Department for International Development (United Kingdom)
www.dfid.gov.uk

Development Assistance Committee, Organisation for Economic Co-operation and Development
www.oecd.org/dac

French Development Agency
www.afd.fr

Millennium Challenge Corporation (United States)
www.mcc.gov

Overseas Development Institute (United Kingdom)
www.odi.org.uk

Reality of Aid (civil society)
www.realityofaid.org

Swedish International Development Cooperation Agency
www.sida.se

United States Agency for International Development
www.usaid.gov

NOTE

1. The total of US$121 billion includes the $1 billion in loans repaid, which is a negative flow and therefore brings down the total. The remaining discrepancy between the bilateral and multilateral contributions and the total is due to rounding.

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CHAPTER 9

THE INTERNATIONAL FINANCIAL INSTITUTIONS

Marcus Taylor

LEARNING OBJECTIVES

- To understand why the IMF and the World Bank were created and how their operations changed over the following decades.
- To comprehend their role in the process of structural adjustment and the controversy it created.
- To learn how the IMF has reacted to the current economic crisis, including the debates over granting developing countries more power within the institution.

OVERVIEW

Few actors in international development have fuelled controversy to the same degree as the leading international financial institutions: the International Monetary Fund (IMF) and the World Bank. Notwithstanding their official objectives of ensuring global economic stability and promoting poverty reduction, these institutions have attracted considerable criticism from a wide range of social movements and political groups. Opponents from the left of the political spectrum have claimed that IMF and World Bank policies serve to entrench global poverty and exacerbate inequalities. As a consequence, the annual meetings of the institutions are routinely confronted with large-scale protests. Conversely, conservative voices have argued that the institutions are overly bureaucratic and increasingly irrelevant in today's globalized world. Editorials in the *Wall Street Journal*, for example, have repeatedly claimed that the expanding role of multinational corporations and global financial markets has lessened the need for the IMF and World Bank and, therefore, they should be streamlined or simply disbanded.

To help to understand these debates, this chapter examines how and why the IMF and World Bank were established and how their roles have evolved. We begin with the Bretton Woods Conference of 1944 at which these international financial institutions (IFIS) were designed. Then we focus on how both institutions assumed a growing influence on developing countries in the context of a deep social and economic crisis during the 1970s and 1980s. At this point, the IMF and World Bank began to use their financial influence to promote structural adjustment policies. These policies involve a series of economic and social reforms designed to promote the role of market forces within the developing world and have provoked much controversy. While the IMF and World Bank suggest that structural adjustment reforms promote strong and stable economic growth, critics claim that their effects have been counterproductive and have led to increased poverty and growing inequality. In examining this debate, we look at the ways in which the IFIs have reformed their practices in response to criticism. In this vein, current policies promoted by the institutions focus not just on economic reforms but on a wider set of

policy changes that incorporate such diverse features as 'good governance', 'building institutions for markets', and 'empowering the poor'. We outline each of these and ask whether they mark a change in direction from structural adjustment or are merely an adaptation. Finally, we turn to the controversy surrounding the IMF over its interventions in the East Asian financial crisis in the late 1990s before reflecting on the impact of the current global economic crisis on the IMF and its governance structures.

THE ORIGINS OF THE IMF AND WORLD BANK

The formation of the IMF and World Bank dates to the Bretton Woods Conference held in New Hampshire in July 1944. With World War II drawing to a close, the United States and Britain began to plan a new international order for the post-war era. At the forefront of their concerns was the creation of an international economic system to promote trade and provide rules for economic relations between countries. This goal stemmed from events in the 1930s, when economic conflicts between major European powers contributed to the outbreak of war. During this earlier period, the international monetary order was characterized by a system of flexible exchange rates, which allowed countries to manipulate their currency in order to gain economic advantages. For example, when faced with economic problems countries might respond by devaluing their currency as a way to cheapen—and therefore boost—their exports. Although this strategy tended to provide short-term gain, it did so at the expense of other countries, which tended to follow suit. This often led to a spiral of currency devaluations that greatly interrupted the stability of international trade and investment.

