Reforming the International Monetary Fund and the World Bank

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INTERNATIONAL GOVERNANCE

Reforming the International Monetary Fund and the World Bank

Interview with Ngaire Woods

The International Monetary Fund and the World Bank face twin crises. The sources of their funding are running dry, and criticism of their policies is widespread. This Oxford political scientist argues that both institutions must be saved because they perform functions that no other institution can provide. In a new book, she offers her own recommendations for reform.

Q. Is the future—the very future—of the International Monetary Fund (IMF) and the World Bank in jeopardy?

A. Certainly the International Monetary Fund is at one of the most serious tipping points in its sixty-year life. Both the Fund and the

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World Bank are facing a very challenging moment because in the 1980s both institutions were pushed to rely much more heavily than ever before on their earnings from making loans to developing countries. But more developing countries are now choosing not to borrow from them or to rely on their resources. Quite simply, their income is drying up. And that means everybody is starting to ask, "Why do we need the Fund and the Bank? What do we need them for?" Recently, the governor of the Bank of England, a senior U.S. Treasury official, and the South African Bank central governor all started asking serious questions about what we need the IMF to do and why it needs radical reform.

Q. In addition, many people believe that the IMF and indeed the World Bank policies have failed to ameliorate or have even exacerbated poverty—a topic that you address extensively in your book. Is that criticism also jeopardizing the existence of these institutions?

A. Yes, it is. In the early 1990s the World Bank came under huge criticism from nongovernmental organizations (NGOs) and others, saying that it was causing environmental damage, that it was forcing modernization on others, that it forced resettlement of indigenous peoples—that the Bank was harming people. By the late 1990s, the IMF had come under similar, very harsh criticism, particularly after its handling of the East Asian financial crisis, when analysts questioned by what right the IMF could demand an expensive and deeply sacrificial range of changes from countries like South Korea. What gives the IMF that right? Is doing this really legitimate? And when you have an American economist like Martin Feldstein, who worked for a Republican administration, asking that question, you know that the universe is beginning to shift slightly.

Q. To pick up on that point, you trace a lot of the history of these institutions in the book. One of the great criticisms against those at the IMF was the adoption of an approach known as "conditionality," which led to some of these onerous demands. In other

words, these agencies would impose difficult conditions on developing nations that wanted to borrow money—conditions that many people thought were created in Washington by the United States. What was the history of that approach?

A. The IMF was not created to deal with sovereign debt crises. During the 1970s, big American and European banks made huge loans to developing countries that suddenly became unrepayable in the 1980s because U.S. interest rates rose as a result of inflation. These loans became very expensive for the developing countries that were trying to pay them back. The banks themselves were so hugely overexposed that when it became clear that a number of countries could not repay these massive loans, it also became clear that the international financial system itself was in crisis. So the IMF was sent in to save the global financial system. To accomplish this, it first and foremost had to ensure that those heavily indebted countries repaid their debts to international commercial banks. To do that fairly cheaply, the IMF simply lent as much money as these countries needed to repay their commercial bank creditors, while at the same time requiring them to tighten their belts in terms of government spending and social programs. The main reason the IMF did that was that those were the tools it already had in its toolbox. The IMF had been building a model within itself to deal with countries that had a short-run cash-flow crisis, and that was the toolkit of the IMF in 1980.

Q What do you mean by "tighten their belts"? What was required?

A. When I say tighten their belts, I mean dramatically reduce government expenditure, which was intended to roll back government spending across the board. Thus, the government would need fewer resources for running the country and therefore have more resources available to repay international banks. That IMF model was aimed at resolving short-run cash-flow crises, and that was not the problem that these countries had. They had massive insolvency problems. They had borrowed hugely at a time when real interest rates (nominal rates less inflation) were negative. Now they had to repay all that money, and they simply could not.

Q. Which countries are we talking about?

A. Mexico, Venezuela, Brazil, Argentina, Indonesia, and the Philippines.

Q. In particular, you address the Mexican crisis in the book. Did this limited toolkit, as you say, seriously exacerbate the Mexican situation?

