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THE BRETTON WOODS INSTITUTIONS: EVOLUTION, REFORM AND CHANGE

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1. INTRODUCTION

The Bretton Woods institutions, the International Monetary Fund (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 an adjustable peg linked to gold, and the World Bank to provide financing for reconstruction and development projects. Over the course of half a century, their roles have undergone drastic changes in response to 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 (BWIs) will be a critical part of any effort to reform global economic governance as we enter the new millennium.

On the occasion of the 50th anniversary of the Bretton Woods conference, a number of forums examined these institutions and proposed various reforms.¹ Momentum for serious reform of the BWIs, however, developed only after the Asian financial crisis in 1997 and its repercussions in Russia in 1998, which brought the world economy to the brink of collapse. It was the devastation of the great depression and the disastrous breakdown of

the international monetary and trading system in the 1930s that led world leaders to create the BWIs. The 'invisible hand' mistakenly nurtured the belief that stable economic growth requires active economic management by 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

Devising a new and safer international financial architecture is not the only major challenge to the BWIs. Although capital flow volatility concerns mainly a couple of dozen middle-income developing countries and transition economies (the so-called emerging markets), its potential threat to the entire international financial system makes it a grave problem indeed. The persistent hunger and poverty of two billion people around the world and the lack of development in the poorest countries also pose a grave challenge. Amidst cheers for the greatly efficient globalized markets, the poor of the world are losing ground further. More than half of the low-income economies saw a decline in living standards and a significant widening of the disparity between rich and poor countries over the past few decades (World Bank 1998). The Bretton Woods institutions must ensure that the world economy provides opportunities for poor countries to side-step the poverty trap and to 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 BWIs. This chapter is an attempt to suggest broad directions of reform. It employs historical and institutional approaches in trying to understand the sources of failures and limitations of the BWIs. A detailed blueprint for reform would require much technical and

analytical work on specific issues, but at this stage, it is more important to forge a consensus on the direction of reform.

The rest of the chapter is organized as follows. The following section reviews the evolution of the BWIs, identifying the main driving forces behind the changes in the role and functions of the system. Section 3 discusses institutional reform, including reform of governance and conditionality. Section 4 discusses how to redefine the roles of the BWIs. A brief conclusion follows.

2. EVOLUTION OF THE BRETTON WOODS INSTITUTIONS

The Bretton Woods institutions were established in 1944 at the New Hampshire Conference where major governments negotiated the institutional set-up for the postwar world economic order. These institutions have made continuous adaptations to reflect the changing economic circumstances and have become quite different from the original concept. The single most important factor in this process of change has been the enormous growth of capital markets with increasing mobility of capital across borders.

2.1. Original design and the golden age

The Bretton Woods system consisted of three elements. An adjustable peg system in which the US dollar played a key role was introduced. Rates of other currencies were pegged to the dollar that was to maintain a fixed parity to gold with infrequent changes in the pegged rates. Capital controls introduced during the wartime were to remain in place in

an effort to prevent similar disruptive capital flows that occurred during the inter-war years. To oversee this new monetary approach, the IMF was created and endowed with financial resources and powers of surveillance. Exchange rates were to be adjusted only with IMF's approval when 'fundamental disequilibria' occurred. In the event of temporary disequilibria, the IMF provided financing to member countries experiencing balance-of-payments difficulties in order to allow adjustments to be made without having to resort to excessively deflationary policies or import restrictions. This monetary and financial arrangement was to provide the basis for a liberal trading system. The International Trade Organization originally proposed to oversee international trade did not materialize, but GATT became its substitute.

While the IMF was designed to provide short-term balance of payments relief, the IBRD was to allocate longer-term funds for investment in productive endeavours. The IBRD has added new affiliates to the World Bank Group: IFC in 1956, IDA in 1960, ICSID in 1966 and MIGA in 1988. Even though the World Bank was almost an after-thought at the time of its creation, it has grown in importance to match the IMF. The Bank's mission was to intermediate between the capital market and governments needing financial support for reconstruction and development projects. Backed by the uncalled portion of capital committed by member governments, the Bank offers funds at favourable rates also to countries which would have difficulties acquiring loans on the market or which would have to borrow at considerably higher interest. The International Development Association (IDA), created in 1960, provides concessional loans to poor developing countries with funds made available through grants from rich capital-exporting member governments.

The quarter century following the creation of the BWIs is deservedly dubbed the 'golden age', an era when the world, except for Africa and parts of Asia, witnessed the greatest period of prosperity in its history. This era also coincided with the period of the Bretton Woods monetary system that ended with the transition to floating exchange rates among major currencies in 1973. It would, however, be misleading to mainly ascribe the achievements of the golden age to the successful functioning of the Bretton Woods system.

At the conclusion of the Second World War, the conditions for rapid growth were in place since the follower countries possessed advanced social capabilities needed to bridge the vast technological gap between the leader country (the US) and themselves (Abramovitz 1986). To realize the potentials offered by the technological gap, domestic institutions for capital accumulation and international institutions for financial stability and trade expansion were required. Domestic institutions provided a social compromise between capital and labour based on collective bargaining and the welfare state, and the Bretton Woods institutions, aided by the hegemonic leadership of the US, and other institutions like the European Payment Union (EPU) filled the need for international institutions.³ The BWIs, therefore, constituted only one aspect of the golden age. Moreover, the relatively smooth operation of these institutions owed a great deal to the stability of the economic environment of that period (Eichengreen 1992). We should nonetheless note that the BWIs were successful in promoting financial stability and liberal trade among the advanced countries, and giving the opportunity to developing countries to latch-on to a growing world economy.

One reason for the success of the Bretton Woods system was its institutional flexibility as exhibited, for example, by the Marshall Plan and the EPU created to complement BWI functions. After the successful currency convertibility of the European countries, achieved with the help of EPU, the IMF began to increase its attention to the developing countries in the 1960s. Another important innovation was the creation of SDRs in 1969 to respond to the shortage of international liquidity. However, one of the inherent difficulties of 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. The creation of SDRs was to be the solution to this problem, but because of disputes over distribution, it was '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 1960, the IDA was established to provide concessional loans to poor countries with limited creditworthiness. It was an attempt to answer the needs of the newly independent countries in Africa and elsewhere and, at the same time, a measure to meet the demand 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 funded mainly infrastructure, with two-thirds of its assistance going to electric power and transportation projects during the first two decades of its operations, but later diversifying into social projects and funding for policy reform.

