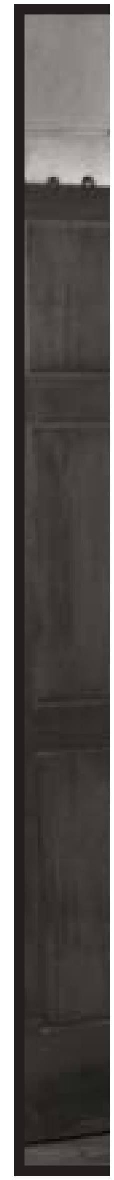
PEOPLE IN ECONOMICS

Concentrating the Mind

Jeremy Clift interviews Professor **Allan H. Meltzer**



ECONOMISTS may rarely be feted by the President of the United States. But, at 75, Professor Allan Meltzer—who briefly served in the U.S. Treasury during the presidency of John F. Kennedy and later was an advisor to Ronald Reagan—is one of the icons of American economics. So he was unfazed when President George W. Bush stepped forward at an award ceremony organized by the American Enterprise Institute (Box 1) in February this year to honor him as one of the leading economists of his time and the foremost authority on the U.S. Federal Reserve System. "I know I'm not the featured speaker," the president said at the Washington ceremony. "I'm just a warm-up act for Allan Meltzer [whom] I want to congratulate . . . for a lifetime of achievement."

Sometimes seen as a scourge of international institutions like the IMF and the World Bank, Meltzer is a sprightly man who revels in the power of ideas. Meltzer's recipe, says Charles Calomiris, a professor of finance and economics at Columbia University in New York, "is the basic application of logic and facts and an unwillingness to embrace dubious intellectual fads, which are amazingly prevalent in international finance." It is a view echoed by Federal Reserve Board Chairman Alan Greenspan, who says that Meltzer "calls the evidence as he sees it."

One of the pioneers, along with Milton Friedman, of monetarist economics, Meltzer sits in his bare office working on the next volume of his mammoth history of the U.S. Federal Reserve. He has become fascinated by how good men can make disastrously wrong decisions. Pointing to Arthur Burns, chairman of the Federal Reserve Board during 1970–78, Meltzer says Burns was "an outstanding economist of his day, yet he produced the biggest peacetime inflation we had ever seen." Why did that happen? "I think that's what we learn from history," Meltzer observes. "People make big mistakes—and that was a big mistake. Why did Burns do it? He didn't do it because he wanted to create inflation, any more than the people who created the Great Depression wanted to create the Great Depression. They had a set of ideas that proved to be wrong."

