The International Monetary Fund
Two Years After the IFIAC (Meltzer) Commission

by Allan H. Meltzer
the Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University and Visiting Scholar, American Enterprise Institute

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Mr. Chairman you, your colleagues and staff have played a major role in reforming and improving the operations of the International Monetary Fund (IMF) and the development banks. By insisting on greater transparency, increased accountability and improved performance, you have rendered a great service to the American public and the people in the developing countries. Your efforts have not only saved taxpayers money, they have raised standards of accountability for performance. I am pleased to have been part of that effort, an effort that is continuing and has the support of the Bush administration, Treasury Secretary O'Neill and his principal staff.

Today, we recognize the second anniversary of the commission report. My colleague Adam Lerrick and I have divided the review of the past two years and prospects for the future into two parts. I will discuss the IMF, and he will discuss the development banks, particularly the World Bank.

What Was and Was Not Done

The Commission proposed four kinds of changes at the IMF. First, it proposed improved transparency and information to permit outside observers to better understand what the IMF had done, what it recommended and what resources it had available. Before this Committee took an interest, even a trained accountant would have difficulty interpreting the IMF's financial statements. The Commission developed a balance sheet that the IMF adopted. Its accounting statements became less opaque. Reports of IMF surveillance of a majority of member countries, so called Article IV consultations, are now routinely posted on the IMF's website along with a lesser, but still substantial, number of staff reports. Improved quality and increased quantity of information helps markets to operate more efficiently and reduces risk. However, the IMF has not restructured accounting in the SDR department, and many countries have not improved the quality of their data. The IMF should do much more to get countries to improve data quality and to release it.

Second, the Commission found considerable overlap between the programs of the Fund and the development banks. It criticized the overlap and the large number of conditions that the IMF negotiated with borrowers, particularly borrowers in crisis. The IMF reduced the number of programs and the number of conditions attached to loans. It now limits conditions to matters directly related to the country's problem.

The Meltzer Commission proposed that troubled crisis countries should not look to the IMF to provide a reform program. Reform has a much better chance if the country adopts and implements its own choices of policy reforms. Management of the economy should remain in local hands. The IMF should confine its role to seeing that the promises are kept and that its loans are used effectively, not squandered on wasteful expenditures, paid to creditors, or used to support the exchange rate.

The IMF has now moved in this direction. A senior IMF official recently said:

> "The main aim is to have a minimum amount of conditionality that enables countries to meet these goals. …
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> How can these goals be achieved? … The IMF needs to be more flexible, not dictating to a country what policies are needed. The country should be allowed to present a program to the IMF. There has to be broad participation in the discussion of policies in the country. And the IMF needs to be selective, patiently waiting for the country to be ready. Already, there are promising signs. The streamlining process is under way, and collaboration with the Bank has been strengthened."[1]

The IMF did not eliminate all duplication. The poverty reduction and growth fund, PRGF, continues. IMF management is sensitive to criticisms about the effect of disinflations on the poorest citizens of countries in adjustment. It does not want to give up poverty relief so that it can temper its macro policies with policies to help the poor during the transition or recession. I believe it does not have enough confidence in the development banks to relinquish PRGF programs to them, where they belong. Increased effectiveness of the development banks would help to make the case for closing the IMF's PRGF program and restricting the IMF to its principal functions: providing information, creating incentives that reduce the number, frequency, depth and virulence of financial crises, assisting governments to resolve crises, and preventing the spread of crises that occur.

[1] "IMF Conditionality: How Much is Enough? IMF Survey, 31 (January 14, 2002), p. 14.

Third, the Commission urged the IMF to phase in over five years an incentive system that induced countries to adopt prudent policies that reduced the risk of financial crises. We proposed a small list of observable, prudent policies (pre-conditions) that, if adopted and maintained, would obligate the IMF to assist the country when it faced a financial crisis.

The great advantage for the country of adopting pre-conditions is that, the IMF's commitment to assist in a crisis, and its monitoring, increase lenders' confidence that the country maintains prudent policies. Pre-conditions in place would act like a good conduct badge. The country would get more capital from the market at lower cost. This would foster development and reduce debt burdens.

IMF senior officials accept this idea. They have proposed a contingent credit line (CCL) to implement the proposal. Unfortunately, no country has agreed to join. I believe there are two principal reasons. First, the IMF bureaucracy will not offer automatic assistance to countries that join. Second, until very recently, all countries received assistance, so there was not much reason for lenders to favor countries with more prudent policies over countries that were riskier. The market does not lend to the poorest countries, with little prospect of repaying loans. But, as Argentina, Ecuador, Russia, and Indonesia have shown, the market has provided large loans to risky borrowers. Now that the IMF has not bailed out creditors of Argentina and others, I expect more discrimination by private lenders and more caution. Lenders who made "moral hazard" loans, expecting to be rescued by the IMF and the G-7, will improve their monitoring and demand better policies by borrowing governments.