The 44 allied countries that met at Bretton Woods agreed that the economic anarchy of the previous decade needed to be avoided. A clear consensus did not exist, however, regarding the precise character of the new international economic order that should be established. Owing to the overwhelming economic and military power of the US, the American delegation was able to ensure that their blueprint proposal, designed by Harold Dexter White, set the basis for conference discussions and, ultimately, the articles of agreement that bound countries to the Bretton Woods system (Peet, 2003). The American delegates had been quite forward about the type of international order they envisioned. Given the overwhelming superiority of the US's industrial base, they sought a system in which international trade could proceed relatively unhindered. This would not only help America to meet its goal of economic expansion, the US delegates claimed, but would also fuel global prosperity and mutual development.

Given that monetary instability was blamed for the disintegration of international trade in the preceding era, the **Bretton Woods system** was founded on the establishment of fixed exchange rates between national currencies. Each currency would be pegged at an agreed amount of US dollars, which in turn were redeemable for gold at a fixed rate. Only small variations to these exchange rates were permitted. Ensuring that currencies remained fixed was intended to provide the stable monetary conditions necessary for expanding world trade.

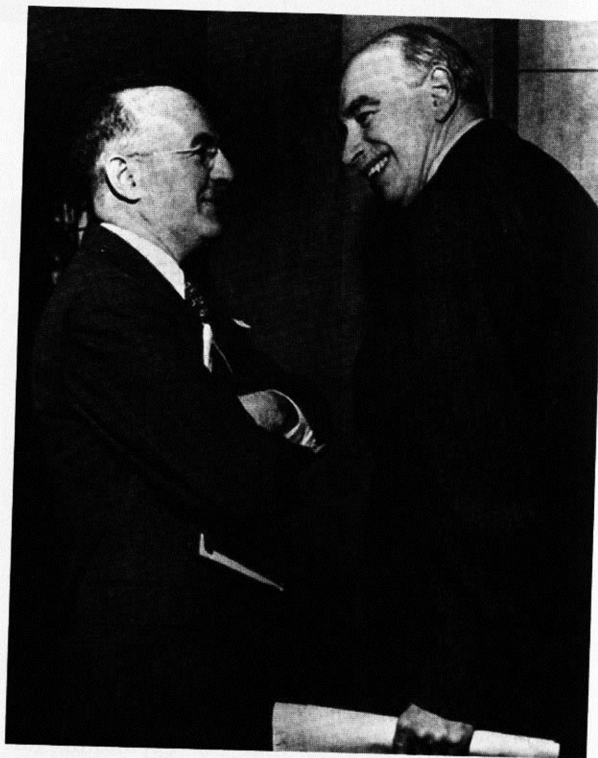

PHOTO 9.1 John Maynard Keynes (right) and Harry Dexter White at the Bretton Woods Conference, 1944.
Source: Wikipedia

> **IMPORTANT CONCEPTS BOX 9.1**
>
> **THE US AIMS FOR BRETTON WOODS**
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> The purpose of the conference is . . . wholly within the American tradition, and completely outside political consideration. The United States wants, after this war, full utilization of its industries, its factories and its farms; full and steady employment for its citizens, particularly its ex-servicemen; and full prosperity and peace. It can have them only in a world with a vigorous trade. But it can have such trade only if currencies are stable, if money keeps its value, and if people can buy and sell with the certainty that the money they receive on the due date will have the value contracted for.
>
> Source: US Department of State press release, cited in Peet (2003: 47).

Once the articles of agreement were ratified by member countries at the end of 1945, the International Monetary Fund was set up to oversee the workings of the system and to manage any potential disruptions. Each member country paid into the IMF a quota of its own currency, as well as some gold or dollar holdings based on the size of its economy. When facing severe economic problems, such as a balance-of-payments crisis in which a country was importing more than export earnings could pay for, countries would be permitted to draw temporarily on the reserves of the IMF to pay international debts. Usage of these funds, therefore, was intended to provide a country with sufficient time to stabilize its economy without resorting to measures such as currency devaluation that would cause international monetary instability. Thus, at this point, the IMF functioned as an important yet modest instrument to maintain international currency stability. This initial role gave no hint of the Fund's later emergence as a powerful agent within international development.