2.2. Adaptations in the world of increasing capital mobility

As a result of the shift to the floating rates system in 1973, the relatively tranquil Bretton Woods approach of fixed exchange rates with infrequent adjustments gave way to much greater exchange rate variability. The two oil shocks in the 1970s shook the world economy. These were followed by the debt crisis of the 1980s, a 'lost' decade for majority of the developing world. In the 1990s, world economy was faced with 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 capital, rather than current, account.

Underlying much of this turbulence was the increasingly free and massive movement 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 BWIs meant that countries had become more integrated through increased trade and capital flows as exchange restrictions and capital controls were replaced with convertibility and increasing capital mobility. While these helped to fuel international trade and investment, they also became the force to unhinge the par value system because any hint of an impending devaluation within this system would invite speculative attacks, making it impossible for governments to make low-key exchange rates adjustments, as changes in economic fundamentals would have necessitated. Devaluations were, therefore, effected only in crisis conditions and at severe political cost. These difficulties were accentuated by the gradual liberalization of capital movements; that is, 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, originating from recycled oil dollars in the aftermath of the first oil shock, was triggered by a steep rise in interest rates and the ensuing world recession of the early 1980s. The commercial bank centred recycling of oil dollars dragged many developing countries into excessive indebtedness, creating systemic risks. The Fund failed to recognize the risks of, or to intervene in, this process. Even after the outbreak of the debt crisis, IMF response was slow, weak and inadequate, and resolution of the crisis had to wait for an initiative of the US Treasury, the Brady Plan of 1989. Similar failures were repeated in the 1990s. The Fund failed to focus on the growing risks of the large capital inflows into Mexico before the 1994-95 crisis, or those of Asian countries before the 1997-98 crisis.

The shift from the par value system to floating exchange rates seemed to diminish the Fund's role as the guarantor of exchange rate stability and regulator of international liquidity, and the Fund responded by intensifying its 'surveillance' role in monitoring domestic policies. The argument was that, since the exchange rate was going to be determined in the market, the Fund needed to monitor not only exchange rate policy, but also domestic fiscal and monetary policies that affected exchange rates. But Fund's surveillance proved to be inadequate in securing exchange rate stability. The floating rate system was characterized by excessive volatility in the 1970s under managed floating and by large misalignments in the 1980s when the US and Japanese governments became more liberal towards exchange rates. Liberalization of capital accounts led to a rapid increase 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 evident that effective coordination of macroeconomic and exchange rate policies of major industrial countries was necessary, the Fund shied away from taking an active role, leaving the task of policy coordination to the squabbling G-7 governments.⁴ Instead, Fund surveillance was confined to the role of 'limiting the likelihood and severity of difficulties calling for [its] support' (Masson and Mussa 1997). IMF's uneasiness in dealing with the exchange rate issue is also reflected in its country programmes, in which recommendations wavered between fixed and floating rates. Contrary to what its name and mandate suggest, the Fund remained less concerned about exchange rate policy than fiscal policy and inflation.

After the abandonment of the Bretton Woods system, the Fund and the Bank evolved into agents of structural reform for debt-ridden developing countries, with loans as inducement and conditionality as the weapon. With the transfer to floating exchange rates and the growth of capital markets, the Fund became irrelevant as a source of finance for the developed countries and began to concentrate on developing, and later transition, countries. The Fund was thus moving closer to development financing with the creation of such new longer-term loan facilities as the Extended Fund Facility in 1974 and Structural Adjustment Facility in 1986. In doing so, the Fund embarked on a path of structural reforms for the borrowing countries, thus stretching its mandate by arguing that these 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, full-blown focus on structural reforms was motivated by the debt crisis of the 1980s. This move has led to widening the scope for loan conditions. As chief architect of

adjustment programmes, the Fund now incorporated a whole range of structural reforms on its agenda.

The Bank, on the other hand, began to grant loans for balance-of-payments support as many developing countries experienced severe macroeconomic imbalances and the 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, in an effort to tackle the deepening economic problems of developing countries, launched in earnest its programme of reforms to eliminate structural rigidities and improve incentives.⁵ The structural adjustment loans differed from past lending modalities in their focus on balance-of-payments problems rather than on specific projects or sector reforms, and introduction of explicit and detailed conditionalities, as well as greater commitment on the part of the Bank to enforce these (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, activities started to overlap (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.

2.3. Washington consensus

The Washington consensus refers to the development approach which arose from the integration of traditional IMF concerns for macroeconomic stability (anti-inflation, anti-deficit policies) and the Bank's agenda of efficiency-enhancing reforms (openness,

competition, deregulation, privatization). A typical package of IMF stabilization and World Bank adjustment includes fiscal and monetary austerity, devaluation, trade liberalization, financial liberalization and banking system restructuring, price liberalization, privatization, labour market deregulation, tax reform and subsidy cuts (Williamson 1990).

The birth of the Washington consensus reflected a shift in ideology toward neoliberalism that emerged after the erosion of the golden age. The golden age growth regime had been based on a social compromise on income distribution and Keynesian management of domestic demand and international liquidity. The single factor responsible for the demise of the golden age is debatable, but problems arose in both areas (Marglin 1990; Schor and You 1995). Renewed capital-labour conflicts and mounting difficulties since the late 1960s in the monetary system, in addition to such exogenous disturbances as the oil shocks, led to a profit squeeze, productivity slowdown and rising inflation in the 1970s. Neoliberalism emerged in this context as the offensive from capital, with the aim to repudiate the deal with labour and to reduce the role of the state in economic management. The conservative governments of Thatcher and Reagan at the beginning of the 1980s ushered in the era of neoliberalism.

