The Bretton Woods Institutions : Evolution, Reform and Change*

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Abstract

The acute financial crisis that threatens the middle-income countries and the chronic development crisis that grips most of the low-income countries call for a radical reform of the Bretton Woods institutions. This paper employs historical and institutional approaches in trying to understand the sources of the failures and limitations of the Bretton Woods institutions and suggests directions for reform and change. After identifying the main driving forces behind their historical evolution, the paper discusses reforming the institutional practices and redefining the roles of the Bretton Woods institutions in order to face the challenges of the two crises and offers some thoughts on strategies for reform.

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The Bretton Woods institutions, the IMF and the World Bank, were created to bring about orderly development of the world economy in the post-World War II era. The IMF was to oversee the new international monetary system of adjustable peg linked to the gold, and the World Bank to provide financing for reconstruction and development projects. Over the course of the half a century's history, their roles have undergone drastic changes in response to the changes in the economic realities and the dominant economic thinking. They have at the same time been key players in shaping the world of today. Reforming the Bretton Woods institutions will be a critical part of any reform of global economic governance as we enter the new millennium.

At the occasion of the fiftieth anniversary of the Bretton Woods conference, a number of forums examined the Bretton Woods institutions and proposed various reforms.[1] However, it was only after the Asian Financial Crisis in 1997 and its repercussions in Russia in 1998 brought the world economy to the brink of a collapse that a momentum for a serious reform of the Bretton Woods institutions was formed. It was the devastation of the Great Depression and the disastrous breakdown of the international monetary and trading system in the 1930s that led the world leaders to create the Bretton Woods Institutions. The grossest failure of the "invisible hand" nurtured the belief that stable economic growth requires active economic management by the government in both the domestic and international spheres. In the wake of the recent financial turmoil the world is once again debating a new "international financial architecture".[2]

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[1] Prominent among these forums were the Bretton Woods Committee (Bretton Woods Commission, 1994), the North-South Roundtable (ul Haq et al., 1995), the G-24 developing countries (Helleiner, 1996), the Institute for International Economics (Kenen, 1994) and the Bretton Woods institutions themselves (Boughton and Lateef, 1995).

[2] See the articles in the Fall 1999 issue of the *Journal of Economic Perspectives,* the November 1999 issue of the *Economic Journal*, Ahluwalia (1999) and Sachs (1998). For official views, see Camdessus (1998), IMF (1999a), UN (1999) and Hills *et al*. (1999).

Devising a new and safer international financial architecture is not the only major challenge to the Bretton Woods institutions. The capital flow volatility problem concerns mainly a couple of dozen middle-income developing countries and transition economies, the so-called emerging markets, although its potential threat to the entire international financial system makes it indeed a grave problem. The persistent hunger and poverty of two billion people around the world and the failure of development in most of the poorest countries also pose a grave challenge to the Bretton Woods institutions. Amidst cheers for the wonderfully efficient globalized markets, the poor in the world have been losing ground further. More than half of the low-income economies saw declining living standards and the disparities between the rich and poor countries widened significantly over the pat few decades (World bank, 1999a). The Bretton Woods institutions must see to it that the world economy provides opportunities for the poor countries to step out of the poverty trap and start catching up with developed countries.

The acute financial crisis that threatens the middle-income countries and the chronic development crisis that grips most of the low-income countries call for a radical reform of the Bretton Woods institutions. This paper is an attempt to suggest broad directions of reform. It employs historical and institutional approaches in trying to understand the sources of the failures and limitations of the Bretton Woods institutions. A detailed blue print for reform would require much technical and analytical work on specific issues. However, at this stage, it is more important to forge a consensus on the direction of reform.

The rest of the paper is organized as follows. The following section reviews the evolution of the Bretton Woods institutions, identifying the main driving forces behind the changes in their roles and functions. Section II discusses the institutional

reform, including reform of governance and conditionality. Section III discusses how to redefine the roles of the Bretton Woods institutions. A brief conclusion follows.

I. Evolution of the Bretton Woods Institutions

The Bretton Woods institutions were born in 1944 at the Bretton Woods Conference where the major governments negotiated the institutional set-up for the postwar world economic order. The Bretton Woods institutions have made continuous adaptations to the changing economic circumstances and become quite different from what they were at the beginning. The single most important factor in this process was the enormous growth of capital markets with increasing mobility of capital across borders.

Original Design and the Golden Age

The Bretton Woods system consisted of three elements. The adjustable peg system was introduced, in which the US dollar played a key role. The rates of other currencies would be pegged to the dollar that would maintain a fixed parity to the gold with infrequent changes in the pegged rates. Capital controls that had been introduced during the wartime were allowed to remain in place in order to prevent the kind of disruptive capital flows that were seen in the inter-war years. The IMF was created to oversee this new monetary system, armed with financial resources and powers of surveillance. The exchange rates would be adjusted only with the approval of the IMF when "fundamental disequilibria" occurred. In the case of temporary disequilibria, the IMF would provide financing to support the member countries experiencing balance of payments difficulties in order to allow balance of payments adjustments without resorting to excessively deflationary policies or import restrictions. This monetary and financial arrangement was supposed to provide the basis for a liberal trading system. The ITO that was to

oversee the international trade did not materialize but was substituted for by the GATT.

While the IMF was designed to provide short-term balance of payments relief, the IBRD was to provide longer-term funds for investment in productive endeavors. The IBRD has grown into the World Bank Group by adding new affiliates: IFC in 1956, IDA in 1960, ICSID in 1966 and MIGA in 1988. Although the World Bank was almost an after-thought at the time of its creation, its importance has grown to match that of the IMF. The Bank's mission was to intermediate between the capital market and the governments in need of financing for reconstruction and development projects. Backed by the uncalled portion of its capital committed by the member governments, the Bank can raise funds at very favorable rates on the capital market even though it lends to countries that could not borrow on the market or borrow only at considerably higher rates. IDA, created in 1960, provides concessional loans to poor developing countries with funds obtained from grants made by rich capital-exporting member governments.

The quarter century following the creation of the Bretton Woods institutions saw the greatest prosperity in human history around the world except in much of Africa and parts of Asia and is deservedly dubbed the Golden Age. This period also coincides with the period of the Bretton Woods monetary system that ended with the transition to floating exchange rates among the major currencies in 1973. It would be wrong, however, to ascribe the successes of the Golden Age mainly to the successful operation of the Bretton Woods institutions.

At the conclusion of the Second World War, the conditions for rapid growth through catching-up were prepared in terms of both the large technological gap between the leader and the followers and the advanced social capabilities in many of the follower countries (Abramovitz, 1986). To realize these potentials, domestic institutions for capital accumulation and international institutions for financial stability and trade

expansion were all that was needed. The social compromise between capital and labor based on collective bargaining and the welfare state provided for the domestic institutions, and the Bretton Woods institutions, aided by the hegemonic leadership of the US and other institutions like the EPU, filled the needs for the international institutions.[3] The role of the Bretton Woods institutions was therefore only a part of what made the Golden Age. Moreover, their relatively smooth operation itself owed a great deal to the stability of the economic environment in that period (Eichengreen, 1992). With these qualifications, we should nonetheless note that they performed useful roles in promoting financial stability and liberal trade among the advanced countries and giving a chance to developing countries to latch on to the growing world economy.

One reason for the success of the Bretton Woods system was the institutional flexibility as exhibited by, for example, the creation of such institutions as the Marshall Plan and the European Payment Union that supplemented the functions of the Bretton Woods institutions. After the European countries successfully achieved currency convertibility with the help of the EPU, the IMF paid increasing attention to developing countries in the 1960s. Another important innovation was the creation of SDRs in 1969 in response to the shortage of international liquidity. One of the inherent difficulties in the Bretton Woods system, stemming from the asymmetry between the US dollar and other currencies, was the conflict between adequate provision of international liquidity and US balance of payments stability, known as the Triffin's dilemma. Creation of SDRs was a solution to this problem, but it was, owing to the disputes over their distribution, "too little, too late" to prevent the eventual fall of the Bretton Woods system.

