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Comments on the Meltzer Report: Can Public-Sector Foreign Debt Alleviate Poverty?

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(Note: All page references are to the Meltzer Report.)

1. The US Congress established a commission to do a six-month quick, relatively inexpensive study of several international financial institutions (IFIs) but mainly the IMF and World Bank. Allan Meltzer, an excellent, experienced macro economist headed the commission and issued the Meltzer Report on March 8 2000 (to see the report, go to my web page, http://www.erols.com/rmyers1 and click on the link). Below I set out some specific observations on the report as it applies to the IMF and World Bank. Overall its recommendations are good but so weakly supported that it is easy to dismiss. However, the report's impact would be considerably increased if more money were allocated to enable the provision of conceptual bases to support the report's recommendations. **Two recommendations, that the IMF lend short for crises only and that the World Bank drastically cut lending in favor of (much smaller) grants[1], are particularly good.** My comments are organized around six conceptual areas in the Meltzer Report. Following these is a seventh section with a personal recommendation regarding the World Bank that stems from the Meltzer Report. I then present five short points about the report, followed by a set of overall conclusions.

2. **I. THE SIGNIFICANCE OF PRIVATE, COMPETITIVE ENTERPRISE.** The commission failed to establish and defend clear benchmarks, or success criteria, by which to judge the performance of the IMF and World Bank. The commission made several fundamental assumptions related to this, but neither states nor defends them. The commission should have clearly stated that sustainable economic growth is the same thing as growth in private, competitive investment/employment and also that the pattern of this growth will exhibit both a trend and departures from this trend. A negative departure or recession/depression constitutes a crisis. The commission recommends that under certain conditions these crises should be the responsibility of the IMF only (not the Bank), **but it doesn't establish intervention criteria.** Regarding the World Bank, the commission recommends that it should be responsible for BOTH raising the private sector growth trend for poor countries AND reducing poverty in those poor countries. The commission would undoubtedly agree that poverty decreases when there is simultaneous growth in employment and labor productivity in competitive market settings. However it does not, as it should have, **establish growth in private employment and productivity as a major criterion by which to judge the Bank's performance.**

3. **II. MONEY FLOWS VERSUS POLICY & KNOWLEDGE?** The IMF and World Bank sell themselves as providers of expert, completely objective policy advice

[1] It is important to realize that giving grants, particularly if they are to go to non-governmental recipients, requires changes in, or liberal re-interpretations of, the World Bank's Articles of Agreement.

and knowledge, but their client countries see them as providers of wads and wads of cash ("free money"). Virtually every IMF and World Bank study of effectiveness focuses only on the impact of their policy advice. The studies completely avoid assessments of the impact of the associated money flows. Thus, no IMF or World Bank self-assessment would be able to conclude, for example, that advice regarding the establishment of competitive financial markets is completely offset by associated money flows that go to monopoly banks. The commission is clearly aware of this problem, but it does not overtly recommend that the IMF and World Bank explicitly and transparently consider the impact of the money flows they initiate. For instance, the commission could have stressed that these institutions provide explicit rationales, in terms of the likely effects on market incentives, for the size and direction of each money transfer operation. An example of the importance of this issue can be seen in the short piece entitled, "The World Bank and Joe Stiglitz vs. Relevance" on my web page (http://www.erols.com/rmyers1)

4. **III. WHAT'S A CRISIS AND HOW BIG IS IT?** The Meltzer Report recommends that the IMF make only short-term loans, only for certain crises and that the World Bank should completely stop all lending for crises. Both of these recommendations are excellent. Unfortunately, because there is no guidance regarding what is and is not a crisis, these recommendations are mainly sterile. Furthermore, the commission gives no meaningful indication of how to determine the dollar value of crisis loans (see p. 47 for an incorrect suggestion). Economists tend to use combinations of words such as, "financial" and "real," "trend lines" and "shocks," and "permanent" and "temporary" to delineate different types of crises. Identifying the type of crisis helps determine criteria for lending and the appropriate loan size. It appears that the Meltzer Commission is mainly concerned with IMF lending for temporary financial shocks, events that are poorly defined and difficult to recognize. However, more time and resources are needed before it is possible to explicitly delineate intervention criteria for the IMF and the methodology for calculating the appropriate monetary volume or size of each IMF/World Bank loan for each client country. Given this shortcoming, this recommendation will most likely result in little change. Perhaps its major impact will be that the word "crisis" will no longer appear in any World Bank reports, but will appear multiple times in every IMF report.