Along with the establishment of the IMF came the creation of the International Bank for Reconstruction and Development (IBRD), which later became known as the World Bank. In the immediate post-war period, the IBRD was designed to make loans at preferential rates of interest to European countries devastated by war. Nonetheless, the role of the IBRD in Europe was greatly diminished when the US government unveiled the Marshall Plan in 1947, under which it unilaterally lent large sums of money to European nations to accelerate the reconstruction process. The accelerating process of decolonization, however, created a new and expanding clientele. US president Harry Truman is widely considered to have launched the project of international development in 1949 when he suggested that decolonization was creating a new 'underdeveloped world' that was in need of a 'program of development' based on 'democratic fair dealing'. By serving as a conduit of development finance into the underdeveloped world, the IBRD was viewed as an important element of this development project.

The new countries that emerged from the collapse of colonialism were commonly considered to be on a natural path towards development, advancing through a sequence of structural transformations from traditional agrarian societies to modern industrial ones (see Chapter 3). Development economists, however, suggested that the rate of development was limited by the stock of capital a country could draw upon for productive investment. In the post-colonial

> **IMPORTANT CONCEPTS BOX 9.2**
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> **IMF: INITIAL FUNCTION**
>
> Originally, the purpose of the IMF was quite limited: to provide financial resources to allow countries to solve balance-of-payments crises without devaluing their currencies. This would help to maintain the system of stable exchange rates established at Bretton Woods that facilitated stable international trade.

> **IMPORTANT CONCEPTS BOX 9.3**
>
> **WORLD BANK: INITIAL FUNCTION**
>
> The original intent of the World Bank was to provide financing for post-war reconstruction and development projects. From 1950 on, however, the Bank focused on providing loans to developing-world countries at lower rates of interest than those of private international banks. These loans were directed mainly towards building infrastructure for development.

period, capital was scarce for most developing-world countries. Domestic savings rates were low, and many private international banks would not lend to these countries because they were viewed as a considerable risk. In this context the IBRD offered a partial solution by acting as an intermediary between private international banks and developing-world governments. Backed by the financial and political support of the leading Western countries, the IBRD was able to finance itself through loans from private international banks at low interest rates. In turn, the IBRD could then lend money to governments in the developing world to finance development projects at rates of interest that such governments could not obtain when dealing directly with private banks.

Initially, the Bank tended to fund very specific types of projects. In the first two decades of its existence, more than 60 per cent of its loans funded projects to build physical infrastructure, such as highways, airports, electricity grids, and hydroelectric dams. To receive such funding, applications from developing countries needed to meet the criteria established by the Bank to ensure that the project was technically sound and would generate sufficient revenue to repay the loan. These criteria tended to exclude many of the poorer nations because they could not guarantee a significant rate of return.

To address this issue, the International Development Association (IDA) was formed in 1960 as a new organization within the World Bank. Like the IBRD, IDA loans also funded large-scale infrastructural projects. However, these loans were provided at a virtually interest-free status over long periods of repayment, which allowed the IDA to fund a range of projects that would not qualify under the IBRD conditions of profitability and repayment. In this manner, a division of labour was created between the IBRD, which provided subsidized credit to middle-income countries, and the IDA, which provided zero-interest loans to poorer developing countries.

GOVERNANCE STRUCTURES

Before tracing the evolution of the IMF and the World Bank, it is useful to examine their governance structures and the exercise of power within them. Unlike the United Nations General Assembly, where each country has one vote, voting rights in the IMF and World Bank are weighted according to quota subscriptions. These are based on the size of a country's economy, meaning that advanced industrial countries have consistently held the majority of the voting power. At present, they hold approximately 57 per cent of the voting rights within the institutions, whereas the poorest 165 countries together have only 29 per cent. The US currently holds close to 17 per cent of the voting rights, providing it with a unilateral veto over constitutional amendments.

Voting power, moreover, translates into direct representation at board meetings. While the IMF and World Bank are run on a day-to-day basis by an internal management structure, the Board of Executive Directors oversees these actions, including approving loans and guarantees, setting the administrative budget, vetting country assistance strategies, and making borrowing and financial decisions. There are 24 seats on the board, and the representatives are chosen through vote shares. As a consequence, the 46 sub-Saharan African countries together have only two representatives on each of the executive boards, while the five richest countries each have one, as do China, Saudi Arabia, and Russia. In addition, the US and the European Union have the unilateral power to choose presidents: the US appoints the president of the World Bank, and Europe designates the president of the IMF. This caused controversy in 2005 when the government of George W. Bush insisted on placing Paul Wolfowitz at the head of the World Bank despite significant opposition from the developing world, from European countries, and within the Bank itself.