A. Yes, it certainly did, because it meant that in 1982 Mexico could not repay its international commercial creditors. The IMF stepped in and lent it just enough money to repay the banks, which only meant that Mexico became more indebted, this time to the IMF, as it borrowed enough money to repay the commercial banks. Meanwhile, the government was cutting back its expenditures, including reducing its welfare programs, so the entire Mexican economy continued to contract. Of course, the markets in the United States and the other countries where Mexicans were trying to sell products were also contracting.

Q. What was the final result of that?

A. It took more than ten years to work through, and by the late 1980s it had become clear to everybody that this was no solution to the debt crisis faced by developing countries. Simply telling them to tighten their belts and repay their creditors was causing poverty, dislocation, and collapse in these economies. And so the strategy changed to include more consideration of the long term and what these countries needed if they were going to try to grow.

Q. Why were the IMF professionals oblivious to the risks of this policy?

A. In my view, in the 1980s they used stabilization and structural adjustment—the policies of the so-called Washington Consensus—for a very simple reason. Their first priority was to prevent an international financial crisis, not to generate economic growth in these countries. Only when they had stopped the international financial crisis did they begin to address what was going on in these economies.

Q. Do they still argue that was a sensible policy?

A. No, there is a fairly widespread consensus now that those early policies were too harsh, that their social, political, and economic impact was more severe than was necessary.

Q. Was there a similar strategy during the Russian crisis?

A. In a way there was, which again reveals in part how limited the toolkit of the time was. It also reveals in part the constraints of a strategy deployed by the United States and Europe with limited resources.

Q. Don't the strategies reflect the influence of their wealthiest clients, in particular, the United States? Wasn't the sense of urgency in 1997 and 1998 a reflection of the fact that the big international banks were the ones that would pay the biggest price for that strategy?

A. That changed between the 1980s and the 1990s. In the 1980s that was the primary concern, because if the banks crashed, the whole system would crash. In the 1990s the investors comprised a much broader group and they were bailed out much less (they were forced to take heavier losses). The driving imperative in Russia was that the United States and Europe wanted to engage with Russia in a way that it could accept and that would integrate it into the international system. And the only institutions that they thought they could use to do so were essentially the IMF and World Bank. But the IMF and World Bank had never been created to do what they would later call "systemic transformations." However, that is actually what they were being deployed to do with remarkably few resources and with this very narrow toolkit, which was also ideological.

Q. In what way was it ideological?

A. In my book I trace the way in which an ideological mindset of the institutions is constantly reinforced by the job that they have before them and the limited tools they have available to do it. The easiest way to do the job in Russia was to apply the same rules and the same framework that they applied elsewhere: They tried to implement stabilization and structure adjustment in Russia. But then a crisis point was reached wherein either the agency had to pull out because Russia was not meeting its targets, or it had to remain only because it was forced to do so by political pressure. For example, the desire to improve President Yeltsin's chances of winning the 1996 election forced the IMF to turn a blind eye to what Russia was not doing to meet financial targets and to keep lending. So the approach was flawed in two ways. In the end, I think the IMF and the Bank had damaging influence on Russia in one sizable respect. They polarized the economic debate so that everyone who was interested in modernizing or reforming Russia was expected to support the orthodoxy of the Fund and the Bank. Anyone who did not take that position was defined as a complete Luddite, a nationalist dinosaur. What was missing was a middle ground.

Q. The position that they promoted was rapid and almost universal deregulation of prices, rapid privatization, capital deregulation, and freely floating the currency.

A. Yes.

Q. And there could have been a middle ground, less rapid deregulation, less rapid privatization?

A. That is right, with much greater attention to institutional development.

Q. In the late 1990s, the World Bank at least started to talk about what it called the ownership of policy-making. That is to say, policy-making would require the participation of developing people. Did that fail?