> "Capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior."
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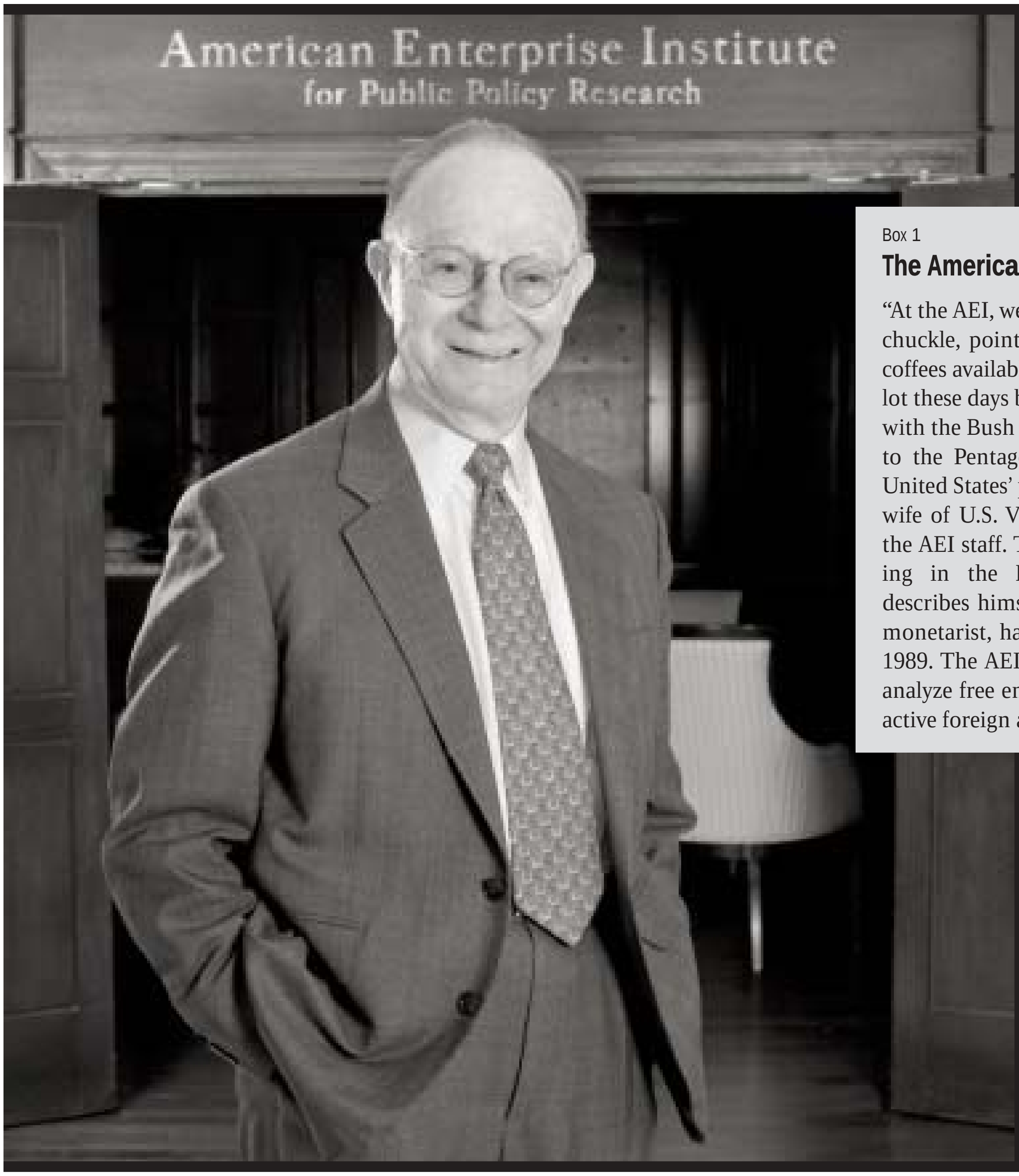
> ***Allan H. Meltzer***
> ***in testimony before the Joint Economic Committee of the U.S. Congress, February 24, 1998***

Meltzer, who started out on the left of American politics (as an undergraduate, he worked for the unsuccessful presidential campaign in 1948 of Henry Wallace, the left-leaning candidate of the Progressive Party), has steadily moved to the right. Working primarily in academia, where he feels most comfortable, Meltzer has spent his life prodding, goading, and questioning others and pointing out inconvenient facts. His late colleague and coauthor Karl Brunner once said that Meltzer argued "with the style of a machine gunner—with sharply pointed and rapid duster shots." In the 1970s, when President Richard Nixon made what Meltzer thought was a big mistake by imposing price controls, Meltzer helped set up—with Brunner—the Shadow Open Market Committee of leading economists. The self-appointed watchdog, which shadowed the Open Market Committee of the Federal Reserve, would offer its own recipes for monetary policy design and actions as alternatives to those of the Federal Reserve.

Initial attraction

Born in 1928, Meltzer grew up in Boston during the Great Depression, although his family was not affected greatly by the economic slump. Searching for the tools to explain what appeared to be a wholesale failure of the capitalist system was what initially attracted him to economics. With Brunner, he developed a general equilibrium model of money, relating money to economic activity and prices and incorporating the role of intermediaries and debt. "Meltzer's econometric work on money demand in the 1960s has stood the test of time as have few empirical studies in economics," said the American Economics Association (AEA) when making him a distinguished fellow in 2001. He has also written his own interpretation of Keynes and contributed to the history of monetary thought. The AEA credited him with being "a principal founder of the thriving research area that we now call political economy."

Meltzer, a former skiing enthusiast who regularly walks the mile and a half to his office, remains active on the teaching staff of Carnegie Mellon University in Pittsburgh, where he occupies a chair named in his honor. "I would describe myself as one of the fortunate people who often don't know



Box 1

The American Enterprise Institute

"At the AEI, we believe in choice," says Meltzer with a chuckle, pointing to the large selection of teas and coffees available for visitors. The AEI is in the news a lot these days because of the think tank's strong links with the Bush administration. Richard Perle, advisor to the Pentagon and one of the architects of the United States' policy toward Iraq, and Lynne Cheney, wife of U.S. Vice President Richard Cheney, are on the AEI staff. Twenty former AEI staff are now serving in the Bush administration. Meltzer, who describes himself as a libertarian and a free market monetarist, has been a visiting scholar at AEI since 1989. The AEI was founded in 1943 to support and analyze free enterprise economies, but it also has an active foreign and defense policy studies section.

they are working because I enjoy so many of the things that I do," he says.