Indeed, the role of the US in influencing IMF and World Bank decisions has been much debated. Although authors differ on the degree of power they ascribe to the US, there are numerous historical examples of US influence over decision-making. For example, in the Cold War period of the 1960s and 1970s, US governments used their ability to withhold IDA quotas to ensure that a disproportionate amount of financing was channelled to strategically crucial US allies and, following the Cuban revolution of 1959, to governments that were seen as bulkheads against communist revolutions (Caufield, 1996). This often involved funding dictatorial regimes with dubious human rights records. Similarly, in the 1970s, the IMF made loans with abnormally flexible conditions to key US allies such as Egypt.

More recently, the record of US influence has been one of mixed success. For example, the US executive was successful in pressuring the World Bank's president to have controversial chief economist Joseph Stiglitz removed from his position at the Bank in 1999. However, it subsequently failed to significantly change the content of the Bank's *World Development Report 2000/2001* despite its considerable opposition to the anti-poverty strategy it advanced (Wade, 2001). In a more constructive way, the US Congress, under pressure from non-governmental organizations such as the Sierra Club, lobbied the US Treasury in 1989 to instruct the US director to vote against all Bank projects that did not have an environmental impact assessment available 120 days before the Board of Governors' vote. Two years later, this practice became incorporated into standard Bank policy. The relationship between the US and the IFIs is therefore quite complex, and both institutions have at times needed to balance their multilateral credentials while appeasing the interests of their primary shareholder.

IMPORTANT CONCEPTS BOX 9.4

IMF QUOTAS AND WORLD BANK SUBSCRIPTIONS

On joining the IMF, each country must pay a subscription quota based loosely on the size of its economy and measured in SDRs (Special Drawing Rights), the IMF's unit of account. A member's quota determines both its financial commitment to the IMF and its voting power within the institution. These quotas also determine how much a country can borrow from the IMF in times of crisis. Technically, a country can borrow 100 per cent of its quota annually, to a limit of 300 per cent cumulatively. In special circumstances, however, these limits can be waived. Quota sizes are reviewed every five years, and the current levels can be viewed on the IMF's website (www.imf.org).

World Bank 'subscriptions' also define voting rights. Upon joining the IBRD, member governments must 'subscribe' to a portion of the Bank's capital stock by pledging to purchase a specified number of shares according to their financial capacity. Members are required to purchase only a small portion of their subscription ('paid-in capital'), while the remaining portion ('callable capital') remains outstanding. Given that the IBRD raises the vast majority of its capital through bond issues, it has never had to request 'callable capital' from its members.

THE TURBULENT 1970S

During the first two decades of their existence, the activities of the IMF and World Bank were relatively modest and did not provoke the controversy that currently envelops them. The decade of the 1970s, however, was a period of notable instability and crisis in the global economy, which prompted a dramatic transformation of both institutions. First, the decision of the United States to withdraw its support for the Bretton Woods system in the early 1970s created a fundamental rupture within the IMF. Concerned with an escalating trade deficit and the growing amount of dollars held by countries abroad, President Richard Nixon effectively abolished the system in 1971 by suspending the convertibility of dollars into gold. This unilateral action broke the principal tenet of the Bretton Woods system and undermined the stability of exchange rates. Eighteen months later, the currencies of industrial countries were allowed to float freely, which undermined the official role of the IMF to provide temporary loans to maintain currency stability.

In adapting to the new circumstances, the IMF did two things. First, it shed the aims of the Bretton Woods system to recast itself as an international lender of last resort. Countries that needed short-term injections of money to pay international debts could turn to the IMF without needing to maintain the value of their exchange rate. Indeed, the IMF now frequently recommended that countries devalue their currencies to strengthen their exporting sectors, which was the opposite of its original purpose.