As ideology shifted toward neoliberalism, Keynesianism and structuralism were discredited by economics professionals. These changes in the dominant thinking formed the background for the rise of the Washington consensus. While many of the policies in the Washington package could have been useful if applied pragmatically, they were typically implemented with excessive zeal in an effort to achieve the textbook ideal, and without due consideration to institutional and political factors. As a result, they often

created such unexpected pressures as demand overkill, financial instability, increased corruption and deterioration in income distribution (Taylor 1997). These have been particularly acute in the case of transition economies where 'big bang' reforms have taken place. This is not the forum for a comprehensive evaluation of Fund-Bank structural adjustment programmes. Suffice it to note that most studies, including those by BWI staff find no systematic effects on growth, inflation and income distribution, although individual country episodes of disaster or success are common.⁶ The studies report only moderate improvement in the balance of payments but at the cost of declining aggregate investment.

The problems of the Washington consensus may be summarized as follows. Growth-related dialogue takes issue with the short-term orientation of adjustment programmes. Compression of aggregate demand being the preferred means of adjustment, these programmes were blamed for the lack of concern for improvement in growth prospects and often for actual damage to growth prospects by implementing cuts in public investment (Taylor 1988). Equity-oriented criticism, on the other hand, reflects the adverse effects of adjustment programmes on poverty and income distribution. Indeed, such adverse effects were apparent in most Latin American and African countries, although not in Asia (Stewart 1995). The sustainability-oriented dialogue criticizes the BWIs not only for their insensitivity of the environmental impact of their programmes, but also criticizes the institutions for 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 1990:933).⁷ On a more specific level, the drive to promote financial

and capital account liberalization in developing and transition economies has proven to be dangerous.

2.4. Two neoliberal crises

The structural reforms and liberalization measures of the Washington consensus that were introduced in the aftermath of the Bretton Woods system could not prevent the general decline of growth in most parts of world, with Sub-Saharan Africa and the former Soviet Union experiencing disastrous falls in standards of living. At that time, East Asia was the notable exception, but has since then gone through a serious financial crisis and setback. The neoliberal world economy has exhibited two kinds of crises: the acute financial crisis which has hit many emerging-market economies and the 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 currently crossing borders everyday, and 80 per cent of which 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—all of which shared the common element that these problems originated in the capital account, unlike earlier payment crises, which arose in the current account (Ahluwalia 1999). After the 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 a country to the ebbs and flows of capital that are regulated by the judgement and opinions

of international bankers and fund managers, turned an entire range of economic and social policies into a popularity contest. Losers in this contest, which may not necessarily be fair because of imperfections in information flows, suffer crises of confidence. Such crises are also highly contagious, increasing systemic risks of the global financial structure.

Having helped generate 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 and Asia are taken by some as vindication of the Fund's role in crisis management. These quick recoveries, however, may simply have 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 of the Asian financial crisis underscored the fact that it was ill-equipped to deal with this new form of crisis (Radelet and Sachs 1998). Troubled countries, faced with a large sudden capital flow reversal would have needed considerable up-front support or swift debt rescheduling rather than phased-funding that comes with high conditionality. Stricken Asian countries began to show signs of stabilization and recovery only after debt rescheduling and a relaxation of the belt-tightening measures initially imposed by the Fund. The recent financial crises have necessitated a fundamental rethinking of the global financial system and the role of the Fund.

While the Fund must redefine its role so as to meet the challenges of the new financial reality with primary focus on prevention and management of acute financial crises in the emerging market economies, the Bank needs to confront the other failure of the neoliberal era, chronic development crisis. The poorest countries of the world have fared badly in the neoliberal era. Between 1980-97, out of the 37 low-income economies for which data are

available, per capita private consumption fell in 20 countries and stagnated in 2.⁸ 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 these countries saw disastrous declines in living standards.

The dismal economic performance of the poorest countries translates into increasing disparity between rich and poor nations. Between 1970 and 1995, average per capita GDP of the poorest third of all countries dropped from 3.1 to 1.9 per cent of the richest third, a relative income decline of 39 per cent (World Bank 1998). The result is devastating: globally, 20 per cent of the world's people in the poorest countries account for a minuscule 1.3 per cent of total private consumption (UNDP 1998). These people are under such abject poverty that their calorie intake is inadequate to support active life.

Many of the countries in the grip of a development crisis have followed the neoliberal 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 success in development by diverging from the standard prescription. The Bank needs to acknowledge its past failures and to find new and more effective ways to address the persistent poverty currently affecting two billion people and the chronic development crisis of the poorest countries.

3. INSTITUTIONAL REFORM OF THE BRETTON WOODS INSTITUTIONS

The importance of institutional reform of the BWIs 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. As a result, many flaws and failures have persisted, including conditionality, which in spite of being fundamentally questionable and practically ineffective, continues to proliferate and to become increasingly intrusive.

3.1. Governance in the Bretton Woods institutions

A defining characteristic of the governance of the BWIs is that major shareholders, the rich industrial countries, control decision-making and that the borrowing countries have little say. Although BWIs are formally cooperative agencies which member countries own and which they voluntarily join, real ownership belongs to select powerful countries. This ownership is ensured by a quota-based voting system.⁹ In order to maintain their identities as universal and public organizations, the BWIs allocated equally to all members a certain share of votes, namely the basic votes, but never to such an extent as to threaten the control of the major shareholders. In fact, the proportion of basic votes has been dramatically reduced, from a peak of 14 per cent in 1955 at the Fund to around 3 per cent at both the Fund and the Bank, to ensure that control remains invested with the wealthy countries even after decolonization led to an increasing, and eventually almost universal, membership at the BWIs (Woods 1998).

The quota-based voting system meant that perspectives and interests of rich capital-exporting countries pervaded the BWIs. Combined with the fact that no country would commit large amounts of resources for international purposes without trying to advance its own power and interests, the voting system produced major problems.

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 internationalist spirit in the original design of the BWIs.¹⁰ But, compared to 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's programmes have been perennially accused of a bias toward demand overkill—an ironic situation, given that the very rationale of IMF loans is to avoid unnecessary deflationary adjustments. It is only natural that lenders advocate financial conservatism, because borrowers may be inclined toward financial irresponsibility. Initially, it was the capital-exporting US that vetoed the more expansionary British Plan and the commodity price stabilization scheme. It was the US that insisted, over objections by the Europeans, on the introduction of conditionality. But as European countries became donors, their stand on loan conditionality and financial discipline for borrowing countries came to resemble 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, as a result of undue influence from large shareholders, there have been too many politically motivated loan decisions. Dominance by the United States, the largest shareholder, meant a frequent injection of US politics and foreign policy into loan

decisions by the BWIs, violating the principle of political neutrality.¹¹ But the US was not alone in its attempts to manipulate loan decisions for advancing its own economic and political objectives. The EU—in what is perhaps the most egregious lending in IMF's history, the loans to Russia—has been at least as guilty as the US. Other notable examples include the role of France in francophone Africa and Japan in Asia in pressuring the BWIs to lend in a manner that bolsters the interests of these countries.