The IBRD also shifted its attention from reconstruction to development. In

[3] See Marglin and Schor (1990) for an institutional analysis of the Golden Age.

1960 the IDA was established to provide concessional loans to poor countries with little creditworthiness. It was a move to answer the needs of the newly independent countries in Africa and elsewhere and, at the same time, a measure to counter the demands of the developing countries for a soft-loan or grant agency under the auspices of the UN. There was also an important shift in the activities of the World Bank. Initially, the Bank's assistance mainly funded infrastructure projects, with two thirds of it going to electric power and transportation during the first two decades of the Bank operation, but it began to diversify into social projects and funding for policy reforms.

Adaptations in the World of Increasing Capital Mobility

The relatively tranquil Bretton Woods system of fixed exchange rates with infrequent adjustments gave way to much greater exchange rate variability as a result of the shift to the floating rates system in 1973. The two Oil Shocks in the seventies shook the world economy. They were followed by the Debt Crisis of the eighties, a lost decade for the greater part of the developing world. In the nineties the world economy faced the challenge of transforming the former socialist planned economies into capitalist market economies. It was also severely tested by the volatility of capital flows that produced a new form of financial crisis originating from the capital, rather than current, account.

Underlying much of this great turbulence was the increasingly free and massive movements of capital. The demise of the Bretton Woods fixed-but-adjustable rate system itself owes a great deal to this. The very success of the Bretton Woods institutions meant that countries had become more integrated through increased trade and capital flows as exchange restrictions and capital controls gave way to convertibility and increasing capital mobility. While this helped to fuel international trade and investment, it also became a force to unhinge the par value system. Under the

par value system, since any hint of an impending devaluation would invite speculative attacks, governments found it impossible to make low-key adjustments in exchange rates as changes in economic fundamentals necessitated them. Devaluations were therefore made only in conditions of crisis and at a severe political cost. The gradual liberalization of capital movements accentuated these difficulties. That is, the increasing capital mobility compounded the difficulty of balancing flexibility and commitment inherent in the fixed-but-adjustable exchange rate system and eventually led to its breakdown.

The Debt Crisis originated from the recycling of oil-dollars in the aftermath of the First Oil Shock, although it was triggered by the steep rise in the interest rates and the ensuing world recession of the early 1980s. The commercial bank-centered recycling of oil-dollars was dragging many developing countries into excessive indebtedness, creating systemic risks. The IMF failed to recognize the risks of and intervene in this process. Even after the outbreak of the Debt Crisis, its response was slow, weak and inadequate, and the resolution of the crisis had to wait until the Brady Plan of 1989, an initiative of the US Treasury. Similar failures were repeated in the 1990s. The Fund failed to recognize the growing risks in the large capital inflows into Mexico before its 1994-95 crisis or those into Asian countries before their 1997-98 crisis.

The shift from the par value system to floating exchange rates seemed to relinquish the Fund's roles as the guarantor of exchange-rate stability and regulator of international liquidity. The Fund responded to this situation by intensifying its 'surveillance' role to monitor the domestic policies. The argument was that, since the exchange rate was going to be determined in the market, the IMF needed to monitor not only the exchange rate policy but also the domestic fiscal and monetary policies that

affect the exchange rate. But the IMF surveillance proved to be an inadequate means of securing exchange rate stability. The experience of the floating rate system has been characterized by excessive volatility in the seventies under the managed floating and large misalignments in the eighties when the US and the Japanese governments took a more liberal attitude towards exchange rates. Liberalization of capital accounts led to rapid increases in gross capital flows, making exchange rates more susceptible to changes in sentiment and short-term movements of capital than changes in economic fundamentals.

While it was becoming clear that an effective coordination of the macroeconomic and exchange rate policies of the major industrial countries was necessary, the IMF shied away from taking an active role in this area, leaving the task of policy coordination to the squabbling G7 governments.[4] The IMF surveillance became instead confined to the role of "limiting the likelihood and severity of difficulties calling for [its] support" (Masson and Mussa, 1997) with doubtful performance. The IMF's uneasiness in dealing with the exchange-rate issue is reflected in its country programs, too. Its recommendation has been wavering between fixed rate and floating rate. Contrary to what its name and mandate suggest, the IMF remained less concerned about the exchange rate policy than fiscal policy and inflation.

After the breakdown of the Bretton Woods system, the Fund and the Bank have evolved into agents of structural reforms in debt-ridden developing countries with loans as an inducement and conditionality as a weapon. The shift to floating exchange rates and the growth of capital markets made the Fund irrelevant as a source of finance to developed countries and concentrate on developing and, later, transition countries.

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[4] The Bretton Woods Commission (1994) has suggested that the IMF take over the responsibility of policy coordination from the G7 countries in order to reduce exchange rate volatility and misalignments,

The Fund was thus moving closer to development financing with creation of the new longer-term loan facilities such as Extended Fund Facility in 1974 and Structural Adjustment Facility in 1986. In doing so, the Fund embarked on structural reforms of the borrowing countries, stretching its mandate by arguing that such reforms would strengthen the countries' prospects for growth and thereby reduce exchange rate instability and the need for IMF assistance. While this shift started as a response to the First Oil Crisis and the ensuing balance-of-payments difficulties in many oil-importing countries, the full-blown focus on structural reforms began after the Debt Crisis of the 1980s. This move has led to widening scope for loan conditions. As the chief architect of the adjustment programs, the Fund now incorporated a whole range of structural reforms in its programs.

The Bank, on the other hand, began to give loans for balance-of-payments support as many developing countries experienced severe macroeconomic imbalances and accumulation of external debts after the oil crises. The Bank introduced structural adjustment lending in 1979, but it was in the early 1980s that the Bank earnestly launched its program of structural reforms to eliminate structural rigidities and improve incentives in an effort to tackle the deepening economic problems of developing countries.[5] The structural adjustment lending differed from the past lending modalities in its focus on balance-of-payments problems rather than specific projects or sector reforms and its introduction of explicit and detailed conditionalities and greater commitment to enforce them (Kapur, 1997).

With the Fund moving closer to development financing and structural reform and the Bank increasing its role for balance-of-payment support and policy reform, the

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and eventually to a system of flexible exchange rate bands.

[5] Adjustment lending rapidly increased and accounted for about a quarter of the total Bank lending in the

two Bretton Woods institutions came to have a greater overlap in their activities (Ahluwalia, 1999). At the same time the views of the two institutions converged greatly, producing the so-called "Washington Consensus" that underpinned their operations in developing and transition economies in the 1980s and 1990s.

Washington Consensus

The Washington Consensus refers to an approach to development born out of the integration of the traditional IMF concerns for macroeconomic stability (anti-inflation, anti-deficit policies) and the Bank agenda of efficiency enhancing reforms (openness, competition, deregulation, privatization). A typical package of IMF stabilization and World Bank adjustment include: fiscal and monetary austerity, devaluation, trade liberalization, financial liberalization and banking system restructuring, price liberalization, privatization, labor market deregulation, tax reform and subsidy cuts (Williamson, 1990).

The birth of the Washington Consensus reflected a shift in the ideological currents toward neo-liberalism, which emerged out of the erosion of the Golden Age. The Golden Age growth regime was based on a compromise on domestic distribution and the Keynesian management of domestic demand and international liquidity. What was responsible for the demise of the Golden Age is debatable, but problems arose in both areas (Marglin, 1990; Schor and You, 1995). Renewed capital-labor conflict and mounting difficulties in the monetary system since the late 1960s, in addition to such exogenous disturbances as the oil shocks, led to a profit squeeze, productivity slowdown and rising inflation in the 1970s. Neo-liberalism emerged in this context as an offensive from the capital that aimed at striking down the deal with the labor and

second half of the 1980s.

reducing the role of the state in economic management. The rise to power of the conservative governments of Thatcher and Reagan at the beginning of the 1980s ushered in an era of neo-liberalism.