Simultaneously, the IMF also began to expand the number of conditions attached to its loans and increase its surveillance of the policies pursued by borrowing countries This trend would become increasingly important in the years that followed. In accepting

financing from the IMF, countries were forced to accept implementation of an IMF-sanctioned reform program to re-establish economic stability. Through what were known as 'stand-by arrangements', the standard IMF package involved austerity measures aimed at reducing government spending and lowering consumption within the economy so as to decrease imports and increase funds available for repaying international debts. As we shall see below, in the 1970s and beyond, growing numbers of developing-world countries found it necessary to borrow money from the IMF and this entrenched the power of the institution within the developing world. Nonetheless, the austerity programs that the IMF insisted on were widely criticized for their adverse effects on the poorer segments of society. In many countries, the financial solvency of the state was often restored through cutting subsidies on basic consumption goods and reducing expenditures on social services (Körner, 1986).

In the World Bank, the 1970s was also a period of notable transformation. Under the presidency of Robert McNamara (1968–81), who had been the US Defense Secretary during the initial escalation of the Vietnam War, the institution dramatically expanded its operations. McNamara viewed the Bank as an underutilized instrument in a fight against global poverty and communism. On assuming office in 1968, McNamara challenged his staff to find ways to increase lending, including making loans to countries hitherto untouched by the World Bank. Lending activity swelled from $2 billion in 1970 to over $11 billion in 1980. At the same time, the Bank's lending profile shifted away from large-scale infrastructural projects to target a wider range of development objectives (see Box 9.5). McNamara emphasized the need for the Bank to fund direct anti-poverty efforts through social programs and projects aimed at modernizing the agricultural sector. Indeed, he saw the agricultural sector as neglected in the rush to industrialize, leaving it as a reservoir of poverty. By focusing on health and education programs, McNamara's approach became known as the 'basic needs' approach (see Chapter 13). Lending for infrastructure fell to about 30 per cent of total Bank funding, whereas loans for anti-poverty projects (including an emphasis on helping small-scale farmers increase productivity) rose to almost 30 per cent.

IMPORTANT CONCEPTS BOX 9.5

ROBERT MCNAMARA'S CALL FOR A 'BASIC NEEDS' APPROACH

Nations need to give greater priority to establishing growth targets in terms of essential human needs: in terms of nutrition, housing, health, literacy and employment—even if it be at the cost of some reduction in the pace of advance in certain narrow and highly privileged sectors whose benefits accrue to the few.

Source: Speech of the World Bank President to the annual meeting, Washington, Fall 1972.

Two important changes stem from McNamara's tenure as head of the World Bank. First, the Bank became considerably more active and powerful on a global level. No longer was it content to lend cautiously to a limited number of developing-world countries. Rather, it was prepared to actively propagate projects in the developing world as part of a broader mission to spread capitalist development. Second, in emphasizing the need to focus on social objectives, the Bank opened up a debate about its own purpose and that of development finance in general. While McNamara's approach was well received by some members of the international development community, there was also a powerful conservative reaction that suggested the Bank should focus simply on promoting economic growth.

THE DEBT CRISIS, STRUCTURAL ADJUSTMENT, AND CONDITIONALITY

As the decade of the 1970s drew to a close, many developing-world countries were faced with the dual burden of high oil prices and falling prices for their primary exports. They began to borrow heavily from private international banks to overcome expenditure shortfalls. These banks, moreover, had accumulated surplus holdings of dollars and were actively seeking to make loans to the developing world, often without regard for long-term sustainability. The orgy of borrowing that followed left countries across the developing world heavily indebted to European and North American banks. In Latin America, for example, the total external debt (private and public) leapt from $100,000 million in 1976 to $336,230 million in 1983 (see Chapter 14).

Events were brought to a head in 1982 when the US made a unilateral decision to raise interest rates. This action quickly and considerably deepened the debt burden of many developing-world countries. Mexico was the first to threaten default when, on 12 August 1982, it announced to the IMF and US government that it could not meet payments on an outstanding $80 billion debt. By October 1983, some 30 countries owing a total of $239 billion had or were attempting to reschedule debt payments; 16 Latin American countries accounted for 74 per cent of this total. Given the magnitude of the loans potentially facing default, a number of major US and international banks faced collapse, which raised the spectre of a financial crash engulfing the entire Western financial system.