Bennett McCallum, a fellow economics professor at Carnegie Mellon, says that Meltzer's work reflects "a thoroughly healthy blend of tenacity and flexibility," adding that he is also somewhat stubborn. This stubbornness has often served Meltzer well, giving him a reputation for being an independent source of ideas. According to Calomiris, who made his remarks, along with McCallum, at Meltzer's award ceremony, "Allan has consistently played the role of the little boy commenting on the emperor's new clothes. But, unlike the boy in the story, Allan has maintained a creative role in advocating reform." Throughout his career, Meltzer has been a source of advice and ideas for the U.S. Congress, becoming what the AEA described as "an intelligent, courageous, and tireless contributor to the public discussion of economic policy issues." He did a number of studies for congressional committees and was vocal in advocating reform of international financial institutions. This, together with his conservative leanings favored by the majority party, made him a natural choice when Congress wanted to set up a special committee to look into the functioning of these institutions as a rider to a bill calling for $18 billion in additional capital for the International Monetary Fund in November 1998. In the wake of the 1997 Asian crisis, congressional concerns included the growing frequency, severity, and cost of financial crises; the fragility of the international monetary system; the ineffectiveness of development banks; and corruption in a number of countries.

"Discussion was overdue," said Meltzer, who had opposed additional funding for the IMF. "Asian problems," he said at the time, "do not require large international loans from the IMF and the developed countries. These loans are more likely to delay than to promote reform. The IMF may threaten to withhold payments, but its history shows that the threat is empty." It was a position rejected by Lawrence Summers, who was U.S. Treasury Secretary when Meltzer's report was published. But Meltzer saw it as his job to shake things up.

Meltzer Commission

What not surprisingly became known as the Meltzer Commission (its official name was the International Financial Institution Advisory Commission) had a very broad mandate and a very short life. The U.S. Congress asked it to evaluate seven major institutions and recommend changes in only six months. The commission chose to concentrate on the IMF, the World Bank, and three regional development institutions—the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. It gave less attention to two other institutions—the Bank for International Settlements and the World Trade Organization.

Among the findings in its report, published in March 2000, the bipartisan commission observed that economic conditions had continued to worsen in the world's poorest countries, despite continued increases in lending. It called for a substantial overhaul of the World Bank and regional development banks. In particular, it suggested that the World Bank and the regional development banks, as well as the IMF, "should write off in their entirety all claims against heavily indebted poor countries that implement an effective economic and social development strategy," and that the IMF should "serve as a quasi lender of last resort to emerging economies" and "restrict its lending to the provision of short-term liquidity."

Meltzer argued "with the style of a machine gunner—with sharply pointed and rapid duster shots," Karl Brunner said.

Three years later, Meltzer believes the commission played a substantial role in prompting change in the international financial institutions but remains highly critical of the World Bank's performance. "Its record of accomplishment in the poorest countries is very poor," he notes.

He is kinder about the performance of the IMF. "There's an enormous difference between the response that we've had from the Fund and the response of the Bank," he argues. "The Fund, it is fair to say, treated us as serious critics who might be wrong about many things but whose views should be looked at, and I think that [IMF Managing Director] Horst Köhler certainly had that view. So a number of the things that we proposed, the Fund has tried to implement." Meltzer pointed to the institution's greater transparency, more focused conditions for borrowing, progress with reducing the debt burdens of the world's poorest states, and creation of the Contingent Credit Line (CCL), a precautionary facility for well-managed economies that could be affected by a crisis spreading from elsewhere. So far, the CCL has not been used, but Stanley Fischer, former First Deputy Managing Director of the IMF who now is President of Citigroup International, says the concept of prequalified lending is a good one. "There certainly is a role for it, although not on the scale that the Meltzer Commission envisaged," he told *F&D*.

Accident-prone system

Meltzer believes that the international financial system remains too accident prone, partly because, in the past, lenders were willing to provide huge loans to even the riskiest countries, believing that the IMF would come to the rescue if there was a default. A way to avoid this, according to Meltzer, is to "change the incentives for lenders"—in other words, convince the big banks and bond markets that they should not expect the IMF to always come to the aid of a country in trouble.