Along with this ideological shift toward neo-liberalism, Keynesianism and structuralism were discredited in the economics profession. These changes in the dominant thinking formed the background for the rise of the Washington Consensus. While many of the policies in the Washington Consensus package could be useful if applied pragmatically, they were typically implemented with an excessive zeal to achieve what the textbook says it should be and without due consideration to the institutional and political factors. As a result, they often created unexpected problems and strains such as demand overkill, financial instability, increased corruption and deterioration in income distribution (Taylor, 1997). These problems have been particularly acute in the case of the transition economies where reforms have been over-loaded.

This is not a place for a comprehensive evaluation of the Fund-Bank structural adjustment programs. Suffice it to note that most studies, including the ones by the staff of the Bretton Woods institutions, find no systematic effects on growth, inflation and income distribution, although individual country episodes of disasters and successes are plenty.[6] They tend to find only a moderate improvement in the balance of payments but at the cost of a decline in aggregate investment. If the assistance from the Bretton Woods institutions result in little improvement in economic performance, it must be taken as a failure.

The problems of the Washington Consensus may be summarized as follows.

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[6] See Schadler et al. (1995) and Fischer (1997) for views of the IMF staff. Killick (1995a) contains a review of many studies. His own conclusion is that the adjustment programs have "rather limited revealed

The growth-oriented critique takes issue with the short-term orientation of the adjustment programs. With compression of aggregate demand as a preferred means of adjustment, the adjustment programs were accused of giving little attention to improving growth prospects and often positively damaging growth prospects by implementing cuts in public investment (Taylor, 1988). The equity-oriented critique points to the adverse effects on poverty and income distribution of the adjustment programs. Indeed, such adverse effects were found in most Latin American and African countries, although not in Asian countries (Stewart, 1995). The sustainability-oriented critique criticizes not only the insensitivity of the Bretton Woods institutions on the environmental impact of their programs. It also criticized their single-minded pursuit of liberalization policies on the ground that "Illiberal policies which do not damage overall macro stability are preferable to liberal policies which are inherently unsustainable or endanger macro instability" (Rodrik, 1990, p.933).[7] On a more specific level, the drive to financial and capital account liberalization in developing and transition economies has proven to be highly dangerous.

Two Neo-Liberal Crises

All the structural reforms and liberalization measures a la Washington Consensus could not prevent a general slowdown of growth after the breakdown of the Bretton Woods system in most parts of world, with sub-Saharan Africa and the former

effects on developing country economies (p.157)."

[7] These critiques are encapsulated in a report by the Group of Twenty Four (G-24, 1987, p.9): "The experience of developing countries that have undertaken Fund supported adjustment programs has not generally been satisfactory. The Fund approach to adjustment has had severe economic costs for many of these countries in terms of declines in the levels of output and growth rates, reductions in employment and adverse effects on income distribution. A typical Fund program prescribes measures that require excessive compression of domestic demand, cuts in real wages, and reductions in government expenditures; these are frequently accompanied by sharp exchange rate depreciation and import liberalization measures, without due regard to their potentially disruptive effects on the domestic

Soviet Union experiencing disastrous falls in standards of living. East Asia was the glaring exception, but the region has just gone through a serious setback following the financial crisis. The world economy in the era of neo-liberalism has exhibited two kinds of crises: an acute financial crisis that has hit many emerging-market economies and a chronic development crisis that has gripped much of the poor developing world.

The incredible rise in the mobility of capital, with about two trillion dollars crossing borders everyday these days of which eighty percent is purely speculative, has become a major threat to economic stability. Indeed, the 1990s witnessed a series of major crises - Mexico in 1994, East Asia in 1997, Russia in 1998 and Brazil in 1999 - which shared a central feature that the problems originated in the capital account unlike the earlier payments crises that arose in the current account (Ahluwalia, 1999). After premature and hasty liberalization of capital movements developing and transition economies became highly vulnerable to periods of rapid expansion of capital flows and their abrupt reversals – a problem aggravated by fragile domestic financial structures and weak financial regulation and supervision. Capital account liberalization, by exposing the country to the webs and flows of capital that is dependent on the judgment and sentiment of international bankers and fund managers, turned a whole range of economic and social policies into a beauty contest. Losers in this contest, which may not necessarily be fair owing to imperfections in the flow of information, suffer crises of confidence. Such crises are also highly contagious, increasing systemic risks of the global financial system.

Having helped create the financial crises by urging capital account liberalization in developing and transition economies, the Fund took on the role of firefighters, enlisting the Bank for a supporting role. The quick recoveries of Mexico

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economy."

and Asia are taken by some as a vindication of the Fund's role in crisis management. However, the quick recoveries may have simply been a consequence of the fact that the crises were mainly panic-driven. In fact, the patent failure of the Fund's initial rescue operations in the wake the Asian Financial Crisis underscored the fact that it was ill equipped to deal with this new form of crisis (Radelet and Sachs, 1998). Faced with a sudden and large reversal of capital flows, what the crisis-stricken countries needed was a large up-front funding or a swift debt rescheduling rather than the high-conditionality phased funding. Crisis-stricken Asian countries began to stabilize only after rescheduling of debt and started to recover only after relaxation of the belt-tightening measures initially imposed by the Fund. The recent financial crises have necessitated a fundamental rethinking on the global financial system and the role of the IMF.

While the Fund must redefine its roles so as to meet the challenges of the new financial reality, with its primary focus on prevention and management of acute financial crises in emerging market economies, the Bank's challenge is to confront the other crisis of the neo-liberal era, the chronic development crisis. Amidst cheers for the wonderfully efficient globalized markets, the poorest countries have fared badly. Between 1980-97, per capital private consumption fell in 20 and stagnated in 2 out of the 37 low-income economies for which the date are available.[8] In contrast, it fell in only 13 out of 40 middle-income economies and in none of the 21 high-income economies. Regionally, Sub-Saharan Africa suffered the most, with 22 out of 33 countries recording a negative or zero growth in per capita consumption. Many of them saw disastrous declines in living standards.

The poor economic performance of the poorest countries naturally meant

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[8] See Table 2, p. 232 for growth of per capita private consumption and p. 290 for classification of economies by income and region in World Bank (1999a).

increasing disparity between the rich and poor nations. Over the quarter century between 1970 and 1995, average per capita GDP of the poorest third of all countries dropped from 3.1 to 1.9 percent of the richest third – a relative income decline of 39 percent (World Bank, 1999a). The consequence is grotesque: Globally, the 20 percent of the world's people in the poorest-income countries account for a minuscule 1.3 percent of total private consumption expenditures (UNDP, 1998). These are the people under such abject poverty that their calorie intake is insufficient to support an active body.

Many of the countries under the grip of the development crisis have followed the neo-liberal prescriptions of the Washington Consensus. At the same time, China and India among the low-income economies and the East Asian countries among the middle-income economies have been able to register spectacular successes in development by diverging in important ways from the standard prescriptions. The Bank must recognize its past failures and find new and more effective ways to address the persistent poverty of two billion people and the chronic development crisis in the poorest countries.

II. Institutional Reform of the Bretton Woods Institutions

The importance of institutional reform of the Bretton Woods institutions cannot be overemphasized. Since they are monopolists or near-monopolists, they cannot be disciplined by external competition or the 'exit' option (Stiglitz, 1999). The alternative, the 'voice' mechanism, has not worked well because of poor governance in terms of representation and participation, accountability and transparency. Many flaws and failures have persisted as a result, including the practice of conditionality. Despite being intrinsically objectionable and practically ineffective, conditionality has continuously proliferated and grown increasingly intrusive.

Governance in the Bretton Woods Institutions

A defining characteristic of the governance of the Bretton Woods institutions is that the major shareholders, the rich industrial countries, control decision-making and that the borrowing countries have little say. While, formally, the Bretton Woods institutions are cooperative institutions voluntarily joined and owned by member countries, real ownership belongs to the select powerful countries. This is ensured by the quota-based voting system.[9] In order to maintain their identities as universal and public organizations the Bretton Woods institutions did allocate a certain share of votes, namely the basic votes, equally to all members, but never to such an extent as to threaten the control of the major shareholders. In fact, the proportion of the basic votes has been dramatically eroded, from the peak of 14 percent in 1955 at the Fund to around 3 percent at both the Fund and the Bank, in order to ensure that wealthy countries remain in control even after the decolonization process led to increasing, and eventually almost universal, membership at the Bretton Woods institutions (Woods, 1998).