In response, the IMF and World Bank began to pipeline billions of dollars to debt-stricken countries to facilitate continued payments on their old debt. In becoming the major funnel for emergency credit to the South, the IMF and World Bank proposed dramatic reforms for developing countries. The basic premise of their operations was that development policy in the preceding decades had become profoundly misguided. In the post-war period, it was generally accepted that the institutions of the state had a major role to play in promoting modernization through industrialization, and this was reflected in policies such as credits to industry and trade protectionism to block foreign competition. For the IMF and World Bank, these policies had created both inefficient industrial sectors that were a drain on national resources and over-inflated state bureaucracies that distorted markets while breeding corruption.

To overcome the crisis, they claimed, it was not enough merely to stabilize the economies of the developing world through standard austerity programs. Rather, a much more profound process of transformation was necessary to open countries to foreign trade and a greater focus on producing export goods. At the same time, the state should decrease its interventions to allow market forces a greater role in distributing resources across the economy. This projected transformation was captured in the notion of structural adjustment. To pursue this new mission of promoting structural adjustment, the IMF and World Bank introduced sweeping changes to the nature and extent of their operations. McNamara had coined the term 'structural adjustment' in 1979 to describe a shift from 'project lending'—i.e., funding a specific project such as building a dam—to 'program lending'. This involved giving less funding to support specific projects, such as building dams and roads, and placing more emphasis on countries' adopting structural adjustment programs. The first specific structural adjustment loan of US$200 million was granted to Turkey in March 1980, and many others followed during the debt crisis.

To ensure that countries undertook these difficult measures, numerous conditions were attached to World Bank and IMF loans, and the release of further portions of structural adjustment loans was made dependent on the successful implementation of prior requirements, as decided by the IMF and the Bank. The institutions therefore took a much stronger role in setting and monitoring the policies of borrowing countries. With both the Bank and the IMF seeking to impose mutually reinforcing cross-conditionality restrictions on lending, the two became embroiled in a far closer association than at any previous time. This rapprochement gave rise to the notion of the **Washington Consensus** as both leading financial institutions wielded their considerable influence in order to propagate a common development doctrine on a global scale.

The immediate phase of adjustment, usually managed by the IMF, consisted of severe austerity measures to restore macroeconomic balances. Through a shock therapy program of rapid liberalization of prices, currency devaluation, and fiscal discipline, a deflationary period could be engineered within which the government would balance its budget and inefficient industries would collapse. In the medium term, structural adjustment pursued the rapid liberalization of trade, deregulation of markets, privatization of state-owned industries, and the introduction of the private sector into providing public goods such as health care. This was intended to allow market forces to play a greater role in distributing resources across different sectors of the economy and to encourage new and dynamic export-oriented industries to form.

While the emphasis of structural adjustment was on long-term economic growth, these reforms also were intended to ensure debt repayment and thereby re-establish the integrity of the international credit system. Thus, the IMF and World Bank were widely perceived as assuming the role of debt collectors for

private banks. At no point did the institutions question the morality of the burden of debt crisis being placed on the developing world rather than being shared with the international banks that had lent money irresponsibly. As an answer to the debt crisis, therefore, structural adjustment appealed greatly to the Western shareholders of the IMF and World Bank, because new loans served to shore up the financial systems of the North, while structural adjustment opened new avenues for investment in the South and refocused the industries in the South towards primary and secondary exports that lowered commodity costs in the West. The question remained, however, of whether structural adjustment would also provide a route towards long-term economic stability and growth within the developing world.

BEYOND STRUCTURAL ADJUSTMENT?

In the 1990s, the IMF and World Bank came under growing pressure because structural adjustment was widely critiqued as being unable to deliver on its primary promises of stable growth and poverty reduction. The severe austerity programs put in place following the debt crisis often achieved their goals of reducing inflation, lowering government deficits, and ameliorating balance-of-payments problems. However, the broader reforms of liberalization, privatization, and deregulation did not appear to be producing a period of rapid and sustained economic growth across the developing world. On the contrary, many countries in Latin America and Africa faced relative economic stagnation, while the social costs of adjustment were often placed on the poorest segments of society (SAPRIN, 2004). Although the IMF and World Bank challenged the negative interpretations of economic performance and social dislocation under structural adjustment—often placing blame on countries' unwillingness to follow their prescriptions sufficiently—they nonetheless began to re-evaluate their primary goals and their policy prescriptions. Three factors in particular—the East Asian 'miracle', stagnation in sub-Saharan Africa, and the Mexican peso crisis—were important in forcing this rethinking.