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

Flaws in the governance of the Bretton Woods institutions are also evident in the lack of accountability and transparency of their operations. Even in the formal set-up, the BWIs are accountable to the finance ministers of member countries who may not necessarily be impartial representatives of the people (Stiglitz 1999). In practice, such accountability means little. Risks of IMF programmes have been disproportionately borne by borrowing countries, with little risk to IMF or its major shareholders (Kapur 1997). The World Bank situation is no different. Controversy has risen over various Bank-financed projects that resulted in poor performance or the destruction of indigenous people's livelihoods and environment, again with little responsibility borne by the Bank.¹² It even objected to

independent project evaluations before being forced by US Congress pressure to introduce these (van de Laar 1980). The Fund has acquiesced to external evaluations only recently.

Accountability suffers when information on decisions and operations of institutions are not subject to public scrutiny. Even though the Fund and Bank both publish copious volumes of operational information, the public does not have access to the most sensitive facts regarding actual decision-makers or the criteria involved. Tens of billions of dollars have been committed during confidential telephone conversations between the managing director of the Fund and finance ministers of a few key countries. The BWIs are justly accused of preaching—but not practising—transparency (Sachs 1997).

The lack of transparency and accountability has allowed the expansion of programmes and objectives. As economic conditions and policy objectives evolved, new agendas have been added, but without a clear demarcation of the roles or a refocus of the programmes. More serious still, limited accountability has enabled failed practices and flawed doctrines to continue, as the persistent practice of conditionality and the continuing influence of the Washington consensus exemplify.

3.2. Conditionality

Conditionality, due to opposition from European members, was not embodied in the original IMF Articles of Agreement.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 Mr Gutt, the managing director, put it in a 1946 statement to the executive board (Dell 1981). The Fund began to apply conditionality in 1952.¹⁴ With the

introduction of successive stand-by agreements, phasing and binding performance criteria over the 1950s, conditionality steadily became more difficult. As the Fund shifted its focus to structural reform in the 1970s, conditionality took on new characteristics and from the 1970s to the 1980s performance criteria per programme were increased by 50 per cent (Killick 1995a).

The World Bank followed IMF's lead in this. While Bank loans had always implied project-level conditionality in the form of loan covenants, the introduction of structural adjustment lending resulted in conditionality becoming highly formal, explicit and detailed. As the Bank devoted increasing resources to structural adjustment, the scope of loan conditions also expanded. From an 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 expanded further in the 1990s to include environment, governance and public expenditures on its agenda (Kapur 1997). The proliferation of conditionalities and interference with domestic politics inevitably followed. For instance, the average number of Bank conditions per adjustment loan increased from 39 in 1980-88 to 56 in 1989-91 (Killick 1995b).

The proliferation of conditionality increased as developing countries replaced European countries as principal borrowers. Initially, Europe's abhorrence of interference with its domestic policies prevented the inclusion of conditionality in the Fund's Articles of Agreement.¹⁵ Even when conditionality was firmly established, a large standby arrangement was approved for the United Kingdom in 1967 with a minimum of conditions. This provoked developing country executive directors to demand equal

treatment, and it became apparent that performance criteria for loans to Latin American and Asian members were, on average, far greater than for Europeans (Dell 1981).

As European countries stopped borrowing from the Fund and the Bank, their objection to conditionality faded and the BWIs, without complaints from Europe, developed highly intrusive programmes as they focused on structural adjustment and reform in developing countries. They came to see themselves as the catalyst for change rather than mere financial institutions. Their experience with structural reform during the debt crisis was utilized in the 1990s after the collapse of the Soviet Union and the liberation of its former Eastern European satellites. Entrusted by the G-7, the BWIs directed the transition experiment, implementing far-reaching stabilization and reform measures. They also attempted a similar transformation exercise in Asia during the financial crisis of 1997, by trying to convert non-orthodox market economies into orthodox ones. This provoked Feldstein (1998: 27) to ask, 'If the policies to be changed are also practised 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 programme?'

On a conceptual level, we can identify four separate conditionality problems. First, there is the conditionality content problem. Many critics have objected to the monetarist aspect and the neoliberal zeal that conditionality frequently embodies. Moreover, the so-called 'one-size-fits-all' approach of the BWIs in designing and implementing programmes has often neglected both the economic and socio-political circumstances of specific countries.

Second, conditionality—expanding into areas which have no direct bearing on loan repayment, including wide-ranging structural reform issues—has become an infringement

on national sovereignty (Collier and Gunning 1999). And the recent tendency of donor governments, responding to pressures from single-issue NGOs, to impose non-economic conditions on human rights, social policy and environment is making its way to the BWIs. Regardless of how desirable the changes sought by these international financial institutions may be, they should not be forced on crisis-stricken governments.

Third, conditionality subverts the democratic process when it goes beyond the essential macroeconomic adjustments needed to restore balance of payments (Stiglitz 1999). In the name of efficiency and good economics, the BWIs tend to impose policies on more or less reluctant governments desperate for money that should rightfully be decided by domestic politics, for instance central bank independence or labour market rules. '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 is an ineffective tool for changing the policies of recipient governments and, not to mention, for improving economic performance.¹⁶ Externally imposed conditionality undermines local 'ownership', the extent to which a borrowing government would regard a programme as its own. It also invites a lack of commitment to carry out programmes, undermines the legitimacy of programmes 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, Powell and Vines 1999). The proliferation of conditionality has thus produced a high incidence of non-compliance

in both Fund and Bank programmes. Non-compliance, in turn, has induced 'paper conditionality': the introduction of programmes which, as all parties recognize, will not be implemented but merely satisfy the need to keep money moving (Martin 1991). These incentive problems render conditionality highly ineffective.

