governments, the institutions have very little influence over how the funds are used. Often, projects are not completed, funds are misappropriated, and promised reforms are not implemented. Instead of improving their own performance, the development banks have expanded their programs to overlap with the IMF. The reverse is also true. The IMF, founded to deal with short-term financial problems, now makes long-term loans for structural reform and poverty alleviation. Some countries remain permanently in debt to the IMF. Long-term lending should be left to the development banks.

NEEDED STRUCTURAL CHANGES

To restore the IFIs effectiveness, these institutions must undergo structural changes.

The proper role of the IMF should be preventing financial crises and the spread of crises that do occur. Crisis prevention does not mean that the IMF continues to "bail out" all lenders, or lends large amounts to maintain pegged exchange rates, or dictates the policies to be followed in client countries. The IMF should not lend to finance the structural reform of the recipient country's institutions. The Fund should give advice, but it should not tie the advice to assistance.

The mission of the development banks -- the World Bank and the regional development banks -- should be four-fold: promoting economic and social development (including the reform of domestic institutions), improving the quality of life, reducing poverty, and providing global and regional public goods. These institutions should not be banks in the traditional sense. Their job should not be to increase the number and size of their loans or to lend to creditworthy countries. It should be to advance development, not lending. Reflecting this, the names of these institutions should be changed from development banks to development agencies.

Steps also must be taken to address the "overlap" problem between the World Bank and the regional development banks. The World Bank has started to create field offices in loan-recipient countries. This is a waste of resources by an overly large and ineffective bureaucracy. The regional development banks already have offices in all of the relevant countries. Many governments and their constituents have closer ties of language, culture, and understanding to the regional agencies. Effectiveness would be improved, and costly overlap reduced, if the regional banks assumed sole responsibility for many of the programs in their regions. The World Bank's direct role should be limited to regions without a development bank and to Africa, where poverty problems are most severe and difficult to solve, and where the regional bank has less experience. The World Bank should continue to supply technical assistance and promote knowledge transfer in all regions.

PRE-CONDITIONS FOR IMF ASSISTANCE
The IMF needs to focus on four main tasks: crisis prevention, crisis management, improved quality and increased quantity of public information, and macroeconomic advice to developing countries.

Each of the serious crises since 1982 has its own special features and some common features. Before the crisis breaks out, investors begin to withdraw funds. The country often guarantees the foreign exchange value of the funds in an attempt to forestall the emergency. This postpones the crisis but does not prevent it. The IMF tries to help the country maintain its exchange rate by lending foreign currency to defend the exchange rate. The country may increase interest rates and promise reforms, but investors see increased risk. If the financial system depends on short-term capital inflow, it may collapse with the exchange rate. The most damaging crises are of this kind.

Not all crises can be prevented. However, the frequency and severity of crises can be reduced by reforming country and IMF practices to increase incentives for policies and behavior that enhance stability. The IMF should be a quasi lender of last resort, not first resort, providing liquidity when markets close. It should work to prevent crises, act to mitigate them, and leave structural reform and development to the capital markets and the development banks.

When countries face a crisis that requires IMF assistance, they need it quickly. To make this possible, countries should meet certain pre-conditions to qualify for the IMF aid. Then, when needed, the assistance should be provided immediately. This would end the existing process in which countries that need assistance have to wait while negotiators agree on a long list of conditions for structural, institutional, and financial changes. Crises worsen during these delays, and there is little evidence that conditions for disbursement of aid, imposed after the crises have begun, have helped much in the past.

The pre-conditions must be straightforward, clear, easily monitored, and enforced. The four most important are that the nation's financial system is adequately capitalized, that government financial policies are prudent, that information on the maturity structure of foreign debt becomes available promptly, and that foreign banks are allowed to compete in local financial markets. Member countries of the World Trade Organization have agreed to phase-in this last condition. I would add a fifth condition: that the exchange rate system be either firmly fixed or floating.

Countries would have strong incentives to meet and to maintain the pre-conditions. IMF acceptance of the country as pre-qualified for automatic assistance would serve as a seal of approval. The country would be able to obtain more foreign capital on more favorable terms. Countries that were not pre-qualified would get fewer loans and would pay higher interest rates to compensate for the additional risk. Pre-conditions would redirect private sector flows away from high-risk borrowers toward those that pursue stabilizing policies. This would reduce the risk in the entire system.