The quota-based voting system meant that the perspectives and the interests of the rich capital-exporting countries pervaded the Bretton Woods institutions. Combined with the plain fact that hardly any country would commit large amounts of resources for international purposes without trying to advance its own power and interests, it produced some important problems in the institutions.

First, there has been a tendency to advocate financial restraint over Keynesian expansion, particularly in the Fund. Reflecting the dominant economic thinking and the political currents of the time, there was definitely a Keynesian, social democratic and

[9] The quotas are supposed to reflect the relative economic strength of the member countries, but quota adjustments are highly political and do not reflect a coherent principle.

internationalist spirit in the original design of the Bretton Woods institutions.[10] But, compared to the ideas contained in the Clearing Union proposal by Keynes himself, the IMF came to be decidedly less Keynesian (Singer, 1995). As a result, the Fund programs have been perennially accused of a bias toward demand overkill – an ironic situation given that the very rationale of the IMF loans is to avoid unnecessarily deflationary adjustments. It is only natural that lenders have a bias toward financial conservatism, as it is natural that borrowers may be inclined toward financial irresponsibility. Initially, it was the capital-exporting US that killed the more expansionary British Plan and the commodity price stabilization scheme. It was the US that insisted on introduction of conditionality over European objections. But when the European countries became donors, their position on loan conditionality and financial discipline of borrowing countries became just like the position of the US. German and Japanese reluctance to expand their economies in the 1980s also points to inherent difficulties of international Keynesianism without political integration.

Second, there have been too many politically-motivated loan decisions as a result of undue influences from the large shareholders. The dominance of the US, the largest shareholder, meant frequent injection of the US politics and foreign policy into the loan decisions of the Bretton Woods institutions in violation of the political neutrality principle.[11] But the US was not alone in attempting to use loans to advance own economic interests and political objectives. In what is perhaps the most egregious

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[10] The purpose of the IMF as set out in Article 1 of the Articles of Agreement includes "the promotion and maintenance of high levels of employment and real income" and "providing opportunity to correct maladjustments in [the] balance of payments without resorting to measures destructive of national or international prosperity" in addition to international monetary cooperation, exchange stability, expansion of trade and convertibility.

[11] Examples of how the IMF and the Bank were used to promote the US foreign policy agenda include, among others, the rejection of the loans to Poland and Czechoslovakia in 1949, cessation of lending to Chile during the Allende years and to Vietnam and Afgahanistan in 1979, and support for Turkey in the mid-1950s and El Salvador in the 1980s over European objections (Payer, 1982).

lending in the history of the IMF, the lending to Russia, the EU has been at least as responsible as the US. Other notable examples include the role of France in Francophone Africa and Japan in Asia in pressing the Bretton Woods institutions to lend in a manner that bolsters their interests.

Third, the exclusion of the borrowing countries from decision-making provided the institutional conditions for the proliferation of increasingly intrusive conditionality and the lack of ownership in adjustment programs. Greater participation by the countries that are directly and heavily affected by their decisions would have ameliorated the situation. It must be added that participation is not entirely a matter of formal governance structure. Notable exceptions notwithstanding, the representatives of the borrowing countries were often more interested in enjoying their stays in Washington than articulating their views at the executive meetings.

Flaws in the governance of the Bretton Woods institutions appear also in the lack of accountability and transparency in their operations. Even in formal set-up, they are accountable to finance ministers of member countries who are not necessarily unbiased representatives of the people (Stiglitz, 1999). In practice, such accountability means little. The risks of the IMF programs have been disproportionately borne by the borrowing countries and little by the IMF or its major shareholders (Kapur, 1997). The situation with the Bank is no different. Huge controversies arose over various Bank-financed projects that resulted in poor performance or destruction of indigenous people's livelihoods and the environment, with little responsibility borne by the Bank.[12] It even objected to the introduction of independent evaluations on the projects before

[12] Some of the notorious projects include the Sardar Sarovar dam project in India, the Polonoroeste Frontier Development Scheme in Brazil and the Pak Mun dam project in Thailand. While the Bank policies recommend adequate compensation for the people forcibly displaced by its projects, a Bank review could not find a single example of a Bank-financed resettlement plan in Latin America or Africa where the Bank's guidelines had been properly implemented (World Bank, 1994).

being forced to do so by the pressure from the US Congress (van de Laar, 1980). The Fund acquiesced to external evaluations only recently.

Accountability suffers when information on the decisions and operations of institutions are not subject to public scrutiny. While both the Fund and the Bank publish information on their operations in copious volumes, the public do not have access to the most sensitive information regarding who made what decisions based on what criteria. Tens of billions of dollars have been committed based on secret phone calls between the Managing Director of the Fund and the finance ministers of a few key countries. The Bretton Woods institutions are rightly accused of preaching without practicing transparency (Sachs, 1997).

The lack of transparency and accountability has allowed the tendency for expansion of programs and objectives. As economic conditions and policy objectives evolve, new programs have been added but without clearly redefining the roles and refocusing the programs. Even more seriously, it has allowed prolongation of failed practices and flawed doctrines as shown in the persistent practice of conditionality and the continuing influence of the Washington Consensus.

Conditionality

Conditionality did not exist in the original IMF Articles of Agreement due to the European opposition.[13] The Fund was in fact considered "a sort of automatic machine selling foreign exchange to members within certain limits and on certain terms" as the Managing Director Gutt put it in a 1946 statement to the Executive Board (Dell, 1981).

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[13] See Dell (1981) for a review of the early debates on conditionality. He finds that "The Europeans had the best of argument, perhaps, but it was the United States that had the resources and it was the resources that counted." (p. 8).

The Fund began to apply conditionality in 1952.[14] With the successive introduction of stand-by agreements, phasing and binding performance criteria over the 1950s, conditionality was steadily becoming more onerous. As the Fund shifted its focus toward structural reform in the 1970s, proliferation of conditionality took a new turn; the number of performance criteria per program increased by 50 percent during the 1970s and the 1980s (Killick, 1995a).

The World Bank followed the IMF leads in this. While its loans always had project-level conditionality in the form of loan covenants, it was since the introduction of structural adjustment lending that conditionality became highly formal, explicit and detailed. As the Bank devoted increasing amount of its resources to structural adjustment lending, the scope of the loan conditions also expanded steadily. From the initial focus on fiscal and trade policies and price liberalization, increasing emphasis was given to privatization and deregulation, and public and financial sector reforms. In addition to these purely economic conditionalities, the Bank's agenda expanded further in the nineties to include environment, governance and public expenditures (Kapur, 1997). Proliferation of conditionalities and interference with domestic politics inevitably followed. For instance, the average number of Bank conditions per adjustment loan increased from 39 for 1980-88 to 56 for 1989-1991 (Killick, 1995b).

The proliferation of conditionality occurred, it would be hard to deny, as developing countries came to replace the European countries as the principal borrowers. Initially, the European abhorrence of interference with domestic policies prevented the inclusion of conditionality in the Articles of Agreement of the Fund.[15] Even when

[14] Introduced initially as a matter of a Board policy decision, it was not until 1969 that the principle of conditionality was given explicit legal sanction through amendment of the Articles of Agreement.
[15] The intrusions by the staff of the Bretton Woods institutions in the economic affairs of their members "would have surprised the American delegation to Bretton Woods and would probably have infuriated the British, who regarded national economic sovereignty as an absolute, whatever might be agreed about

conditionality was firmly in place and greatly expanded, a large standby arrangement for the United Kingdom was approved in 1967 with a minimum of conditions. This provoked a concern among developing country Executive Directors as to equal treatment, and it was found that the number of performance criteria in loans for Latin American and Asian members had been on average far greater than for European members (Dell, 1981).