3.3. Directions for institutional reform

It is vital that the BWIs, in order to continue as the central institutions for governing global economy, reform their structures of governance and modes of operation. First, they must devise ways in which developing country concerns can be better represented, because shared stewardship is needed more than ever. Transforming the Interim Committee and the Development Committee, currently ceremonial advisory agents, into decision-making bodies with better representation of the developing and transition countries would be one such option.¹⁷ At the same time, the voting system must be reformed to give greater representation to the developing countries. This is not to suggest equal vote for countries of different size and capabilities, because equal vote would not only be unworkable due to the superpowers' reluctance to participate, but it would also imply a highly distorted representation among peoples. Some combination of quota-based votes and basic votes would seem to offer a reasonable solution. Although this is precisely the system used by the BWIs, the share of basic votes at present is so minimal that these have little impact. Perhaps an arrangement of a 'double-majority' rule, requiring a majority in both quota-based votes and basic votes is needed.¹⁸

Second, transparency and accountability need to be strengthened. While there have been recent efforts to provide more information and to acknowledge external evaluations, they

fall far short of what is needed. External evaluation of individual programmes must be strengthened, with representatives from relevant countries included in the appraisal teams, and the staff in charge held accountable for failed programmes. All relevant information should be made available, and the practice of decision by consensus, which keeps genuine decisions, negotiations, and arm-twisting behind the scenes should be replaced with open discussions and voting procedures (Woods 1998).

Third, the practice of conditionality should be fundamentally reformed. As a remedy to conditionality ineffectiveness, some scholars have argued for simpler terms and stronger penalties for countries that renege (Mosley, Harrigan and Toyé 1995; Hills, Peterson and Goldstein 1999). Having the government of the recipient country formulate its adjustment programmes in order to strengthen ownership is also an option. A more drastic reform proposal is to make conditionality *ex post*—that is, to direct loans to only those countries that have good policies in place and thus simply make conditionality obsolete (Gilbert, Powell and Vines 1999).

These reform proposals are not without certain drawbacks. Simpler conditionality may reduce—but not eliminate—the ownership/incentive aspect. The Fund, in loans to support balance of payments, could take this approach, but with a built-in modification option, in case demand compression exceeds target. Programmes formulated by recipient countries can succeed only if the governments concerned are committed to reform, and the BWIs are prepared to approve the programmes with minimal BWI input. Otherwise, it would simply be a cosmetic change. Therefore, this idea may best be put into practice in conjunction with *ex post* conditionality. As far as 'good-policy' countries are concerned, it makes eminent sense for the BWI to provide automatic approval of a programme prepared by the

recipient country and thus eliminate conditionality, as we know it. The issue here is determining the criteria to be used for evaluating the recipient as a 'good policy' or a 'poor policy' country. These stipulations, however indirect, could still infringe on sovereignty and undermine the democratic political process. In order to minimize this problem, the criteria must be restricted to a small set of macroeconomic performance measures.

Another problem with *ex post* conditionality is that it will steer resources away from 'poor policy' countries, often the most needy. These countries have been turning to the Fund programme after programme, creating the Fund trend of approving programmes for a permanent group of developing countries (Bird 1996). As there is not much point in keeping these countries in a debt trap, the Fund should get out by simply forgiving these countries their debts and leave the task to the Bank. The Bank, on the other hand, should not simply sustain aid to these recipients, but increase it, albeit in a totally different manner as is discussed in the next section.

Fourth, efforts should be made to decentralize as much as possible the decision-making process and research activities of the BWIs that are currently concentrated in their Washington headquarters. Without such a move, it will be difficult to achieve true ownership and involvement of the people and to devise policies that fully acknowledge special local conditions. Transferring more research and decision-making activities to the local offices is essential for enhancing ownership, and the Bank fully realizes the importance of decentralization.¹⁹ Rhetorical change aside, however, there is little change in ground operations. Meetings are being held with local NGOs and labour unions, but these constitute mere cosmetic touches rather than serious consensus building.

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

4. REDEFINING THE ROLES OF THE BRETTON WOODS INSTITUTIONS

Capital flow volatility and the highly contagious nature of recent financial crises prove that the current international financial system is unable to safeguard the world economy and that a new, safer international financial architecture is needed. At the same time, the persistent development crisis calls for a major rethinking of the options available to help accelerate growth in poor countries. It is in the context of these challenges that we must redefine the roles of the Bretton Woods institutions.

4.1. New international financial architecture and the Fund

The recent crises provoked impassioned calls for a fundamental overhaul of 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 did not evolve out of the blue. As indicated 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. Rather, the Fund has been drawn into clearing up the financial mess left behind by volatile capital flows. Many of the proposals for strengthening international financial architecture concern measures that individual countries, both recipient and originating countries, should do, or the creation of new international institutions. As worthy as these may be, it is of central importance that the Fund play a constructive role 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 through 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 economic conditions and institutional history. Instead of imposing universal standards, the emphasis should be on helping countries improve laws and regulations in order to minimize systemic risks and develop the expertise to back up national laws. For another, insofar as common minimum standards are advisable, there are disagreements on the proper institution to take charge of setting up

and implementing them. While many seem content to leave the task to the BWIs or other existing institutions like the Basle Committee and the International Organization of Securities Commissions, others see the importance of creating a global financial regulator (Eatwell and Taylor 1998; Kaufman 1998). In any case, with a multiplicity of accumulated country experience at their disposal, the BWIs are well positioned to play a constructive role in this regard.

Second, the Fund should review its position on capital account liberalization. The BWIs were created at a time when capital controls were almost the universal practice. While these agencies were instrumental in promoting financial market integration and free capital mobility, they are not prepared to deal with the volatility and contagion problems. Therefore, unless the international financial system is radically improved, it is vital that developing and transition economies retain their autonomy in managing capital accounts. This aspect must be incorporated in discussions on broadening the IMF mandate 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 are affected by weak financial supervision and regulation (see, for instance, Hills, Peterson and Goldstein 1999). While the benefits of free capital flows are yet to be established, it is clear that capital account liberalization has created 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 recent regional crises should not be overlooked.²² In a sense, capital controls, particularly

with regard to 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, in the interest of more rational management of global demand, the Fund should assume responsibility for 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). Currency fluctuations among G-3 can have serious repercussions on smaller economies, generating macroeconomic imbalances and financial instabilities. Unfortunately, the Fund remains non-committed on the issue of exchange rate management, and suggests 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 needs to pay greater attention to exchange rate stability.