1. The East Asian 'Miracle'

The countries of South Korea, Taiwan, Hong Kong, and Singapore did not follow the structural adjustment model. While they embraced the premise of export-oriented growth, they achieved it through sustained involvement of the state in nurturing selected industrial sectors to compete on international markets. The successes of the East Asian countries were encapsulated in the notion of an 'East Asian miracle', which seemed to contrast greatly with the experiences of countries in Latin America and Africa that had followed the orthodox structural adjustment model (see Chapter 7).

2. Stagnation in Sub-Saharan Africa

Owing to high levels of debt during the 1980s, the IMF and World Bank wielded considerable influence over numerous countries in sub-Saharan Africa. As a result, these countries often undertook significant structural adjustment programs. The results, however, were profoundly disappointing. With only a few exceptions, the region was characterized by stagnant economies and worsening social indicators during much of the 1980s and 1990s. Critics also claimed that the increase in armed conflict in the region and the escalating HIV/AIDS crisis were strongly related to the impact of structural adjustment in reducing state capacity.

3. The Mexican Peso Crisis

In the late 1980s and early 1990s, Mexico was heralded as a success story that many advocates of structural adjustment used to justify its validity. The structural adjustment program pursued by Mexico in the 1980s had initially imposed considerable economic and social dislocation. However, with inflation tamed and market liberalization encouraging a stream of US investment into export-oriented industries, Mexico in the early 1990s appeared to be booming. Proponents suggested that rapid economic growth would remedy ongoing problems of stagnant wages and high poverty levels. In the latter part of 1994, however, the flows of investment turned into capital flight as investors became afraid that the Mexican boom was built on tenuous social and political foundations. Mexico was thrown into a deep recession, with wages falling and unemployment increasing, and the economic turmoil was resolved only when the US sponsored a massive IMF bailout package and the Mexican government socialized the debts of private banks.

CRITICAL ISSUES BOX 9.6 — THE BANK REFLECTS ON STRUCTURAL ADJUSTMENT

In 2001, the World Bank published a report containing what it had learned from engaging with civil society over the successes and failures of structural adjustment:

- Adjustment should come 'from within', based on local analysis, local knowledge, local perceptions of political 'room for manoeuvre'.
- Institutions are essential to making adjustment succeed by generating new prosperity.
- In some cases, a step-by-step approach to adjustment is appropriate to allow complex reforms to be closely linked with the development of institutions.
- It is important to provide adequate safety nets to help mitigate potentially adverse effects of adjustment on the poor.
- Special attention should be paid to safeguarding social expenditures and maintaining access to health care and education.

Source: World Bank (2001).

In view of the Mexican peso crisis, the East Asian successes, and the failures of structural adjustment in sub-Saharan Africa, the financial institutions faced growing criticism. In response, both institutions—but especially the World Bank—have sought to reinvent themselves by making changes to their policy prescriptions and the ways in which they engage client countries. One of the important questions is whether these changes have been superficial—aimed primarily at improving public image—or reflect substantive changes in the way that the IFIs conceptualize development issues and orient their policy.

THE WORLD BANK, GOOD GOVERNANCE, AND INSTITUTION-BUILDING

Introducing the concept of good governance was the first major move by the World Bank to explain the poor record of structural adjustment in many countries in the developing world. In addressing the reason for the failure of reforms in sub-Saharan Africa, the Bank suggested that '[f]undamental in many countries is the deteriorating quality of government, epitomized by bureaucratic obstruction, rent seeking, weak judicial systems and arbitrary decision making' (World Bank, 1989: 3). While it insisted that structural adjustment remained the only correct long-term solution to the problems of developing-world countries, the Bank argued that the gains from reform were often lost because the institutions of the state were not enabling markets to work efficiently. In short, market liberalization was not failing the developing world, but political and legal systems ridden by corruption and inequalities were failing the markets. Systemic failures of government and other state institutions therefore served to undermine the reforms.