As the European countries stopped borrowing from the Fund and the Bank, their objections to conditionality evaporated. Freed from the European objections, the Bretton Woods institutions developed highly intrusive programs as they focused on structural adjustment and reform in developing countries. They came to see themselves a catalyst for change rather than merely financial institutions. Their experience with structural reform during the debt crisis was put to use in the 1990s after the collapse of the Soviet Union and the liberation of its former Easter European satellites. Entrusted by the G7, the Bretton Woods institutions became the director of the transition experiment, implementing far-reaching stabilization and reform measures. And they attempted to do a similar transformation exercise in Asia in responding to the Asian Financial Crisis of 1997, trying to convert the non-orthodox market economies into orthodox ones. This provoked Feldstein (1998, p.27) to ask, "If the policies to be changed are also practiced in the major industrial economies of Europe, would the IMF think it appropriate to force similar changes in those countries if they were subject to a fund program?"

On a conceptual level, we can identify four separate problems of conditionality. First, there is a problem of the content of conditionality. Many critics have objected to the monetarist aspect and the neo-liberal zeal that conditionality frequently embodies.

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plans for a Fund and a Bank" (Oliver, 1985, p.41).

Moreover, the so-called "one size fits all" approach of the Bretton Woods institutions in designing and implementing the programs has often meant that country-specific circumstances, both economic and socio-political, are neglected.

Second, conditionality has become an infringement on national sovereignty as it has expanded into areas that have no direct bearing on repayment of loans to include wide-ranging structural reform issues (Collier and Gunning, 1999). And the recent tendency for the donor governments, in response to pressures from single-issue NGOs, to impose non-economic conditions on human rights, social policy and environment is finding ways into the Bretton Woods institutions. No matter how desirable the changes sought by these conditions may be, they should not be forced upon governments on their knees by the international financial institutions.

Third, conditionality subverts democratic political process when it goes beyond the macroeconomic adjustment essential for restoring balance of payments (Stiglitz, 1999). In the name of efficiency and good economics, the Bretton Woods institutions have developed a habit of imposing policies that should properly be decided by domestic politics, for instance independence of the central bank or labor market rules, on more or less reluctant governments desperate for money. "This process … has undermined political legitimacy in dozens of developing countries, especially since the IMF is often happy to conspire with governments to make end runs around parliaments in the interests of "reform." ... [We should aim] to restore legitimacy to local politics, and abandon the misguided belief that the IMF and World Bank can micro-manage the process of economic reform" (Sachs, 1998).

Fourth, conditionality has been ineffective in changing the policies of the

recipient governments, not to mention improving economic performance.[16] Externally imposed conditionality undermines local 'ownership' - the extent to which the borrowing government regards the program as its own. It also invites lack of commitment to carry out programs, undermines the legitimacy of programs and strengthens opposition to reform. It can even drive reform-minded governments to oppose reform in order to maximize the price at which reform can be sold (Gilbert *et al.*, 1999). Proliferation of conditionality has thus produced high incidence of non-compliance in both the Fund and the Bank programs. The non-compliance problem in turn has produced a phenomenon of "paper conditionality": programs that all parties recognize will not be implemented and that merely satisfies the need to keep the money moving (Martin, 1991). All these incentive problems conspire to render conditionality highly ineffective.

Directions for Institutional Reform

It is critical that the Bretton Woods institutions must, in order to continue to be the central institutions for governing the global economy, reform its governance and mode of operation. First, they must devise ways in which developing country concerns can be better represented as a shared sense of stewardship is needed more than ever. Transforming the Interim Committee and the Development Committee, currently a ceremonial advisory body, into a decision-making body with better representation of the developing and transition countries would be such an option.[17] At the same time, the

[16] See Mosley *et al.* (1995). An indirect evidence on the ineffectiveness of conditionality is provided by the Bank staffs, who show that Bank supervision had no significant effect on success after controlling for political economy variables (Dollar and Svensson, 1997).
[17] I am persuaded by the view of Ahluwalia (1999) on this issue. At the annual meeting of 1999, the IMF Board of governors approved transformation of the Interim Committee into the International Monetary and Financial Committee. In addition to the name change, more substantive discussions are expected as there is now an explicit provision for preparatory meetings. But there is no change in the composition of

voting system must be reformed toward a greater representation by developing countries. This is not to suggest that equal vote for countries of different sizes and capabilities is desirable, because it would not only be unworkable due to the unwillingness of the powerful countries to participate but also imply a highly unequal representation among peoples. Some combination of quota-based votes and basic votes seems a reasonable solution. Although it is precisely the practiced of the Bretton Woods institutions, the share of the basic votes is so minimal that the basic votes have little significance. Perhaps, something like a double-majority rule – requiring a majority based on quotas and a majority based on basic votes – is needed.[18]

Second, transparency and accountability need be strengthened. While there have recently been steps toward releasing more information and receiving external evaluations, they fall far short of what is needed. External evaluation of individual programs must be strengthened, with representatives of the program countries included in the evaluation teams, and the staff in charge must be held accountable to failed programs. Relevant information should be released as much as possible. And the practice of consensus decision that helps to keep the real decision-making, negotiating and arm-twisting processes behind the scenes should be ended in favor of decision-making by open discussion and voting (Woods, 1998).

Third, the practice of conditionality should be fundamentally reformed. As a remedy to the ineffectiveness of conditionality, some have argued for simpler conditionality with stronger punishments on renegers (Mosley *et al.*, 1995; Hills *et al.*, 1999). Another idea is to have adjustment programs designed by the recipient government in order to strengthen ownership. A more drastic reform proposal is to

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the committee members or in its status as an advisory body.

[18] See Woods (1998) for a good discussion on this issue.

make conditionality *ex post* - that is, to direct loans to only those countries that have good policies in place and simply do away with conditionality (Gilbert *et al.*, 1999).

These reform ideas are not free from objections. Simpler conditionality may reduce but not eliminate ownership/incentive problems. The Fund loans to support balance of payments may take this approach, but with automatic modification in case demand compression exceeds target. Having programs prepared by the recipient governments first would work only if the governments are serious about reform and the Bretton Woods institutions are prepared to accept them with minimal input of their own. Otherwise, it would simply be a cosmetic change. Therefore, this idea may be best put into practice in conjunction with the *ex post* conditionality. As far as 'good-policy' countries are concerned, it makes eminent sense to have automatic approval of the program prepared by the recipient country and thereby get rid of conditionality as we know it. The problem here is what criteria to use in judging if a country is a 'good-policy' or a 'poor policy' one. However indirect, these criteria could still cause infringement on sovereignty and subversion of democratic political process. In order to minimize this problem, they need to be confined to a small set of macroeconomic performance measures.

Another problem with the *ex post* conditionality is that it will direct resources away from the 'poor policy' countries, which are often the most needy. These countries have been coming back to the Fund one program after another, producing a tendency for the Fund to have programs in an enduring set of developing countries (Bird, 1996). There is no point in continuing to keep them in the debt trap. The Fund should get out of these countries by simply forgiving their debts and leave the task to the Bank. The Bank should not simply sustain but increase aid to them, but in a totally different manner as discussed in the next section.

Fourth, decision-making and research activities of the Bretton Woods institutions that are now concentrated in their Washington headquarters should be decentralized as much as possible. Without such a move, it will be difficult to achieve true ownership and involvement of the affected people and devise policies that are fully considerate of the special local conditions. More research and decision-making at the local offices is a necessary condition for enhancing ownership, the importance of which the Bank now fully acknowledges.[19] Rhetorical change aside, however, there is little change in ground operations. They may now hold meetings with local NGOs and labor unions, but these are more cosmetic touches than serious consensus building.

Decentralization of research in the Bretton Woods institutions would also be an effective way of injecting a greater dose of pragmatism into their programs and greater diversity in their intellectual and political perspectives into the institutional thinking. Because of the screening effect of the hiring process and the later socialization effect the staff community in Washington is apt to develop a more or less homogeneous outlook and take doctrinaire positions without much regard to specificities of local contexts. This has to change. The staff size of the Washington headquarters should be radically cut down, and much more research projects should be carried out within the recipient countries. This would also enable substantial increases in hiring of local economists who are knowledgeable about the specific local conditions and the subtle political implications. At the same time, it will help build up local capacity in policy research.