Fourth, the Fund should reconsider its lending policy by moving away from long-term lending and focusing on its role as global lender of the last resort. It must be noted that the Fund, together with G-7 governments, has already assumed the role of lender of last resort by providing emergency rescue financing to countries facing liquidity crises. In order to strengthen this role, the Fund recently created new facilities: the Supplemental Reserve Facility and the Contingent Credit Line. However, in spite of increased resources through the New Arrangements to Borrow in 1998 and increased quota in 1999, these measures are inadequate to counter major swings in capital flows.²³ Reliance on supplementary funds from G-7 governments has at times resulted in the inclusion of unnecessary loan conditions.²⁴ If the Fund were 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 eliminated on

repurchase by the borrowing country (UN 1999). This move would ease the Fund's problem of resource shortage as well as relieve some of the pressure exerted by contributing governments.

Making the IMF a true global lender of last resort would empower the Fund with greater authority and resources, and understandably it looks favourably on this role (Fischer 1999a). However, the financial bureaucrats of the Fund should not be allowed to wield even greater power over crisis economies or emasculate local political systems than they already do. Thus, a set of criteria should be developed so that last resort financing would be available without any conditionality only if a crisis clearly is driven by panic or contagion. In case of other payment crises in 'good policy' countries, conditionality should cover only the minimum macroeconomic adjustments needed for balance-of-payments improvement, and be subject to automatic modification in case demand compression exceeds target. The Fund should refrain from lending to 'poor policy' countries.²⁵

Finally, the Fund needs to develop a 'bail-in' programme, which would promote greater private sector involvement in forestalling and resolving crises (Fischer 1999b). Strengthening the Fund's role as lender of last resort raises the concern of moral hazard in international lending. For borrowing countries, the problem can be minimized by linking availability and borrowing costs of the emergency-rescue financing to their crisis prevention measures. But the problem can become serious with respect to creditors who will be tempted to downplay the risks of lending to developing and transition economies if they are bailed out repeatedly from the effects of reckless lending. This is morally and politically unacceptable, as well as being economically inefficient.

The bail-in option can take alternative forms. The Fund can encourage the utilization of such market-based incentives as private contingency credit lines *a la* Argentine in order to keep the private sector involved. This is a useful defence, but similar to building up large reserves, is costly. The Fund could provide guarantees, thus reducing the costs of such arrangements. Another method used, for instance in the framework of the Paris Club or more recently in the Korean case, is to encourage—and to intervene in—debt restructuring negotiations. However, this process is frequently adopted *ad hoc* and *ex post* and often entails the conversion of private debt into public debt with little loss-sharing. A more fundamental reform is the introduction of collective-action clauses in sovereign bond contracts and the formation of creditor clubs for bank loans so as to make quick rescheduling possible in the event of a crisis. This may introduce increased borrowing costs by forestalling the creditors' exit option, but the certainty of orderly rescheduling may also be an attractive alternative to creditors. Such arrangements would be helpful for crisis prevention and resolution, but are difficult for developing countries to institute on their own, thus making an active role by the Fund and support by the G-7 countries necessary. One of the more radical proposals for bailing-in the private sector calls for the creation of an international bankruptcy court whereby an orderly debt workout can take place under a debt stand-still (Sachs 1995; UNCTAD 1998). This proposal, however, has certain difficulties. For instance, the court would need to function according to pre-arranged criteria in order to ensure that decisions on debt stand-still can be given quickly, or the court may encounter problems with the enforcement of debt workout programmes (Rogoff 1999). These difficulties should not, however, prevent further investigation of the possibilities of an international bankruptcy court.

4.2. Development crisis and the Bank

Unlike the acute financial crises in emerging economies, the chronic development crisis has failed to advance any bold proposals. Politicians give frequent lip service to the urgent need to eradicate the abject poverty faced by a third of the world's population, but there is little action on the ground. There is also a serious paucity of action plans from the BWIs to fight the dilemma.

It would seem that the BWIs have always lacked coherent development strategies. First, the BWIs failed to introduce a commodity price stabilization scheme despite the fact that large fluctuations in these prices were causing 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. Although the Bank later took up this issue, it was only on a limited scale. Third, the difficult question of promoting the political and institutional changes vital for sustainable development without compromising sovereignty was never faced squarely and was left to be moulded in practice by the financially powerful.

Since the 1980s the BWIs supported the 'market-friendly' development strategy based on the Washington consensus. However, it was not a genuine global strategy for development as the BWIs frequently failed to consider the overall effect of their actions in individual countries, producing a fallacy of composition (Stewart and FitzGerald 1997). A classic example is the episode in the 1980s, when individual countries with balance-of-payment difficulties resulting from falling commodity prices were advised to encourage commodity production and export, which subsequently precipitated further declines in commodity

prices. Moreover, the Washington consensus failed to generate sustained growth in most poor countries, often exacerbating income distribution and policy sustainability.

It is true that the BWIs have gradually shifted their emphases and objectives. The distributional impact of programmes receives greater attention and, in the case of the Bank, environmental consequences acknowledged. There has also been some change in the underlying economics and subsequently in the policy stance of the BWIs. The importance of certain public interventions such as prudential regulation of financial institutions and the establishment of social safety nets are recognized. The need to provide supporting revenue is also now recognized. The Fund's doctrine of higher interest rate stimulating saving and therefore growth is no longer maintained, and it has been realized that controls on external capital movements can help contain financial fragility. The World Bank is now developing a 'comprehensive development framework' that purports to seek 'broader goals' with 'more instruments.'²⁷

However, doubts remain with regard to the degree of actual change in the position of the Fund. Its 1997 programmes for Thailand, Indonesia and South Korea were heavily criticized for stipulating a fiscal tightening when no chronic deficit problem existed, for imposing a high interest rate policy where it could cause serious damage because of the high leverage ratio of firms, and for advocating all-out capital market liberalization when an earlier liberalization attempt had precipitated the crisis.²⁸ The Bank has certainly changed a great deal in terms of its rhetoric, but so far there has been little noticeable change in its country operations and in its capacity to accommodate dissenting views.