If this proves to be correct, borrowers' incentives for prudent policies will be strengthened. More countries may willingly adopt more prudent policies and join an improved CCL. A critical condition is that incentives work both ways. Countries with imprudent policies should not get IMF assistance in a crisis once a five-year phase-in is completed.

Fourth, the Commission urged the IMF to improve crisis management by making different responses to prudent and imprudent lenders. The majority proposed that the IMF restrict its aid to two kinds of countries: those with prudent policies and those countries threatened by the policies and practices of imprudent neighbors and trading partners.

As Argentina moved toward crisis, the IMF approved a stand-by loan to Brazil, a country currently with responsible monetary and fiscal policies, that seemed to be injured by Argentina's decline. After mistakes in December 2000 and August 2001, the IMF stopped lending to

Argentina. Instead of offering Argentina a large loan with many conditions based on empty promises, the new IMF insisted on a coherent, consistent plan developed, adopted and implemented by the Argentine government. It has refused to finance Argentina's budget deficit or the bailout of international and domestic creditors. It has not provided additional billions to support an overvalued exchange rate or to finance capital flight.

If the IMF withstands the pressure to throw in more money, moral hazard will be reduced. Lenders will expect to bear losses, if they make risky loans. Countries that want to borrow to grow will have much greater incentive to adopt prudent policies, to rely more on foreign direct investment and less on short-term borrowing. They will invite foreign banks into their country and strengthen domestic financial institutions. The risk of crises will decline.

What Remains to be Done?

In the last decade, the global economy experienced severe crises in 1994-95, 1997-98, and 2001. This alone tells us that the system was not working well. Tens of billions in emergency loans attempted to stem the crises. In many of the crisis countries, the banking and financial systems collapsed, the exchange rate went into free fall, unemployment rose as output fell.

Argentina, the latest crisis country, has one of the most severe crises. Unemployment rates will reach 30% of the labor force or more. That is worse than the worst year of the Great Depression in the United States. Mistaken policies have paralyzed economic transactions and bankrupted financial institutions.

The main problem with bailouts is that they cover over today's problem but encourage a larger problem somewhere else. Twenty years of bailouts and conditional lending have failed. The crises have become larger. The promises to meet conditions are kept infrequently.

This should not come as a surprise. The system of conditional bailouts and conditional lending relied on command and control. Countries had good reason to promise reforms, but few incentives to carry them through once recovery was underway. Lenders came to expect that the IMF and the other international financial institutions would not just bail them out. They would reward them with higher interest rates and fees for renegotiating and extending the maturity of their debt.

We have started to replace command and control with incentives for lenders and borrowers. If we continue on this path, with patience and conviction in the face of pressures, we will achieve a better system. Lenders must have incentives to use the improved information that the IMF now provides to study the risks they have taken or are about to take. Borrowers must have heightened incentives to adopt and maintain prudent policies. Rapid support for countries that meet pre-conditions provides the incentives.

Some critics of the new policies assert that markets have failed, that openness, privatization and market incentives have been tried and have failed. This is a peculiar claim. It ignores such successes as Chile, China, Korea, Mexico, Poland, Taiwan and many others. It fails to mention that Argentina's problems are not novel. Their economy is barely open to trade. Their markets continue to suffer from the rigidities adopted by Juan Peron's governments. There can be little budget discipline until there is a financial responsibility law that restricts provincial spending. Argentina's exchange rate was overvalued, its budget in deficit. The current government has no plan as yet to restore economic activity without inflation.

Argentina journalists ask me repeatedly, what does Argentina have to do to get IMF assistance. President Bush, Secretary O'Neill, Mr. Koehler, Managing Director of the IMF, and many others have answered that question repeatedly. Argentina must come forward with a consistent, coherent plan that restores growth without inflation, increases productivity, and settles its defaulted debt.

Policy toward Argentina is an abrupt change from past policies. Having embarked on a new and better course, the IMF and the G-7 must not go back to the old ways.

We are in the early phase of a transition to a safer, sounder international financial system based on proposals for reform that this Committee and our Commission brought to public attention. Lenders now have reason to recognize the risks in lending to developing countries and therefore to be more prudent. Borrowers now have reason to recognize that excessive borrowing or imprudent behavior is costly to their country and, because they may be dismissed from office suddenly, to them personally. Recognition of the true risks and costs on both sides will do much more than so-called Basle standards to reduce moral hazard, promote more orderly development lending, save the taxpayers money, and reduce the frequency of crises and tragedies in developing countries.

With your support and the continued support of the new administrations at the IMF and the U.S. Treasury, we will achieve that safer, sounder system.