Third countries harmed by the collapse of a trading partner would automatically receive assistance if they meet the pre-conditions. Countries that do not meet the pre-conditions would receive IMF help only in a crisis that affected the entire
Removing structural reform from the IMF's mandate is based on a well-known proposition that money can solve liquidity problems, but not real structural problems. In developing countries, structural problems arise because of regulation, tariffs, inadequate financial supervision, absence of the rule of law, and other impediments to investment. As recent experience demonstrates, loans and liquid resources often allow countries to delay reform.

The IMF can help sustain market discipline through the publication of timely, accurate information on economic, financial, and political developments. Accurate information permits lenders and investors to make informed decisions. The IMF has a major role in improving the quality and increasing the quantity and timeliness of country data. Publication of reports of IMF missions and the IMF's recommendations is a welcome development. Improved information reduces uncertainty and improves lenders' decisions. Release of information encourages reform and permits investors to make continuous marginal adjustments instead of rushing to exit when anticipations change quickly. Further, improving information and opening the economy to foreign banks reduces reliance on renewable, short-term loans. Thus, it reduces one of the major problems of development finance: excessive reliance on short-term loans.

Another issue is "moral hazard," which arises in international lending when governments or IFIs permit foreign lenders to believe that they will be bailed out in a crisis. Part of the solution for reducing or eliminating moral hazard lies in letting foreign financial institutions compete in the local market. They would hold both assets and liabilities denominated in local currency, so they would be less exposed to exchange rate risk. An open financial system would encourage foreign entrants with a long-term commitment, thereby reducing reliance on short-term capital. And foreign banks would bring expertise in risk management and act as relatively safe havens if a crisis occurs.

A MORE FOCUSED MISSION FOR DEVELOPMENT BANKS

The development banks' main problems are that their programs lack focus, are often loosely related -- or unrelated -- to their stated goals, and all too frequently fail to accomplish their objectives. After decades of programs, many of the poorest nations have lower living standards than in the past. The fault does not lie totally with the development banks, but they have not found ways around the obstacles that some governments create. And they continue to lend despite the obstacles and the resulting failures.

Countries that have made substantial progress are those that have strengthened institutions and the role of markets; those that have not made these reforms have made little, if any, progress. Most of the very poor countries owe large debts to the IFIs that cannot be serviced or repaid. These debts need to be forgiven entirely, but only after countries implement reforms.

Changes to the development banks should focus on three broad areas. First, the development banks should work to improve the quality of life, even in countries
where corruption and institutional arrangements hinder or prevent economic development. In place of loans, the development banks should offer grants paying up to 90 percent of the cost of approved projects. To increase achievement and reduce waste, grants should be given after competitive bidding and should require independent monitoring and auditing of results. Payments should be made, after performance is certified, directly to suppliers instead of to governments. This would give the suppliers an incentive to assure that inoculations are made, potable water is supplied, sanitation is improved, and literacy rates are increased, and that these and other programs produce measurable results. Second, long-term subsidized loans to develop effective institutions would assist countries that willingly adopt and sustain the necessary reforms. Here, too, independent auditors must certify that progress continues. Third is the issue of global and regional public goods. Many problems that prevent development or reduce the quality of life are common to many different countries. The development banks have maintained a country-specific focus. They have not tried to find solutions to common concerns involving health issues, tropical agriculture, and many other areas. Research is costly, and individual market demand is too small to induce companies to do the research. By bringing countries together and subsidizing their joint research efforts, the development banks can close the gap between social and private rates of return.

Scarce official financial resources need to be concentrated on poor countries without access to alternative funds. Countries should graduate automatically and regularly from the development banks' programs. Graduation would release more money to help the poorest countries. The development banks should continue to offer technical assistance to countries that graduate, but these countries should borrow in the market and be subject to market discipline.

A CALL FOR REFORM

The international economy has experienced several prolonged, deep financial crises in the past 20 years. At the same time, economic development has bypassed the poorest countries. Many of them are in Africa, but extreme poverty can be found also in Latin America, Asia, and southern and eastern Europe.

Reform of the international financial institutions is needed to increase economic stability, improve the flow of information, encourage economic development, support institutional reform, reduce poverty, and support provision of regional and global public goods.

(Note: The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. government.)