5. Prohibiting the World Bank from lending for crises would markedly reduce excessive lending by the World Bank. It is probable that in the 1994-99 period over 50% of the lending operations proposed to the Bank's Board used some sort of crisis as their rationale. The word "crisis" is used repeatedly in a much higher percentage of lending documentation. The Meltzer Report makes it clear that its concern is "financial" crises. Unfortunately, this leaves ample scope for the World Bank to continue to lend for all other sorts of crises, despite the fact that subsidized, long-term World Bank lending is inappropriate, even welfare reducing, for virtually all types of economic and financial crises. A recent, particularly pernicious World Bank initiative is lending for disaster relief (Turkey in 1999). The financial costs and disincentive effects of such lending diminish, or even prevent recovery. It is not clear that the Meltzer Report would proscribe this type of lending.

6. **IV. POLICY-BASED (ADJUSTMENT) LENDING SHOULD CEASE.** The commission is clearly weary of adjustment or policy-based lending, but doesn't recommend that it be discontinued altogether. It recommends that the IMF not do it ("The current practice of extending long-term loans in exchange for member countries' agreeing to abide by conditions set by the IMF should cease." p. 43), but then undoes this with a series of specific suggestions regarding desirable policies. For example, that the IMF should establish a, "…proper fiscal requirement…" (p. 45). For the World Bank, the commission endorses policy-based or institution-building lending to poor countries only, although accompanied by independent monitoring or auditing (p. 93) so as to insure loan quality. My work in the Bank's Operations Evaluation Department (OED), supplemented with straightforward deductive logic, suggests that there is no such thing as a satisfactory/sustainable policy-based lending operation. Empirical (David Dollar) analyses suggesting positive effects due to adjustment lending are invalidated by enormous variations in the meaning of dependent and independent variables such as "satisfactory/sustainable" and "adjustment operation." In fact, prospective policy-based lending operations will continue to cause opportunity losses as compared to other adjustment alternatives not involving lending.

7. A crucial problem with policy-based lending is that, unlike IMF lending for shocks, there is no way, even conceptually, to determine the appropriate size or dollar amount of an adjustment operation. To some, myself included, this is a definitive shortcoming. Although not the only reason, it alone is sufficient to destroy the intellectual integrity of policy-based lending. The commission is silent on this as it applies to the development banks. However, discomfiture may have led it to recommend **a significant switch from lending to grants,** even though a different rationale for the grant recommendation is offered (p. 91).

8. **V. CORRUPTION AND CREDITWORTHINESS.** The commission was obviously concerned that IMF and World Bank lending contributes to (provides finance for) corruption (p. 20), but it doesn't take on the issue. The commission ties itself in knots by asserting that targeting lending is useless because money is completely fungible (p. 86). That is, that lending targeted to finance particular expenditures may not finance them, but instead may end up elsewhere, including in officials' pockets. Curiously, the private sector seems to reduce the fungibility of money by effectively targeting it. Studies suggest that corruption flourishes when private income-earning opportunities are constrained (e.g., by governments) and when there are relatively large amounts of "rent" floating around. Rent is money that is not clearly earned and owned. It is obtained without contributing to the production of goods and services, usually from public sector taxes and borrowing (i.e., from the IMF and World Bank) or from monopolies or from indirect or untargeted subsidies which don't stimulate socially productive behavior.

9. The above suggests that the key to reducing corruption, and the likelihood that IMF or World Bank loans finance it, is to **transfer money only into productive and competitive situations in which income-earning opportunities abound**, or in other words, only into **situations of good creditworthiness.** In order to avoid financing corruption or excessive consumption, the lending must either directly or indirectly

(through appropriate government expenditures) stimulate productive (developmental) behavior. That is, be transferred into situations in which incentives are such that borrowed money will be invested. Such lending is conceptually appropriate for the IMF in instances of temporary negative shocks, **primarily to prevent contagion.** However, the commission seemed to feel, correctly in my view, that only private commercial banks, not the World Bank, should lend in situations of good creditworthiness. The rationale for this is a good one, involving a moral hazard: Subsidized, public sector World Bank lending can corrupt the competitive commercial atmosphere and reduce creditworthiness.

10. The commission saw a conundrum: World Bank lending should not be directed into situations of good creditworthiness, but lending into situations of poor creditworthiness will likely finance corruption. The appropriate conclusion to draw from this is that the World Bank should stop lending altogether. The commission moved a long way toward this position with two recommendations. One is to phase out World Bank lending to creditworthy countries and/or to countries with per capita income levels above an arbitrary level (p. 87). The other is to stress the transfer of grants, not loans for the very poor, supposedly not creditworthy countries. Unfortunately, the commission eschewed logic in recommending that the World Bank continue to provide subsidized lending, "…for institutional reform…" to poor countries that are presumably not creditworthy (p. 93). In doing this, the commission has endorsed business as usual at the World Bank and consigned poor countries to continued poverty and corruption.