In any case, a shift from the Washington consensus to 'comprehensive development framework' is not enough. What is needed is a truly global approach, in which the Bank becomes a staunch advocate of a system of international trade and finance that supports 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. Before internal changes can be effected in developing countries, the patronizing attitude of 'We know what is best for you' needs to be replaced by extending a helping hand to domestic forces of change. Instead of endeavouring to teach good economics or micro-manage economies through conditionality, the Bank should provide assistance in the field in terms of resources and technical support.

The legacy of past mistakes, which resulted in the hopeless indebtedness of poor countries must be expunged. Recently, the HIPC initiative has shown some progress when the rich nations met to agree on a financial plan to write-off the \$100 billion debt of the world's poorest countries.²⁹ But the gradualist approach in implementation only prolongs the debt overhang of poor countries. It is time to eliminate the indebtedness problem with a one-shot write-off, after which the Fund should refrain from providing long-term development loans, and the Bank should take primary responsibility for tackling the development crisis.

What should be the main functions of the Bank? Obviously, the Bank needs to concentrate its efforts on the poor IDA countries, and its aid should clearly be focused on the provision of public goods that generate little interest among private capital. The Bank could promote development of the poor countries by contributing to investments in health, education, environmental protection and technology transfer. Infrastructure should be financed by

private capital as much as possible, and only critically important but privately non-fundable projects should be considered for support by the Bank. Instead of formal conditionality for these projects, the primary means of ensuring quality management could be the noticeable presence of Bank staff in the recipient countries.

To support social projects, the Bank should adopt the principle of fewer loans and more grants. Loans for social investment may be useful in 'good policy' countries but in 'poor policy' countries, these may ultimately create debt problems without achieving much good. In the beginning, Bank activities were motivated by imperfections in the capital market that denied developing countries access to foreign capital. But since then, there has been considerable development in capital markets and it should not be difficult to have good investment projects financed privately. It is a fact that, despite the increasing capital markets, poor developing countries are still by and large shut off from private capital inflows. But this stems mostly from the fact that economic and political conditions in these countries make potentially good projects commercially unattractive. Given these circumstances, it is no longer as compelling to justify Bank activities in terms of correcting capital market failures.

Recently, under the leadership of President James Wolfensohn, the Bank announced its intention to expand from a 'loan bank' to a 'knowledge bank'. It is argued that as knowledge is a public good, the Bank can contribute to international development by producing and disseminating knowledge on development policies. Its loan operations will also improve if this knowledge is used to identify suitable projects and programmes. The modality of a 'knowledge bank' contrasts with the 'conditionality bank' (Gilbert, Powell and Vines 1999). According to conventional views, the Bank, because of conditionality,

has better prospects of repayment and returns on investment and can subsequently lend profitably to projects and programmes which private capital would not risk. While both interpretations highlight loans as the key activity of the Bank, they deviate only in what other activities—imposing conditionality and monitoring or producing and applying development knowledge—would enable the Bank to do better than private lending institutions. Such an interpretation of the 'knowledge bank' is not sufficiently far-reaching: the Bank should not restrict its mission to making commercially feasible loans, had the capital market been perfect. Instead, it should redefine its role to become a development agency, offering not only policy advice, but also providing the field with 'development soldiers' gifted with skills, expertise and dedication while maximizing the hiring of local people.

4.3. The Bank-Fund relations

Since the mid-1970s and more earnestly in the 1980s, the Fund and the Bank experienced a large degree of overlap in their activities. The 1966 guidelines for Fund-Bank collaboration demarcated the areas of primary responsibility for each institution: macroeconomic issues such as exchange rates, balance of payments and stabilization for the Fund and development programmes and project evaluation for the Bank. But the increasing overlap created two major problems- possibility of conflict between the two and the possibility of each institution losing sight of its core mission.

By and large, collaboration rather than conflict has prevailed between the Fund and the Bank for three reasons.³⁰ First, there was pressure for more effective collaboration from the rich countries on the two institutions (Junguito 1996). Second, the Fund was in the

driver's seat, with its adjustment programme giving the seal of approval sought by the market.³¹ And finally, the two institutions converged greatly in their policy views.

But this is no cause for celebration. While collaboration and coordination to enhance the effectiveness of the overlapping and interconnected agenda is one thing, suppression of differences of opinion and healthy debate is another matter. It is a known fact that in matters of economic policy, consensus is rare. Maintaining the pretence of consensus precludes possibilities of correcting flawed policies and undermines legitimacy of the programmes. The BWIs need to discard the bureaucratic instinct for maintaining an identical voice in favour of freer discussions on controversial issues.

This, on the other hand, does not imply that they should continue to converge in activity.³² A sharper division of labour is needed, with the Fund focusing on short-term and systemic problems of international finance and the Bank on the long-term development needs of poor countries. Since issues of international finance are closely linked to the interests of rich and powerful countries while development needs are not, the Bank's scarce resources and activities are easily diverted away from their target. The Bank's approval of the Emergency Structural Adjustment Lending procedure that enables it to allocate funds to supplement IMF financing during crises is causing serious concern, and the Bank should resist providing extra funds for IMF rescue financing. Instead, the Bank's resources and capacities must be deployed to confront the persistent development crisis.

Clearer division of labour between the Fund and the Bank does not eliminate the need for mutual collaboration and their joint efforts to strengthen financial systems through the newly created Financial Sector Liaison Committee are indeed justified. The Bank has also

assisted in crisis management by emphasizing the social aspects of adjustment and by providing technical assistance for financial restructuring. It is making efforts to promote better policy responses to the social repercussions of financial crises (World Bank 1999). Strengthening social policy is now an integral part of the new financial system.

5. CONCLUSION: THE BRETTON WOODS INSTITUTIONS FOR THE TWENTY-FIRST CENTURY

Reforming the Bretton Woods institutions is an important part of redesigning the governance of world economy in the twenty-first century. Based on historical and institutional analyses, this chapter has suggested the various reform measures. First, measures for institutional reform include (i) reforming the voting system to give greater voice to developing countries; (ii) enhancing transparency and accountability; (iii) radically downsizing or eliminating conditionality, and (iv) decentralizing research and the decision-making process.