A. Ownership is a really interesting area. In the chapter on Africa, I discuss it because for the Bank and for the Fund, it is a real contradiction. On the one hand, they want countries themselves to be, as they say, in the driver's seat. But, on the other hand, if countries themselves were really in the driver's seat, most of what the Fund and Bank do would be redundant. So, for the Bank and Fund, ownership does not, in the end, mean ownership as you and I might see it. If you wanted real ownership, you could ask two very simple questions of any policy or project. You could ask, where did this policy or project really originate—in Washington, DC, or in the country that supposedly owns it? And what kind of resources is the country itself putting into this project? The answer to that immediately gives you an indication of how committed the country is and to what extent such a consideration is a priority. Those are not at all the tests that the Bank and Fund applied. They applied a different test: Does the country understand the policy that we are pressing on them? And have we explained it to a wide section of the society? That is a very different approach. At its weakest, it just looks like amplified public relations. At its strongest, it involves an attempt to engineer societies so that they respond better to the agenda pursued by the Fund and Bank.

Q The way you describe it, that agenda seems to begin with a cavalier attitude that the professionals at the Fund and the Bank know what is best for these countries.

A. There is no doubt that most professionals at the Bank and Fund genuinely believe that they know what is best for these countries. If only they would conform to an ideal vision of an economy, then what the Bank and Fund have to prescribe for them would probably work. But these countries have very specific political and social conditions, which means some things work in them and some things do not.

Q. You talked quite provocatively about where the Fund professionals and the Bank professionals have been educated. It seems to have been in the elite academic institutions in the United States.

A. And that provide an excellent academic training in economic modeling. If there is one complaint I hear reverberating among the African members of the IMF and World Bank, in particular, it is that the officials sent to advise them on how to run their economies know nothing about how their economies work. The IMF representative goes to African countries and gives advice, for example, on interest rates. And yet, nobody in the IMF actually understands how what economists call "financial transition mechanisms" work in African economies. In other words, they do not actually understand what impact a change in the interest rate will have on investment or on the economy itself in any one of the African member states.

Q. You feel rather strongly about maintaining these organizations. They were born sixty years ago in the wake of World War II, and yet you think they maintain viability despite all these problems and all these failures. Why?

A. Because there are some things that each institution is uniquely placed to deliver. I do not think that the Bank or the Fund should be doing things that other institutions can do. They should not be asking themselves what they do well, because that is not a good reason for them to do things. They are public institutions; they are paid for by taxpayers. They should do what they alone can do, and there are some of those things. The World Bank was created with a very important purpose—to raise money in capital markets and lend that money to countries. So that capital, and the great engine that capital can give an economy, would flow to places where private markets would never go or would not reach far enough and fast enough. That remains a very valid reason to have a World Bank.

The IMF equally has a unique purpose—it serves as an insurance function for all its members. All countries face some risk of financial crisis in a world where exchange rates are volatile, where there are trillions of dollars sloshing around in global capital markets, and where individual countries try to accumulate huge foreign exchange reserves against crisis. That is what the Asians are doing at the moment. But it is much cheaper for countries to pool their reserves and for all to have access to the reserves when any one of them gets into crisis. That was the original conception of the IMF. There is a reason to do it internationally rather than, say, individually or regionally, because financial crises these days tend to engulf an entire region. So the ideal of having an IMF that is international means that the risks are more widely spread. It is not the case that all members of the IMF will face the same financial crisis at the same time. The risks could balance out across the whole membership.

Q. I believe many readers would like to know what decisions, and demands, the IMF and World Bank should make. But you address a different question, which is, how do we restructure the IMF and the World Bank to create incentives to enable them to make better decisions?

A. I focus on process because what they do and how they do it are closely linked. I do not think that, for example, the Asian economies are ever going to have confidence that the IMF will be even-handed among all its members while it is headquartered in the seat of the U.S. government and has a senior management that is, for all intents and purposes, appointed by the U.S. government. Every decision is vulnerable to a veto by the U.S. government, even though the U.S. vote is some 17 percent of the whole organization. A modern IMF that is going to serve this unique purpose will have to be one that commands the confidence of its whole membership. It cannot be seen as a simple tool of U.S. foreign policy. I do not believe it has ever been purely a tool of U.S. foreign policy. But while that perception is held in so many parts of the world, the Fund has a huge legitimacy problem.

