Response to Professor Bird

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

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Published In
WORLD ECONOMICS, 1, 3.
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Allan H. Meltzer

Allan Meltzer replies to the criticisms made by Graham Bird in the preceding article Sins of the Commission. Although many would be shared by several members of the International Financial Institution Advisory Commission, the views expressed here are the author's.

I am grateful to the editors for offering the opportunity to respond, briefly, to Professor Bird’s scatter-shot criticisms of the Report (2000) of the International Financial Institution Advisory Commission that I had the privilege to chair. The international economy is very different from the world of (adjustable) fixed exchange rates and restricted capital flows envisaged by Maynard Keynes, Harry White and others who contributed to the design of the original system. The 50th Anniversary of the International Monetary Fund (IMF) and the World Bank passed without serious attention to the changes that are needed to adjust to a world of large capital flows and frequent crises.

The international financial institutions have changed opportunistically by responding to events. An issue before the Commission, the international financial institutions, and the member countries was whether the opportunistic changes left the institutions equipped to perform the tasks that are needed in the next twenty or thirty years. Can we prevent frequent, deep financial crises or reduce their intensity? Can we raise living standards for the poorest, sustain economic and social development where it is underway, and start development where it is not? How should we provide global and regional public goods?

That Professor Bird missed these main points of the report is beyond doubt. Virtually everyone, including the leadership of the IMF and the Bank, talk about the need for change. The Bank's President, James Wolfensohn, speaks about reform and new approaches at
almost every opportunity. He has even produced a grandiose but vague statement, called the Comprehensive Development Plan, which is long on the rhetoric of change but short on specifics and incentives. The IMF, for its part, is conducting a serious searching self-examination both of its mission and its operational deficiencies, in part a response to the Commission’s report.

Deficiencies, yes. One can read Professor Bird’s collection of criticisms without realizing that many of the poorest countries have not developed; they have retrogressed; that the development banks have done little to respond effectively to the spread of diseases in Africa, or to encourage the institutional reforms that the World Bank’s own research shows to be a necessary condition for economic development. The Commission heard testimony from practicing NGOs that potable water, sanitary sewers, and rudimentary education are lacking in large parts of the poorest countries. All this after decades of World Bank activity and billions of dollars lent.

Then there is Russia and the Ukraine where large loans to support reforms have achieved little good. Money disappeared; capital flight increased; poverty worsened; corruption increased. Promises of reform were given with each new loan, renewed when the loan was renewed, and broken between renewals. Reform and restructuring of socialist economies are new undertakings. It is an understatement to say that the IMF and the Bank were not equipped for the task and have not had much success.

Of course, all of these problems or failures are not caused by the IMF, the World Bank or the regional banks. Development does not occur where local leaders steal the borrowed money, where governments are corrupt, as in Mobutu’s Zaire, but also where local institutions are inadequate to run development programs.

The Commission members understand that these problems are not easily solved. They believe, however, that a different framework with new approaches was necessary, desirable, and would be more effective. The Commission concluded that a meaningful effort to improve performance should begin with an understanding of what succeeds and what does not. Studies of conditional lending, done at the IMF and elsewhere, show no evidence that the conditions imposed by the IMF have significant effects on living standards or speed of recovery. Certainly there are technical problems in
conducting studies of "conditional-ity", but it is striking how little empirical support the IMF can muster to show the effectiveness of its programs. The Bank does a less than adequate job of measuring its performance and the effectiveness of its programs. On this point, the Commission and President Wolfensohn agreed on the public record.¹

The IMF

Professor Bird quotes the report's criticism of the IMF. "The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its advice often incorrect." Commission (2000, pp. 5–6). He offers no evidence to refute these charges, and he seems unaware that since 1982, one financial crisis has followed another, that recent crises have threatened the stability of the global financial system, and that many of the citizens of countries like Mexico, Thailand, and Indonesia live at a lower standard now than ten or more years ago.

¹ See the Commission's hearings for February 2, 2000 at: http://phantom-x.gsia.cmu.edu/IFIAC

Did the IMF have a large role in the post-crisis recoveries? The answer is mixed. The Brady plan ended the Latin American crises. Devaluation and massive net imports by the United States contributed greatly to restore growth in Asia. The result is a large US current account deficit, currently more than $400 billion at annual rates. Until the deficit is reduced, it is too early to conclude that the crisis will not return, perhaps in a new form.

Bird takes little note of these problems. Like some of the less astute journalists, he describes the report as an attempt to return to the IMF's original mission. That mission was to maintain a system of adjustable, pegged exchange rates by facilitating lending from surplus countries to deficit countries. A reader of the Report should know that the majority opposed pegged rates. No one proposed or even mentioned returning to the old system.

Later, Bird charges that the Commission did not understand that capital markets are imperfect. Why, then, did we emphasize the need for greater transparency, improved information, including publication of IMF country (Article 4) reports? If loan markets are perfect, why have an IMF or World Bank except to give advice and
technical assistance? Indeed, why have them at all? The advice could be purchased in a perfect market for information. Contrary to his claim, the bipartisan majority view was that the IMF (and the development banks) provide public goods, but they can and should improve their performance.

