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MELTZER REPORT MISSES THE MARK Commission's recommendations for World Bank, IMF need further consideration

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What should the global financial architecture look like, and who should be playing a role in shaping it? Discussions over these two questions heated up when the International Financial Institution Advisory Commission released its final report last March. The commission, headed by Carnegie Mellon University professor Allan Meltzer, was created by Congress in the fall of 1998 as part of its \$18 billion International Monetary Fund (IMF) finance package. The primary task of the commission was to consider the future roles of seven international financial institutions, especially the IMF and the World Bank. Although the commission's report was approved by the majority of its members, four members issued a statement of dissent.

The commission's majority report should be seen as a chance to push ahead with the debate over the future of the global financial architecture. Particular attention should be given to determining what kind of global financial framework would lift most people's living standards and what role international financial institutions like the IMF and World Bank should play in that framework.

Three issues in the commission's report – debt forgiveness, capital controls, and development policies – warrant further consideration. The first of these involves debt forgiveness. The commission agrees that debt forgiveness for highly indebted poor countries (HIPC)s should be one of the first steps in reforming the global financial system. While this is certainly laudable, the commission's majority wants to attach unacceptable conditions to debt forgiveness. As for the second issue – capital controls – the commission does not seem to recognize these as useful public policy tools, but its recommendations, when examined closely, are contradictory. The final issue involves the parameters of the development debate, which the commission defines too narrowly. The commission encourages fiscal and monetary restraint and financial deregulation – which have been shown to be harmful to working people – and continues to ignore the growing criticism of increased labor market flexibility that has also hurt workers. Its proposal for a new structure of the World Bank is bound by a similar narrow mindedness – while the commission advocates a shift in emphasis at the World Bank from lending to grant giving, the commission expects the World Bank to attach conditions to these grants that, in reality, are untenable.

Debt forgiveness

As for the first of these issues, the commission reached unanimous agreement: the debt of HIPC's should be forgiven. But how this debt should be forgiven was a point of contention among the commissioners. The commission's majority attached strict conditions that offset and undermine its value to poor economies. The commission's majority recommended that debt forgiveness be conditioned on countries adopting fiscal restraint, capital account liberalization, and flexible exchange-rate arrangements or currency boards. These conditions would also logically require monetary restraint and financial market deregulation. Dissenting opinions within the commission itself point out that such an arrangement would make only the HIPC's subject to the proposed debt forgiveness conditions. Furthermore, there is a history of strong criticism of the IMF's and World Bank's labor market policies, reiterated in American University Professor Jerry Levinson's separate dissenting statement (Levinson 2000). Although the majority's report briefly acknowledges these criticisms, it fails to meaningfully address them. This obvious omission would seem to indicate that the majority implicitly endorses increased labor market flexibility as part of effective development policy.

Unfortunately, all of these policies are harmful to the poorest countries. Pro-cyclical macro policies hamper growth and aggravate the burden of business cycles. Similarly, several researchers have identified financial market liberalization as one of the root causes for the increased frequency of currency crises. As much as the commission has done to push the envelope on debt forgiveness, attaching it to harmful policies makes the recommendation a damaging proposal for public policy.

Capital controls

Capital controls are a useful public policy tool. Even the IMF, which still champions capital account liberalization, has acknowledged the importance of capital controls – under certain circumstances – in its own recent study on 14 developing economies (Ariyoshi et al. 2000). It is understandable that some countries may want to use capital controls to maintain control over their own economic policies and to protect themselves from the vagaries of global financial markets.

But free capital mobility limits countries' ability to use this policy tool for long-term projects or for socially desirable issues. One example can be found in France, where the government, under pressures from international capital markets, had to abandon its attempts to use expansionary fiscal and monetary policies to fight unemployment in 1982.

Short-term capital flows – better known as “hot money” – have been identified as one of the major causes of economic instability in developing economies. The fact that short-term lending has often resumed quickly after an economic crisis clearly testifies to the need for capital controls on “hot money,” as recent history illustrates. After a year of capital outflows in Mexico, international investors loaned it \$1.3 billion in short-term loans in the fourth quarter of 1995, less than a year after its crisis. These short-term loans continued to increase through the third quarter of 1996, amounting to a stunning \$8.3 billion in that quarter alone. Similarly, short-term loans to Korea resumed about a year after its crisis, with \$1.3 billion in the third quarter of 1998 and \$2.8 billion in the first quarter of 1999, thus reaching almost pre-crisis heights. There is no reason to believe that this “hot money” won't leave the economies in question any less vulnerable to short-term withdrawal than a few years ago.

By slowing capital inflows with the help of capital controls, countries can reduce the pool of funds that can flee at the first signs of trouble and thereby precipitating a crisis. Thus, the commission should have given more consideration to the role of capital controls, especially since its own thinking on capital controls seems internally

contradictory. Evidence of these incompatible policy proposals can be found in its recommendations for the IMF and the World Bank, as the commission's proposal for each institution implicitly requires different approaches to capital controls.

The IMF proposal requires reductions in capital controls. To pre-qualify for IMF stand-by facilities, countries need to allow for the free entry and operation of foreign banks. Similarly, the commission recommends that client countries establish fully flexible exchange rates or currency boards. The commission calls for these extreme choices – either entirely fixed or fully flexible exchange rates – because they are immune or respond instantaneously to large swings in capital flows. However, in economies with capital controls in place, capital flows have less impact on exchange rates and the choice of a regime is less of an issue. Thus, the recommendation for an exchange rate regime only makes sense if capital controls are expected to be reduced.