Changes in the roles and policies of the Fund should include (i) contributing to strengthening national financial systems; (ii) encouraging measures to curb excessive inflows of short-term capital; (iii) coordinating macroeconomic policy and stabilizing exchange rates; (iv) discontinuing long-term lending and focusing on the lender of last resort function; and (v) developing a mechanism for orderly debt workout.

New roles suggested for the Bank include (i) advocating global economic governance conducive to development of poor countries; (ii) giving up attempts to micro-manage

recipient economies; (iii) focusing on provision of public goods in poor countries; and (iv) shifting away from loans toward grants.

In addition, a clearer division of labour, which would be based on 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 many technical details have to be elaborated. Political constraints also need to be considered in devising a practical reform strategy, but before any realistic reform proposal is possible, advanced countries need to be fully engaged in the process and the concerns of developing countries must be well represented. To ensure the involvement of developing countries in the new international financial architecture dialogue, the US government created the G-22, which was later expanded to G-33 and then was succeeded by G-20. This kind of *ad hoc* consultation should be replaced with an institutionalized forum for reaching a consensus on the governance of global finance and development.

In order to maximize opportunities for genuine reform, we have to maximize the forces that favour reform, by utilizing both the 'voice' mechanism and the 'exit' mechanism. The voice mechanism must be strengthened by a more effective formation of the mutual interests of developing countries. On certain issues, the NGO community may be able to provide support, as exemplified by Jubilee 2000 movement and Tobin Tax movement. The 'exit' mechanism here does not imply closure of the economy or withdrawal from the world market. Rather, it refers to the possibility of developing countries having alternative

sources of official support for funding and technical assistance when the private capital market is effectively beyond reach.

The BWIs have been so powerful and resistant to reform, precisely because of their unique monopoly position. This would imply that competitive pressure on these institutions could prove beneficial. Subjecting 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 itself in both crisis management and development financing, but would also bring competitive pressure on the Washington-based Bretton Woods institutions to improve their performance. A starting point for this road would be the establishment of Asian Monetary Fund, for which support must now be stronger than when the AMF was first proposed.

A related issue is whether it is better for global financial governance to have consolidated institutional framework, i.e. the BWIs with enhanced powers, or to have a multiplicity of institutions with overlapping and competing jurisdictions. Indeed, there are calls for the 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 favourably 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 a world-wide 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 BWIs in ways that can best meet the challenges of the next century.

NOTES

* I am thankful to the comments and encouragement from Deepak Nayyar. I have also benefited greatly from discussions with Devish Kapur, Andrea Cornia, Robert Brenner and other participants at the project meeting held in June 1999 in Helsinki. Anonymous referees also provided valuable suggestions. Needless to say, remaining inadequacies are solely mine.

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 articles in the *Journal of Economic Perspectives* (fall 1999), the *Economic Journal* (Nov. 1999), and Ahluwalia (1999) and Sachs (1998). For official views, see Camdessus (1998), IMF (1999a), UN (1999) and Hills, Peterson and Goldstein (1999).

³ See Marglin and Schor (1990) for an institutional analysis of the 'golden age'.

⁴ The Bretton Woods Commission (1994) has suggested that the IMF take over the responsibility of policy coordination from the G-7 countries in order to reduce exchange rate volatility and misalignments, and eventually to introduce a system of flexible exchange rate bands.

⁵ Adjustment lending increased rapidly, accounting for about 25 per cent of the Bank's total lending during the second half of the 1980s.

⁶ See Schadler *et al.* (1995) and Fischer (1997) for the views of IMF staff. Killick's analysis (1995a: 157) contains a review of many studies, and he concludes that the adjustment programmes have 'rather limited revealed effects on developing country economies'.

⁷ These critiques are encapsulated in a report by the Group of Twenty-Four (G-24 1987: 9), 'The experience of developing countries that have undertaken Fund supported adjustment programmes 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 programme 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 economy'.

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

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

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, rejection of the loans to Poland and Czechoslovakia in 1949, cessation of lending to Chile during the Allende years and to Vietnam and Afghanistan in 1979, and support for Turkey in the mid-1950s and El Salvador in the 1980s despite European objections (Payer 1982).

¹² Some of the infamous 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 Bank policies recommend adequate compensation for people forcibly displaced by its projects, a Bank review could not point to a single example of a Bank-financed resettlement plan in Latin America or Africa where the Bank's guidelines had been implemented properly (World Bank 1994).

¹³ See Dell (1981: 8) 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'.

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 an amendment of the Articles of Agreement.

¹⁵ Interference by Bretton Woods institutions staff 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 plans for a Fund and a Bank' (Oliver 1985: 41).

¹⁶ See Mosley, Harrigan and Toye (1995). Indirect evidence on the ineffectiveness of conditionality is provided by Bank staff, 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 the 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 the committee members or in its status as an advisory body.

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

¹⁹ A report by its Evaluations Department found a highly significant relationship between borrower ownership and programme 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.

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.

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, Peterson and Goldstein 1999).

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 taxes on capital inflows. But the rationale of the Chilean system is precisely to be able to adjust tax

rates according to economic conditions. Chile removed the taxes as the current account went into deficit and consequently there was need to attract more foreign capital.

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 succeeded in including the removal of the import diversification policy—restrictions on the importation of certain Japanese manufactured products—in the letter of intent for the Korea loan of 1997.

²⁵ A possible objection to this arises when strategically important countries, which do not qualify as 'good-policy' ones, are in trouble. But these troubled countries should be the responsibility of those governments that have strategic interests in them, rather than the responsibility of IMF.

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

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

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

²⁹ The real value of a 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.

³⁰ See Junguito (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 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 such Fund policies as bank closure, fiscal restraint and raising the interest rate.

³¹ The Bank's Structural Adjustment Loans were expected to be used in cases where a Fund programme was already in place, thus giving Fund staff the final say in mutually formulated policy framework papers for SAF and ESAF programmes.

³² The increasing overlap in the activities of the Fund and the Bank prompted some to suggest a merger to avoid duplication of work and conflicting advice (Crook 1991). But the recent crises highlight the Fund's need to focus increasing attention to short-term market factors and systemic issues. This implies greater emphasis in the distinctive role of the Fund versus that of the Bank (Ahluwalia 1999).

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(March 2000)

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