The bipartisan majority concluded that the principal public goods that the IMF should provide are: (1) greater financial and economic stability, (2) improved information to help lenders make better decisions, and (3) advice and technical assistance so that developing and emerging countries can benefit from research and experience elsewhere. To achieve these public goods, the Report relies heavily on incentives within the country and on its leaders in place of restrictions imposed by international agencies. The Commission was skeptical that even the most able public servants can successfully administer 50 or 60 country programs, as the IMF tries to do.

The interested reader can find all of this in the report, so I will address only one feature of IMF reform that may be obvious to many but is not explicit. In contrast to the present system with main emphasis on crisis management and direction from Washington, the Commission opted for greater weight on crisis prevention.

All crises cannot be prevented, but incentives for crisis avoidance can be improved. The Commission concluded that there are three principal reasons financial crises have become larger, more frequent, and more widespread: (1) weak financial systems; (2) pegged exchange rates; and (3) the long delay between the beginning of a crisis and the beginning of assistance. The delay is caused by the long list of "conditions" that a country is forced to accept before the IMF lends money.

The Commission's recommendations proposed to make lending automatic for countries that meet four pre-conditions. Bird missed the role of the pre-conditions. They give the country an incentive to reform. Instead of relying on ex-post conditions that countries often do not meet, the Commission opted for a system of incentives that encourage countries to choose reform in their self-interest.

Consider what would happen if the pre-conditions become a requirement for automatic assistance. There would be two lists—countries that met the pre-conditions and those that did not. The first group would obtain more capital at a lower interest rate. The second would get less capital at
higher cost, reflecting the greater risk. Since capital markets annually provide 50 to 100 times the amount of lending by international financial institutions, countries that want to attract capital would have strong incentives to meet the standards. If they failed to meet the standards after five years, they could not expect assistance. Those who lend to them would then know that they are making risky loans and that they must bear the risk they undertake. Third countries would be assisted under the majority proposal.

The development banks

The World Bank does a poor job of reducing poverty or supporting development. About 70% of its loans go to eleven middle-income countries. All of these countries borrow in the capital markets.

Since money is fungible, the Bank usually cannot know how the funds are used. Countries have an incentive to offer projects that the Bank will support and subsidize. Many of these projects, possibly all, would be financed in the capital markets if the governments of these countries gave the same guarantee to private lenders that they give to the Bank.

Countries with investment grade ratings and large holdings of foreign exchange, like China, can finance any poverty or development program they choose. Such countries should continue to receive technical assistance, but the development banks’ limited resources should support effective programs in countries that are poor and do not have access to capital markets. The majority favored restricting loans and grants in this way.

The Commission concluded that the development banks should provide three public goods: (1) grants to improve the quality of life, (2) subsidized loans to encourage institutional changes that facilitate development, and (3) loans to support provision of global or regional public goods. The Report proposes policies to reduce theft and corruption, increase effectiveness and accountability, and improve incentives.

Professor Bird dismisses these proposals as “unscientific” and “intemperate”. It is clear that he failed to recognize both the logic in the Commission’s recommendations and the need for change.

Conclusion

There is a striking difference between the responses by Bird and the IMF. The IMF has accepted the Commission’s main recommendations. Although details differ in
important respects, there is no doubt that the IMF has moved in the direction that the Commission recommended and is considering additional changes.

The IMF’s Deputy Managing Director Sugisaki wrote:

This core activity [surveillance] has been transformed significantly since the Asian crisis. The focus is now on codes and standards—relating to financial sector soundness; transparency in fiscal, monetary, and financial policies; data provision; and corporate governance—to guide the conduct of economic policy in a variety of areas...

[The IMF, together with the World Bank, has embarked on an ambitious Financial Sector Assessment Program to assess financial sector vulnerabilities as well as observance of financial system standards.

Sugisaki (2000, p. 215)

Sugisaki concludes: ‘Clearly the long-run goal must be to ... encourage countries to move toward sustainable access to and reliance upon private capital.’ Sugisaki (2000, p. 216)

In place of “standards” read pre-conditions for loans. The IMF has also committed to higher interest rates, as the majority recommended, although it is unlikely to adopt a true penalty rate. It has moved toward greater transparency of its own and its clients’ financial position. Article 4 reports will be published.

Release of information is critical; improvements in the quality of information are essential. Development of the world economy is fostered by the flow of capital from surplus to deficit regions, but market efficiency must be improved. International institutions have an advantage in improving the quantity and quality of information about borrowing countries.

In a world with fluctuating exchange rates, or hard-fixed rates, and greater financial stability, crises will be less frequent and less severe. The important public good that the IMF can supply is more and better information.

More could be said in reply. It would only reinforce what should now be clear. There is agreement between the Commission and the IMF on the direction that reform should take, on pre-conditions for lending, on the need to improve data collection and dissemination of information, and on higher interest rates for IMF loans. I do not suggest that there is complete agreement. For current purposes, it is sufficient to note that the Report has a coherent framework, that readers can find it, and that, if adopted, the proposal would create...
a different IMF for the year 2000 and beyond.

The World Bank and the development banks have shown less interest in responding to the Commission’s report. Given their poor record of achievement and the absence of coherent focus, it is likely that taxpayers in many countries will begin to question why so little is accomplished in the poorest countries, why so much money goes to countries that can finance their own development and so little to those that cannot, why almost all funds go to country-specific projects when so many problems are transnational, regional, or global.

Perhaps with this guidance, Professor Bird will be able to see what others have found.

References