11. The mistake the commission has made is to treat public and private sector debt similarly and to assume that private borrowers in poor countries can not possibly be creditworthy. In fact, if the World Bank were to implement the commission's recommendation to appropriately target grants, not loans into poor countries, the private sectors in these countries would become creditworthy for commercial credit, thus obviating the need for development bank lending. This grant-enhanced approach to faster private sector development provides an excellent measure of the opportunity or welfare cost of policy-based or adjustment lending. Had the commission fully extended its logic regarding recommending development assistance grants, **it would have correctly concluded that no development bank lending whatsoever is appropriate. Development grants, on the other hand, are both appropriate and necessary.**

12. **VI. CAN MORE LENDING AND EXTERNAL PUBLIC SECTOR DEBT ALLEVIATE POVERTY?** The commission seems to have agreed with Mr. Wolfensohn's argument that more World Bank subsidized lending will alleviate poverty in poor countries. As a result, the Meltzer Report condones a continuation of such lending (p. 93) although, and this is important, **such lending should be supplemented with significant grant transfers** (p. 91) from a reoriented World Bank. In fact, the World Bank has not and will not succeed in alleviating poverty with more subsidized lending and debt. Its past poverty-related lending is the reason there are HIPCS (highly indebted poor countries) and the reason that the commission must now (very sensibly) recommend that all HIPIC debt be written off. It is a major inconsistency in the report that it recommends that old poverty-inspired debt be written off but that the World Bank undertake new poverty-inspired lending.

13. The World Bank, even if renamed the World Development Agency, will continue to fail at poverty alleviation for two important, related reasons. The first is that World Bank lending to public sectors, no matter how subsidized the lending, is not an appropriate instrument of poverty alleviation. The second is that the World Bank does not recognize and act upon the fact that that **the best, possibly only route to poverty alleviation is the expansion of private-sector employment and productivity in competitive settings.** That World Bank lending won't alleviate poverty seems to have been appreciated by at least some on the commission. However, they seem to have given scant attention to the crucial role that expansion of productive employment has in poverty alleviation. Assuredly it is the case that if private-sector employment and productivity expand in a competitive setting, both real wages and employment will increase, so that household incomes rise. The key therefore is to stimulate private investment in a competitive setting.

14. A look at the preconditions (economists call them "priors") for stimulating growth in private investment and employment in a competitive setting discloses that such growth is inconsistent with the buildup of longer-term public sector external (i.e., World Bank) debt, no matter how much the lending is subsidized. This negative relationship between World Bank debt and growth in competitive, productive private sector investment and employment is at the heart of the World Bank's failures. It should have been, or should be the focus of intense scrutiny. The following is a simplistic listing of why more World Bank debt depresses growth in private investment and competition and in employment and productivity. First, more external (World Bank) debt means higher taxes, or lower non-debt, public sector expenditures, either of which depresses private investment and employment. Among other things, less private investment means less competition. Second, the greater the public sector's external debt, the more the country's exchange rate is likely to be unfavorable to domestic private investment and employment, particularly in the production of tradable output. Third, the more the public sector borrows from abroad, the less likely that small domestic capital markets will reflect the interests of domestic savers and the small, innovative private investors who are so important for increasing competition and productivity.

15. Without a doubt some of the commission members are aware of these issues, but they apparently lacked the time, resources, or inclination to delve into them definitively. One result is that the commission does not provide complete and convincing support for its recommendation that the World Bank give grants. In particular, it does not support this recommendation by reference to best practices as these are derived from studies on altruism. Beyond this, the commission fails to provide sufficient and convincing argumentation to support a recommendation that the World Bank stop lending altogether. This is most unfortunate given the greater free market atmosphere in which the World Bank is expected to operate. In such a setting, grants, if appropriately sized and targeted, can contribute significantly to poverty alleviation. On the other hand, especially in a free market setting, World Bank lending to public sectors, even if subsidized, will not reduce, and could well deepen or prolong poverty in poor countries.

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16. **VII. AN ALTERNATIVE RECOMMEMDATION.** The best way to stimulate development and alleviate poverty is to **directly target grants or subsidies (not loans)** to stimulate competition and growth in private-sector investment, employment and productivity. The World Bank violates this first-best approach in three important respects. It only gives loans, not grants, only to governments. Furthermore, it extends only **in**direct rather than direct subsidies, through subsidization of interest rates on its loans to governments. These indirect subsidies tend to stimulate corruption or excessive consumption particularly amongst public officials, since the loans go to governments. The Bank operates in this less-than-perfect way because at present it is essentially prohibited from asking for independent financing for direct grants or subsidies. Instead it borrows at concessional interest rates and on-lends at slightly higher but still concessional rates to all clients. The Meltzer Commission estimates, using two different measures, that the value of the subsidy from the Bank's loan portfolio is something like $22 to $31 billion (p. 75, footnote 18).