[19] A report by its Evaluations Department found a highly significant relationship between borrower ownership and program success (Johnston and Wasty, 1993). The IMF was more reluctant to acknowledge the importance of this issue, but has recently come around to advocate greater ownership.

III. Redefining the Roles of the Bretton Woods Institutions

The volatility of capital flows and the highly contagious nature of the recent financial crises show that the current international financial system is unable to safeguard the world economy and that we need a new and safer international financial architecture. At the same time the chronic development crisis calls for a major rethinking on how to help accelerate growth in poor countries of the world. These challenges provide the context in which we must redefine the roles of the Bretton Woods institutions.

New International Financial Architecture and the Fund

The recent crises provoked impassioned calls for a fundamental reform of the global financial governance.[20] As a UN report put it, there is an "enormous discrepancy that exists between an increasingly sophisticated and dynamic international financial world, with rapid globalization of financial portfolios, and the lack of a proper institutional framework to regulate it" (UN, 1999). However, this state of affairs has not come about all of a sudden. As we saw in the historical review, the Fund has been increasingly marginalized in managing capital flows and exchange rates even as they become more and more volatile. Instead, the Fund has been drawn into clearing up the financial mess left behind by the volatile capital flows. Many of the proposals for strengthening the international financial architecture concern what individual countries, both the recipient and the originating countries, should do or creation of new international institutions.

[20] There emerged a shared sense of crisis and a broad agreement on the need for serious reforms in the summer of 1998, when the crisis-stricken East Asia was plunging into the depths of recession and, particularly after the Russian crisis, the contagion effect was threatening a global deflation. However, the Bretton Woods institutions and G-7 are once again retreating into complacency and business as usual. The 1999 Bank-Fund Annual Meeting was a big disappointment. The dominant feeling was that the crisis has passed, that lessons have been learned and that more intelligent ad hoc action is a better bet than grand systemic reforms.

However worthy they may be, it is of central importance that the Fund play constructive roles in stabilizing global finance through crisis prevention, not just crisis management.

First, the Fund, along with the Bank, should help strengthen the financial systems of individual countries. It is beyond dispute that national financial systems must be strengthened by such measures as greater transparency, better regulation and supervision, and improved corporate governance and bankruptcy laws.[21] There are two caveats, however. For one, it would be difficult and probably unwise to apply universal global standards, given the diversity of the economic conditions and institutional history. Emphasis should be on helping countries improve laws and regulations in order to contain systemic risks and develop expertise to back them up rather than imposing universal standards. For another, insofar as common minimum standards are advisable, there are disagreements on what institution must take charge in setting and implementing them. While many seem content with leaving the task to the Bretton Woods institutions and other existing institutions like the Basle Committee and the International Organization of Securities Commissions, some see the need to create a global financial regulator (Eatwell and Taylor, 1998; Kaufman, 1998). In any case, the Bretton Woods institutions are well positioned to play a constructive role with the wealth of country experience they have accumulated.

Second, the Fund should change its position on capital account liberalization. The Bretton Woods institutions were created at a time when capital controls were an almost universal practice. While they played an instrumental role in promoting financial market integration and free capital mobility, they have not prepared themselves to deal

[21] While this is commonly recognized as something that capital-recipient countries must do, it is also important for capital-originating countries to take some measures in this area. Chief among them are strengthening the regulation of highly-leveraged financial institutions and the introduction of "collective action clauses" in their sovereign bond contracts so that developing countries could do the same without being stigmatized in the market (Hills *et al.*, 1999).

with the problems of volatility and contagion. Therefore, it is vital that developing and transition economies retain autonomy in managing the capital account unless the international financial system is radically improved. This consideration must be incorporated into the discussions on broadening IMF mandates to include capital account convertibility.

In fact, the Fund should go one step further and officially sanction and encourage certain types of measures to curb excessive inflows of short-term capital in developing and transition economies that suffer from weak financial supervision and regulation (see, for instance, Hills *et al.*, 1999). While the benefits of free capital flows are yet to be established, it is clear that capital account liberalization has created huge difficulties in macroeconomic management and acute vulnerabilities in financial systems (Furman and Stiglitz, 1998). The fact that China and India in Asia and Chile in Latin America were able to avoid severe financial gyrations or sharp output contractions during the recent regional crises should not be ignored.[22] In a sense, capital controls, particularly on the inflows, are a form of prudential policy operating at the macro level. It seems illogical for those who advocate tightening prudential regulation on financial institutions to be hostile toward any measures to control capital flows.

Third, the Fund should take charge of macroeconomic policy coordination and exchange rate stabilization, instead of leaving the task to the G-7 (or G-3 after the monetary unification in EU) in the interest of a more rational global demand management. The currency fluctuations among G-3 can have serious repercussions to the smaller economies, generating macroeconomic imbalances and financial instabilities.

[22] This is not to say that capital controls are without problems and costs. But they seem minor compared to the big danger of free capital mobility. Opponents of capital controls point to the fact that Chile has recently removed the taxes on capital inflows. But the rationale of the Chilean system is precisely to be able to adjust the tax rates according to the economic conditions. Chile removed the taxes as the current account went into deficit and consequently there was need to attract more foreign capital.

Unfortunately, the Fund remains silent on the issue of exchange rate management, offering further study as the only answer (IMF, 1999). As more and more developing economies choose to float their currencies in thin exchange markets, the Fund should pay greater attention exchange rate stability.

Fourth, the Fund should change its lending policy. The Fund should move away from long-term lending and focus on its role as the global lender of last resort. It must be noted that the Fund, together with G-7 governments, has already been playing the role of the lender of last resort by providing emergency rescue financing to countries facing liquidity crises. Recently, the Fund has created new facilities - the Supplemental Reserve Facility and the Contingent Credit Line – in order to strengthen this role. However, even after it increased its resources through the New Arrangements to Borrow in 1998 and the increase in quota in 1999, they are far from being sufficient to counter major swings in capital flows.[23] The reliance on supplementary funds from G-7 governments has at times resulted in insertion of absurd loan conditions.[24] In order to enable the Fund to be a true global lender of last resort, it would have to be empowered to issue SDRs to itself subject to a limit, which would be extinguished upon repurchase by the borrowing country (UN, 1999). This move would relieve the Fund of the resource shortage problem and excessive pressures from contributing governments.

Making the Fund a true global lender of last resort will mean greater powers and resources for the Fund, and understandably it favors this role (Fischer, 1999a). However, we should not let the financial bureaucrats of the Fund wield even greater

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[23] The total amount of resources available to the Fund under the NAB and the General Arrangements to Borrow rose to SDR 34 billion, double the amount under the GAB alone. And the quota increase of 1999 raised overall quotas from SDR 146 billion to SDR 212 billion, vastly improving the Fund' s liquidity position (IMF, 1999b).

[24] A blatant example of this occurred when the Japanese government successfully insisted on including removal of the import diversification policy – restrictions on importation of certain Japanese manufactured products – in the letter of intent for the Korea loan of 1997.

powers than now over crisis economies and emasculate local political systems. For this purpose, a set of criteria must be developed so that last resort financing would be available without any conditionality but at penalty interest rates only when a crisis is clearly driven by panic or contagion. In other payment crises in 'good policy' countries, conditionality must be confined to the minimum macroeconomic adjustments for the purpose of balance-of-payments improvement subject to automatic modification in case demand compression exceeds the target. For 'poor policy' countries, the Fund should not lend.[25]

Finally, the Fund must develop a program for 'bailing-in' - involving the private sector more fully in forestalling and resolving crises (Fischer, 1999b). Strengthening the Fund's role as the lender of last resort raises concern on moral hazard in international lending. For the borrowing countries, the problem can be minimized by linking the availability and the borrowing cost of the emergency rescue finance to their crisis prevention efforts. But the problem may become serious with respect to the creditors who will be tempted to downplay the risks of lending to developing and transition economies if their careless lending gets bailed out again and again. This is morally and politically unacceptable in addition to being economically inefficient.