The need for an IMF as lender-of-last resort would decline if capital markets were more regulated and capital controls were used more effectively. The report, however, seems to accept the view that markets, especially capital markets, are efficient, and that capital flows will take capital to where it is most productive. Hence, opening borders and letting private investors decide what projects are most efficient will enhance global competitiveness and make everybody better off. With this line of reasoning, labor and environmental standards are seen as barriers to capital mobility and thus counter to economic efficiency.

But in reality, investors may not invest in the most efficient projects. Investors may disregard productive investments if there is more money in speculation. The disruptive effects of speculative investments have been felt by Turkey in 1994, by Thailand, Malaysia, Indonesia, and Korea in 1997 and 1998, and by Russia in 1998. These are not isolated events. An IMF study in 1996 reported that two-thirds of IMF member countries experienced serious banking-sector problems between 1980 and 1996 when capital markets became more liberalized (Lindgren et al. 1996). Similarly, in a summary of recent studies on capital mobility, Blecker (1999) finds that, at least for developing economies, there is strong evidence that increased capital mobility raises the chance of crises. Weller (1999) also found that countries become systematically more susceptible to crises after financial market deregulation. In other words, the IMF recommendations for less capital controls are partly responsible for the increased frequency of crisis. More capital controls – at least on short-term capital – would increase financial stability and reduce the need for the IMF to serve as international lender-of-last-resort.

On the other hand, the commission's proposal for the World Bank implicitly requires some capital controls in order for it to work properly. Openness to international capital flows constrains a nation's sovereignty in designing economic policies,¹ making it difficult for countries to make the massive, long-term public expenditures necessary to pursue the worthwhile development programs that the commission recommends, such as vaccines, public health, AIDS research, education, or infrastructure improvements. But given the current situation, capital markets are likely to interpret the resulting budget deficits as a bad sign and force governments to scale back these efforts. Ultimately, for the commission's recommendations for the World Bank to work, capital controls are needed (even though the commission never explicitly says so).

If the commission simply accepted the idea that capital controls can be good economic policies, the debate could move forward. The focus of the debate could turn to identifying those capital flows that are the most beneficial for the recipients, and how capital controls can be designed to allow necessary capital to flow into these economies while keeping harmful "hot money" from disrupting them.

Toward a development alternative

One of the benefits of capital controls is that they provide countries with more leeway in designing their own

policies. Once short-term capital flows are under control, developing countries could then focus more on internal development.

To wean domestic borrowers of international capital, domestic financial institutions should be strengthened. Part of Japan's success during its high-growth era was based on its ability to channel deposits into large development projects via its postal savings system. The Meltzer commission, though, relies on foreign banks as the main mechanism for domestic financial market development. Research, however, has shown that increased international competition actually results in a reduction of the credit supply in developing economies (Weller 2000a, 2000b). Small and medium-sized enterprises, start-ups, rural producers, and low- and middle-income households will experience more financial constraints than others if international competition in domestic financial markets is strengthened.

More importantly, if foreign direct investment is given priority over domestic development in creating viable financial markets, the need for international capital will continue, as large sectors of the economy will remain underserved by financial institutions. Thus, developing economies will have to continue to borrow on international capital markets, which will likely result in export-led growth strategies to repay international debts. These strategies, in turn, encourage environmentally harmful and unsustainable economic policies. Developing economies should instead focus on strengthening their own financial institutions, which would reduce the need for more international capital.

Second, a framework for sustainable development should include strong labor market institutions. To the detriment of workers around the world, the commission's report implicitly accepts the IMF recommendation of greater labor market flexibility. Yet, even the World Bank reported in its 1995 *World Development Report* that countries that allow for more worker involvement have higher growth rates. Similarly, in a speech in January 2000, then-World Bank chief economist Joseph Stiglitz recommended improvements in labor relations and the promotion of core labor standards as the basis for democratic economic development.

Redesigning the international financial institutions

The IMF and World Bank have been criticized for their mishandling of financial crises and the ineffective design and implementation of development projects, providing an impetus to reform these and other international financial institutions (IFIs). Fortunately, the issue is no longer whether, but how these institutions should be reformed.

New and improved IFIs are needed, requiring a reconsideration of the IMF and World Bank's policies and operations.

To make funding more appropriate to the task at hand, namely to improve the living standards for working people in countries around the world, the policies of the IFIs should be changed. These policy changes include:

- providing more grants and less loans, which would give recipient countries less incentive to raid their environment and exploit their workers to repay international loans;
- encouraging internal development over dependence on external capital flows;
- encouraging and providing assistance in the design and implementation of effective capital controls;
- requiring adherence to labor and environmental standards by international borrowers or grant recipients. International Labor Organization certification of labor standards, for instance, could become a condition for receiving IFI grants or loans.²

Changing the policies of the IFIs is one thing, external accountability is yet a separate issue. The external account-

ability of the IFIs could be increased by making policy decisions more public than in the past. Greater transparency of IMF and World Bank operations is a useful tool once appropriate policies have been identified and it has been determined to whom the IFIs should be accountable. Thus, the IFIs should create or improve mechanisms for consultation with and accountability to all relevant groups in the countries that will be affected by their policies. Labor unions and NGOs seem natural partners in increasing the external accountability of the IFIs.

Simply changing IFI policies without increasing these institutions' accountability to a broader share of the population will do little to universally improve living standards. Once external accountability of the IFIs is increased, a new policy orientation is likely to benefit everybody and not just financial investors.

Endnotes

1. For a full discussion of factors that constrain interest rate policy under capital mobility see Blecker (1999, 20-5). Similarly, research suggests that there are hints of the constraining effects of capital mobility on fiscal policy, even though the impact seems to be more erratic than for interest rate policy (see Blecker 1999, 25-31).
2. Levinson (1999) proposes using the ILO labor rights certification process when the United States considers giving countries trade preferences.

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