Q. The history of the World Bank and the IMF is that they did serve U.S. foreign policy interests from the 1950s.

A. Yes, they did, but at the same time as I traced that history I show all sorts of points in history when there was no clear-cut American interest. We speak of an American interest, often forgetting that the State Department, the U.S. Treasury, the U.S. executive, the U.S. NGOs, and Congress can each have quite different interests in different countries. And there are times when the Fund and Bank do enjoy autonomy, some independence from the United States and from their other shareholders. Maintaining that independence does require some self-restraint on the part of the United States.

Q. You proposed five or six reforms. Let us summarize them.

A. The reforms I propose in the book are actually very modest. They are perfectly feasible under the current status quo. The very obvious one is that, first, you change who picks the leader of each organization. What I argue in the book is that whoever is president of the World Bank or whoever is managing director of the IMF holds the whole list of staff to account. And if the staff think they are being held to account by somebody who represents the U.S. administration, it is not ideal.

Q. In the case of the World Bank, it is the United States in control, right?

A. Yes, but equally in the IMF, the number two is appointed by the United States, and it is the number two, the first deputy managing director, who for all intents and purposes is managing the organization. And then the whole staff works with an eye to what they know the U.S. administration would like them to be doing. So it skews the accountability of the organization. Leadership selection is very important.

The way in which countries participate in decisions of the organization is crucial. At the moment, there is no reason an executive director from one of the powerful countries would have any reason to consult, for example, the executive director who represents some twenty or so African countries. That has to change. There must be at least an incentive to consult. So, for that reason, in the book, I propose a modest change in voting power but also an extension of the rule that you do not just have to command a majority of the weighted vote, because the G7 can do that on their own. But you also have to command a majority of the entire membership. In other words, you have to have ninety countries on board to pass measures in the IMF. And that would very simply and easily give all the board a powerful incentive to consult the poorest, most numerous groups of countries.

Q. What about transparency?

A. The IMF and World Bank were originally born to do quite narrow technocratic things. They now are intervening and affecting political systems in countries. They are influencing, in all the most heavily indebted countries, who gets to participate in economic decisions in countries. This is a big political mandate that they have gradually accrued for themselves. Given that, they have to be accountable to a wider range of people. It is not enough that the central bank in each of these countries knows what the IMF is doing. It has to be the case that all people within these countries know what these institutions are doing. So I argue in the book for a full publication of the transcripts of board meetings. Any citizen in Britain or the United States or Zambia should be able to find out exactly what the person representing them has said in a board meeting.

Q. What about who should be financing the IMF and the World Bank?

A. In the 1980s, the burden of paying for these organizations was thrust very heavily onto the shoulders of the poor and borrowing countries. But that is no longer a fair deal because both the IMF and the World Bank are now doing a lot more. For example, they are involved in trying to prevent terrorist funding. They are involved in producing knowledge information standards and monitoring for global markets. These are not services that are accessed only by their borrowing members. They are ostensibly of use to everyone in the world economy, and therefore there is a rationale for every country in the world economy to be contributing more equally to these organizations.

Q. Are there any final reforms that you would recommend? What did we leave out?

A. Perhaps the simplest reform—and the least popular—would be to have every staff member at the IMF and World Bank work on the same country, if not for his or her whole career, then, for example, for ten-year periods of that career, because it is the only way to build into the institutions an incentive for their economists to actually learn about the economies that they are advising. If the IMF and World Bank are to advise economies, they have to ensure that they actually have expertise.

Q Let me return to one former question, given that you raised the question of whether the way economics is taught and our professional understanding of economics are equal to the job. Do you sense that academic economics has become too abstract in the search for universal tools?

A. All social sciences have a highly theoretical end and a highly empirical end. The sad thing about economics is that the profession has somehow decided that the truly clever must prove they are truly clever by only working at the highly theoretical end of the spectrum, leaving the empirical work to those, as they see it, incapable of performing at this highest level of theoretical extraction. That is crazy.

Q. Where do you think the IMF and World Bank will be ten years from now?

A. I think that some of the reforms I proposed actually will take place. When even the central bank governors and treasury officials of major countries are saying that these institutions need to reform, the institutions themselves will unavoidably have to change. Their most powerful members will accept that changes have to be made.