Bailing-in could take a few alternative forms. One that the Fund encourages is utilization of market-based incentives and instruments for the private sector to remain involved such as private contingency credit lines *a la* Argentine. This is a useful device, but it is a costly defense similar to building up large reserves. The Fund could provide guarantees and thereby reduce the cost of making such arrangements. Another method that has been used, for instance in the framework of the Paris Club or more recently in

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[25] A possible objection to this is that when strategically important countries that do not qualify as "good-policy' ones are in trouble, they cannot be ignored. But such cases should be left to be handled by those

the Korean case, is to encourage and intervene in debt restructuring negotiations. However, this process has been *ad hoc* and *ex post* and often entailed conversion of private debt into public debt with little loss-sharing. A more fundamental reform is introduction of collective-action clauses in sovereign bond contracts and formation of the creditor clubs for bank loans so that in the event of a crisis a quick rescheduling can take place. This may increase the borrowing cost by forestalling the exit option for the creditors, but the certainty of orderly rescheduling may also be attractive to the creditors. Such arrangements would serve well for the purposes of crisis prevention and crisis resolution, but it would be difficult for developing countries to institute them on their own. An active role by the Fund and the support of the G-7 countries would be necessary. The most radical proposal for bailing-in the private sector calls for creation of an international bankruptcy court whereby an orderly debt workout can take place under a debt stand-still (Sachs, 1995; UNCTAD, 1998). Radical as it is, this idea has many difficulties. The court should be able to come to a quick decision on debt stand-still based on pre-set criteria. Enforcement of debt workout programs can also pose great difficulties (Rogoff, 1999). However, such difficulties should not prevent us from studying this idea further.

Development Crisis and the Bank

Unlike the acute financial crises in the emerging economies, the chronic development crisis has failed to elicit any bold proposals. Politicians give frequent lip service to the urgent human needs to eradicate the abject poverty facing a third of the human population, but there is little action on the ground. The Bretton Woods institutions, too, have not come up with any bold action plans to fight the development crisis.

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governments that have strategic interests in the troubled countries rather than by the IMF.

The fact of the matter is that the Bretton Woods institutions lacked a coherent strategy for development from the beginning till today. The first sign of this was the failure to introduce a scheme to stabilize commodity prices despite the fact that large fluctuations in commodity prices had been a key source of difficulties in managing developing country economies.[26] Second, there was initially no plan for orderly and adequate capital flows, not to mention transfer of technology, to the developing countries. The Bank took this up later, but only on a limited scale and scope. Third, the difficult question of how to promote the political and institutional changes necessary for sustainable development without compromising sovereignty was never faced squarely. Instead, it was left to be molded in practice by the financially powerful.

Since the 1980s the Washington Consensus came to represent the development strategy promoted by the Bretton Woods institutions. However, it was not a genuine global strategy for development as the Bretton Woods institutions frequently failed to add up the consequences of their actions in individual countries, producing a fallacy of composition (Stewart and FitzGerald, 1997). A classic example was provided by the episode of falling commodity prices in the 1980s, when the Bretton Woods institutions told the individual countries that had balance-of-payment difficulties as a consequence of falling commodity prices that they must encourage commodity production and export, precipitating further declines in commodity prices. Moreover, as we already saw, the Washington Consensus failed to generate sustained growth in most poor countries, often exacerbated income distribution and paid little attention to policy sustainability.

It is true that the Bretton Woods institutions have gradually shifted their emphases and objectives. They now pay greater attention to the distributional impact of

[26] The IMF responded to this problem by creating Compensatory Financing Facility, but it is not an *ex ante* but *ex post* measure available only after a fall in commodity prices created balance-of-payments

their programs and, in the case of the Bank, the environmental consequences. There has also been some change in the underlying economics and consequently the policy stance of the Bretton Woods institutions. They now recognize the importance of some public interventions such as prudential regulation of financial institutions and establishment of social safety net. The need to provide supporting revenues is also now recognized. The Fund no longer maintains the doctrine that higher interest rate stimulates saving and therefore growth. There has also been realization that controls on external capital movements can help contain financial fragility. The World Bank is now developing Comprehensive Development Framework that purports to seek "broader goals" with "more instruments."[27]

However, there remain doubts about the degree to which the Fund position has changed. Its programs for the Asian countries – Thailand, Indonesia and South Korea - in 1997 were heavily criticized for requiring fiscal tightening where no chronic deficit problem exists, imposing a high interest rate policy where it could cause serious damages owing to the high leverage ratio of firms, and demanding all-out capital market liberalization where earlier liberalization was an important cause of the crisis.[28] The Bank has certainly changed a great deal in terms of its rhetoric, but there has so far been little noticeable change in its country operations and in its capacity to accommodate dissenting views.

In any case, a move from the Washington Consensus to Comprehensive Development Framework is not enough. A truly global approach is necessary. For this, the Bank should become a staunch advocate of a system of international trade and

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difficulties.

[27] See Wolfensohn (1999) and Stiglitz (1998) for elaboration of this idea.

[28] They did, however, emphasize strengthening of financial supervision and social safety net from the outset, and the Fund relented on fiscal and monetary tightening as the economies went into severe recession.

finance that is supportive of rapid growth in poor countries and allows a degree of freedom in choosing development strategy. This will include commodity price stabilization as well as the reform of international finance discussed above. As far as efforts to bring about internal changes in developing countries, there has to be a fundamental break away from "We know what is good for you" attitude to extending helping hands to domestic forces of change. The Bank should stop trying to teach good economics and micro-manage the economies through conditionality. It should instead give real help in the field in terms of real resources and technical assistance.

The legacy of past mistakes in the form of hopeless indebtedness by poor countries must be cleared up, too. Recently, there was some progress in the HIPC initiative with the rich countries agreeing on how to finance a plan to write off $100 billion of debt owed by the world's poorest countries.[29] However, progress in implementation is slow. This gradualist approach only serves to prolong the debt overhang in the poor countries and the bankrupt policy of trying to induce policy reform with loans as a leverage. It is time to put an end to the indebtedness problem by a one-shot write-off. Then, the Fund should get out of the business of providing long-term development loans, and the Bank should take the primary responsibility to tackle the development crisis.

What should be the main activities of the Bank? Obviously, the Bank must concentrate its efforts on the poor IDA countries, and its aid should clearly be focused on providing public goods in which private capital shows little interest. The best way in which the Bank could help poor countries develop is to contribute to investment in health, education, environmental protection and technology transfer. Infrastructure

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[29] The real value of the debt write-off, even if it comes into fruition, would be a fraction of this amount given that many of these countries are simply unable to repay the debt.

should be financed by private capital as much as possible, and only critically important but privately non-fundable projects must be considered for the Bank's support. For these projects, instead of formal conditionality, heavy presence of the Bank staff in the recipient countries must be the primary means of ensuring quality management.

In carrying out these projects, the Bank should make fewer loans and more grants. Loans can be useful for 'good policy' countries in supporting social investment, but loans to 'poor policy' countries may end up creating debt problems without doing much good. In the beginning, the rationale for the Bank activities was the imperfections in the capital market that denied developing countries access to foreign capital. However, the capital market has developed greatly since then and there is no reason why good investment projects cannot be financed by private capital. It is true that poor developing countries are still by and large shut off from private capital inflows despite the growth of the capital market. But this is mostly because the economic and political conditions in these countries are such that what could be potentially good projects are not in fact commercially sensible. Given this situation, it has become less compelling to justify the Bank activities in terms of correcting capital market failures.