The IMF, he says, should limit its role to preventing crises from spreading to neighboring countries, trading partners, and innocent bystanders. "Instead of lengthy negotiations to extract promises of reform, it shouldn't lend to countries that have not adopted and maintained some specified policies that enhance stability. If there is a threat of a spreading crisis, the IMF should help potential victims, not the culprit," Meltzer stresses.

Instituting these changes, he argues, would replace what he calls "the command and control system" of condition-based lending with a system based on incentives for countries that choose and adopt stabilizing policies. "Governments could explain to voters and legislators that reforms would reduce country risk, lowering interest rates," Meltzer explains. "Reformed borrowers would obtain more credit from the market at lower cost, facilitating economic and social development. The IMF would be free to set standards and allow countries to implement the standards in their own way. Lenders would know the countries that adopted the standards and those that did not. They would know also that if they lent to countries that hadn't reformed, they should expect to lose in a crisis. IMF loans would not bail them out."

Meltzer believes that certain conditions encourage stability and growth. "Not all market economies prosper," he says. "The difference between countries or periods depends greatly on the presence or absence of internal and external institutions that produce stability and the willingness of countries to join the international system and make the internal reforms that permit the market to function well. Accepting the rule of law, fiscal discipline, openness to trade, and private property are key elements." (See Box 2.)

Global power picture

Looking ahead, Meltzer sees a much more volatile world, with the war in Iraq as the first war over weapons proliferation. He expects growing friction between Europe and the United States, arguing that France and Germany, in particular, are "free riding" on the back of U.S. security. "In the past,

Box 2

Institutions key to growth

"What fosters growth," Meltzer says, "is no longer a secret because we have run the experiment and we've seen what happens. Why was it true that Cantonese who moved to Hong Kong—then a British colony—were, by the mid-1990s, 30 times richer than the people in China that they left behind? The answer has very little to do with the people who moved and a lot to do with the institutions that they came to. In Hong Kong, they came under British institutions that had protection of property rights, the rule of law, and all that. Even though they did not have democratic accountability, they had a very effective, humane government operating under British rules and institutions. And growth occurred without very many resources, including the fact that they had to buy their water from the land that they had left. It is a tremendously dramatic story of how institutions make so much difference in world development."

U.S. leadership was often the force that drove the alliance together. What has changed most is not the discovery of self-interest; it is that, with the end of the Cold War and removal of the Soviet military threat, European governments have greater opportunity to be free riders and a reduced need to accept U.S. leadership and U.S. response to the change. This has reshaped the alliance, and it will continue to do so, thereby changing a main building block of political stability, or even ending the alliance. We should try to work with the Europeans, but we should expect continued friction."

In Asia, the situation is different. "Japan is in a different position because it still depends to a very considerable extent on defense from the United States," Meltzer explains. "So while the Cold War has ended and the Europeans aren't threatened by China and North Korea, the Japanese still are, and they are still dependent on defense arrangements with the United States. So there is much less change in Asia."

But he expects Europe to be largely preoccupied with internal problems over the coming years, including the accession of new members to the European Union, constitutional reform, and differences over defense policy, particularly between France and the United Kingdom. He foresees a growing gap emerging between per capita incomes in North America and European countries burdened by the costs of aging populations and the welfare state. "We are now in a period where the welfare state really is a burden," he argues. "Governments in Europe have come to recognize that, but the public doesn't have any sense of crisis or foreboding."

In the new global order, Meltzer sees it as the job of the United States to initiate the changes needed to ensure continued stability—including reform of the international financial institutions, revised rules for world trade, and more targeted help for developing countries. "Success," he argued in his speech before President Bush, "would continue the remarkable progress of the last sixty years. Failure would likely slow this long period of global growth, increased liberty, and human progress."

All this is a long way from Meltzer's current focus—the second volume of his history of the Federal Reserve, which covers the period from 1951 until the late 1960s. The first volume—which he has dubbed "the biography of an institution"—took him almost 30 years to write, and Meltzer is still not sure where he will end the second volume. "I'll decide when I get there," he quips. Some hope that may not be too long. Noting Meltzer's meticulous analysis, Fed Chairman Greenspan said when introducing the first volume that he had "but one request. Could we put Volume II on a track that's a tad faster?" ■

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Meltzer's book A History of the Federal Reserve *was published in 2003 by the University of Chicago Press.*