17. Currently the Bank charges all borrowers the same concessional rates so that both the subsidy and the Bank's net earnings per dollar lent are the same across all borrowers. This means that those who borrow the most receive the largest subsidy. More importantly from the current perspective, it means that the Bank can't cross-subsidize, or pile up earnings from investments and higher interest charges to richer borrowers, in order to finance grants or direct subsidies to poorer clients. The Meltzer Commission has recommended that the World Bank markedly decrease lending (and subsidies) to the better off developing countries and make grants, but lend less to the very poor countries. The problem is that these recommendations worsen the World Bank's ability to finance grants or direct subsidies.

18. A possibility, requiring considerable political fortitude, would be for the Bank to maintain or expand its borrowings, but increase its earnings, through stringent cost reductions, more investment income and differentially higher lending rate charges to the richer developing countries. Doing so would enable it to cross-subsidize, or finance grants or direct subsidies with internally generated funds. Such a strategy carries considerable principal/agent risks, given Bank Staff independence and tendencies toward financial profligacy. However, principal/agent problems can be reduced with greater oversight. In addition, this cross-subsidy strategy will reduce the considerable harm caused by profligate lending to the least developed countries.

19. **VIII. SHORT POINTS.** Here are some brief observations following a re-reading of the report.

i. The report is better on, and more relevant to the IMF **even though the World Bank is by far the larger, more costly failure.**

ii. The report presents quickie analyses of the success and failures of certain IMF interventions, but was apparently frustrated by an inability to evaluate any Bank operations, nearly all of which have so many goals that evaluation is impossible. The report might have recommended **a few evaluation criteria (e.g., growth in employment**

and productivity) that should be applied to the assessment of all World Bank loan (or grant) operations.

iii. The report discusses short-term developments in real wages but not longer-term changes in **country employment, and real wage bills, that are more relevant to poverty alleviation.**

iv. The report might have directed the World Bank to make more operational use of new development-relevant findings mainly concerning **principal/agent, problems, total factor productivity (TFP), altruism and the effective transmission of subsidies.**

v. The commission tacitly approved of sequencing trade liberalization before financial sector reform. In fact, these two reforms must occur together, which implies that **the WTO should be given a fairly muscular role in the World Bank's loan approval process.**

20. **IX. CONCLUSIONS.** The Meltzer commission makes generally good recommendations, but vacillates regarding the Bank and does not convincingly support its recommendations. As a result, the report is likely to have little impact, even though the IMF and World Bank are in desperate need of refocusing, reform and, in the case of the Bank, downsizing. Here are the other conclusions.

a. The report should clearly state the importance, to development, poverty alleviation and stabilization, of growth in private investment, employment and productivity in a competitive setting. This would enable it to define steady growth, in these three variables, as the responsibility of the World Bank. Significant negative departures from the growth trend of these variables would be the responsibility of the IMF, which would intervene to mitigate contagion.

b. The commission does not sufficiently stress the fact that the failures of the IMF and World Bank result from incorrect or inappropriate volumes, timing or targeting of money flows rather than from poor or inappropriate policy advice.

c. The report's excellent recommendations that the IMF only lend for -- and the World Bank not lend for -- crises is nullified by the absence of any delineation of what is and what is not a crisis.

d. The commission doesn't recommend, as it should, the cessation of all adjustment or policy-based lending. Adjustment lending is defined by two characteristics. One is that money flows are not targeted and are completely fungible. The other is that disbursements are supposedly contingent upon the adoption of an approved menu of policy reforms. Adjustment lending should be discontinued because disbursements can't be made contingent on policy reforms, because the money flows can't be sized and targeted and because an appropriate policy menu can't be agreed upon.

e. Corruption flourishes when large amounts of money fall into the hands of people/institutions that are not creditworthy. By not making this connection and not discussing the relationship between creditworthiness and World Bank and IMF lending, the commission mishandles the corruption issue.

f. The commission has, perhaps grudgingly, endorsed more World Bank lending to alleviate poverty, although with the important proviso that Bank lending be drastically

cut in favor of (much smaller amounts of) grants. Unfortunately, greater external public sector debt exacerbates poverty. The commission avoids a discussion of what constitutes poverty and the role that growth in private sector employment and productivity in a competitive setting can play in poverty alleviation. As a result, it fails to direct the Bank on how to correctly size and target grants to increase employment and productivity, so as to alleviate poverty.

g. Finally there is an issue of how the World Bank might finance grants. The Meltzer Report is essentially silent on this. A possibility that is consistent with current practices would be for the World Bank to reduce costs, increase its investment income and institute differential interest rate charges so as to accumulate greater earnings or "profits". If these are complemented with stringent administrative cost controlling measures, the Bank could well accumulate sufficient annual funds to finance an appropriate volume of development grants, or directly targeted subsidies.

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