Recently, under the leadership of the President James Wolfensohn, the Bank declared its intention to transform itself from a 'loan bank' to a 'knowledge bank'. Knowledge being a public good, it is argued, the Bank can contribute to international development by producing and disseminating knowledge on development policies. Its loan operations will also be improved if this knowledge is used to identify good projects and programs. This 'knowledge bank' view contrasts with the 'conditionality bank' view that the Bank can lend profitably to projects and programs that private capital cannot because its ability to enforce conditionality raises prospects of repayment and returns on investment (Gilbert *et al*, 1999). Both views see making loans as the key

activity of the Bank, and differ only in terms of what other activities, imposing conditionality and monitoring or producing and applying development knowledge, enable the Bank to do better than the private lending institutions. Such an interpretation of the 'knowledge bank' does not go far enough. The Bank should not see itself as a bank with a mission of making loans to what it deems would be commercially sensible had the capital market been perfect. Instead, it should redefine its role as development agency. Instead of offering mere policy advice, the Bank should put on field 'development soldiers' with skills, expertise and dedication while maximizing hiring of the local people.

The Bank-Fund Relations

Starting in the mid-1970s and more earnestly in the 1980s, the Fund and the Bank came to have a large degree of overlap in their activities. The 1966 guidelines for Fund-Bank collaboration had demarcated areas of primary responsibility for each institution: macroeconomic issues such as exchange rates, balance of payments and stabilization for the Fund and development programs and project evaluation for the Bank. But the increasing overlap of their activities created two major concerns - the possibility of conflict between the two institutions and the possibility of each institution losing focus on its core mission.

By and large, collaboration rather than conflict prevailed between the Fund and the Bank for three reasons.[30] First, there was pressure from the rich countries on the

[30] See Junquito (1996) for a review of the Fund-Bank collaboration. The most celebrated case of overt conflict between the Fund and the Bank was the Argentina fiasco in 1988, when the Bank decided to go ahead with adjustment lending despite the collapse of EEF negotiations with the Fund. It led to the Bank-Fund Concordat of 1989, which superseded the earlier guidelines and elaborated procedures to enhance coordination between the two institutions (Ahluwalia, 1999). More recently, in handling the Asian Financial Crisis, the Bank expressed its disagreement with the Fund's policies such as bank closure, fiscal restraint and raising the interest rate.

administrations of the two institutions to collaborate more effectively (Junquito, 1996). Second, the Fund was in the driving seat, with its adjustment program being taken by the market as the seal of approval.[31] Third, as already discussed, the two institutions converged greatly in their policy views.

But this is no cause for celebration. Collaboration and coordination to enhance the effectiveness of the overlapping and interconnected work is one thing. Suppression of the differences of opinion and healthy debates is another. We know that in matters of economic policy consensus is rare. Pretending there is a consensus while there is not precludes possibilities of correcting erroneous policies and undermines legitimacy of programs. The Bretton Woods institutions need to discard the bureaucratic instinct for maintaining the same voice in favor of freer discussions on controversial issues.

This does not, however, mean that they should continue the trend of convergence in their activities.[32] There is a need for a shaper division of labor, with the Fund focusing on short-term and systemic problems of the international finance and the Bank on long-term development needs of poor countries. Since the former issues are immediately connected to the interests of the rich and powerful countries while the latter is not, the scarce Bank resources and activities can easily be diverted away from where they must focus. It is worrisome that the Bank has approved the Emergency Structural Adjustment Lending procedure that enables the Bank to provide direct financing to supplement Fund financing at times of crisis. The Bank should resist the role of providing extra funds for the IMF rescue financing. Instead, its resources and

[31] The Bank's SALs were expected to be used in cases where a Fund program was already in place, and the Fund staff usually had the final say in the Fund-Bank joint-preparation of the Policy Framework Papers for SAF and ESAF programs.

[32] The increasing overlap in the activities of the Fund and the Bank prompted some to suggest a merger as a way of avoiding duplication of work and conflicting advice (Crook, 1991). But the recent crises show that the Fund must pay increasing attention to the short-term market factors and the systemic issues. This implies greater distinctiveness in the Fund's role from that of the Bank (Ahluwalia, 1999).

capacities must be deployed to confront the other crisis of the neo-liberal era, the chronic development crisis.

A sharper division of labor between the Fund and the Bank does not remove the need for collaboration between them. For instance, their collaboration in strengthening financial systems through the newly created Financial Sector Liaison Committee is perfectly desirable. The Bank has also played useful roles in crisis management by emphasizing the social aspects of adjustment and providing technical assistance for financial restructuring. It is making efforts to promote better policy responses to the social consequences of financial crises (World Bank, 1999b). Strengthening social policy is now considered an integral part of the new financial system.

Conclusion: The Bretton Woods Institutions for the 21st Century

Reforming the Bretton Woods institutions is an important part of designing the governance of the world economy in the 21st century. Based on historical and institutional analyses, this paper has suggested the following reform measures. First, measures for institutional reform include

1. Reforming the voting system to give greater voice to developing countries
2. Enhancing transparency and accountability
3. Radically downsizing or eliminating conditionality
4. Decentralization of research and decision-making.

Changes in the roles and policies of the Fund should include

1. Contributing to strengthening national financial systems
2. Encouraging measures to curb excessive inflows of short-term capital
3. Macroeconomic policy coordination and exchange rate stabilization

4. Discontinuing long-term lending and focusing on the lender of last resort function
5. Developing a mechanism for orderly debt workout.

New roles suggested for the Bank include

1. Advocating global economic governance conducive to development of poor countries
2. Giving up attempts to micro-manage recipient economies
3. Focusing on provision of public goods in poor countries
4. Shifting away from loans toward grants.

In addition, a shaper division of labor, with the Fund focusing on short-term and systemic problems of the international finance and the Bank on long-term development needs of poor countries, has been recommended.

These are tall orders, and there are many technical details that have to be elaborated. In devising a practical reform strategy, it is also necessary to consider political constraints. Any realistic reform proposal must come out of a process in which the advanced countries are fully engaged and developing country concerns are well represented. In order to get developing countries involved with the discussion on the new international financial architecture, the US government created G-22, which was expanded later into G-33 and then succeeded by G-20. Rather than this kind of *ad hoc* consultation, there is a need for an institutionalized forum for forming a consensus on the governance of global finance and development.

In order to maximize the chances for a real reform, we have to maximize the forces in favor of reform. Both the "voice" mechanism and the "exit" mechanism must be utilized. The voice mechanism must be strengthened by a more effective formation of common ground among the developing countries. They may also draw on the support

of the NGO community on some issues, as in the example of the Jubilee 2000 movement and Tobin Tax movement. The "exit" mechanism here does not mean the option of closing the economy and withdrawing from the world market. It means the existence of alternative official sources of support for funding and technical assistance for developing countries when the private capital market is effectively beyond reach.

The Bretton Woods institutions have been so powerful and resistant to reform, precisely because of the monopoly position they hold in this regard. There is a need for competitive pressure on these institutions. Subjecting much of their research to open competition may be a good way to increase the competitive pressure (Mellor, 1996). A more significant step would be to design a network of regional and sub-regional organizations, including the regional and sub-regional development banks and reserve funds, to support the management of monetary and financial issues (UN, 1999). This would not only play a useful role in itself in both crisis management and development financing, but also bring competitive pressure on the Washington-based Bretton Woods institutions to improve their performance. A starting point for this road would be establishment of the AMF, support for which must now be stronger than when it was first proposed.

A related issue is whether it is better for global financial governance to have consolidated institutional framework, i.e. the Bretton Woods institutions with enhanced powers, or to have a multiplicity of institutions with overlapping and competing jurisdictions. Indeed, there are calls for creation of new institutions such as a global financial regulator, an international bankruptcy court and an international deposit insurance system. From the perspective of using competitive pressure to discipline the powerful institutions, such proposals should be considered favorably even at the risk of duplicating similar functions. After all, all of these institutions co-exist along with a

lender of last resort in domestic financial systems. Just as the national financial markets came to acquire a measure of stability after the establishment of banking and securities regulations, deposit insurance and lenders of last resort, stabilizing today's globalized financial markets will require similar functions at the global level. And it is preferable to have alternative institutions available than to have a single super agency. This is not to say that it is unimportant to strengthen the roles and functions of the Bretton Woods institutions in ways that can best meet the challenges of the next century.

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