The goal of good governance is to craft a political architecture that supports market economies, with an emphasis on stable property rights and accountable decision-making. Corruption is seen as a central problem that distorts markets and hampers their ability to efficiently distribute resources across the economy. For the World Bank, corrupt government officials often make decisions favouring certain groups in return for monetary reward, which skews the playing field and reduces the efficiency of the market. For 'good governance' to prevail, the Bank argued, it was necessary to find mechanisms that would enforce transparency and accountability. The former would ensure that citizens could see how decisions were made and therefore could force state officials to make decisions that benefited the common good, not special interests. Simultaneously, if the rule of law is not applied freely and fairly, the legal basis for a market system can falter. As Adam Smith argued some 200 years earlier, market actors must be certain that their private property is secure and their contracts will be upheld. If the law is not applied equally, a lack of confidence in the rules of the game will restrain market activity and frustrate development. As a consequence, good governance also must include judicial independence from both

governmental influence and private actors and requires an accountable police force to implement the rule of law with an even hand.

The notion of good governance offered a useful concept by which the Bank could explain the failures of structural adjustment and justify further reforms in developing countries. For market-oriented development strategies to be effective, the political systems that surround them must be made accountable, transparent, responsive, efficient, and inclusive. Critics, however, have delivered sharp responses. While few doubt that limiting corruption is an important goal in and of itself, they suggest that good governance has not been a necessary factor in the development of many countries, including those in the West, where corruption was often rife during their early development. In a more contemporary setting, China—which has seen the most rapid expansion of any developing economy in recent decades—would fail on many counts of good governance. By blaming the political environment for the failure of structural adjustment, the good governance doctrine denies that there may be weaknesses in the structural adjustment strategy itself. Moreover, given that the World Bank and IMF governing boards are Western-dominated and operate in secrecy, it seemed hypocritical to demand transparency and accountability from client countries.

The response from the World Bank to such critiques has been to broaden the scope of the debate by highlighting a wider spectrum of social and political institutions that are conducive to successful reform. Not only must accountability and transparency be present in all political and legal processes, but the state must play a proactive role in fashioning other social institutions to help markets work efficiently and fairly. Drawing on new theoretical trends in economics, such as the 'new institutional economics' represented by such authors as Douglas North (see Harriss et al., 1995; Epilogue in this volume), the World Bank now places greater emphasis on the institutional context in which development occurs. Along with good governance, governments are expected to enforce a clear, fair, and consistent set of rules by which all market actors must operate.

In emphasizing the role of institutions in development, the Bank is arguing that states need to facilitate and regulate the conditions for free economic exchange and to correct potential market failures caused by unequally distributed information among market agents. These situations are viewed to be particularly common in the developing world because of the underdeveloped nature of market institutions. This means that there is a role for the state in establishing institutions that channel information about market conditions, goods, and participants, a role greater than the anti-state bias of initial restructuring models suggested. It would include such tasks as preventing the establishment of monopolies that would strangle competition and ensuring the efficient operation of labour markets by constructing institutions that would maintain a suitably flexible labour force.

Consequently, in the late 1990s, the Bank moved to what it labelled a 'comprehensive agenda' for development that encompassed not just economic policies but also the institutional, human, and physical dimensions of development strategy. These areas range from good governance and the rule of law through to social safety nets, education, health, rural and urban strategies, and environmental and cultural dimensions (Wolfensohn, 1999). Together, they form an ambitious policy agenda covering a holistic range of issues that broadens the scope of policy and institutional reform well beyond the original confines of structural adjustment. Critics, however, suggest that this expansion has drawn the World Bank into policy areas that far exceed its expertise. Others suggest that solidifying structural adjustment in this manner is unlikely to have a profound developmental effect. Instead, they advocate a move away from the market-centric model to one that acknowledges the central importance of the role played by the state in development, as evidenced by the experiences of countries as diverse as the United States, Norway, Japan, and South Korea (Chang and Grabel, 2004).

THE IMF AND THE ASIAN CRISIS

When the World Bank in the 1990s was expanding its range of policy advice, the IMF maintained a more consistent focus on macroeconomic policy. During the 1990s, the IMF placed further emphasis on the need for developing countries to open themselves to foreign investment. By removing restrictions on the entry of foreign capital, the IMF suggested, developing

countries could tap into a large source of finance for development. In particular, during the 1990s, the IMF argued that it was necessary for developing countries to attract **foreign portfolio investment** (FPI) by opening up their stock markets to foreign investors. This process is called 'capital account liberalization', and the IMF suggests that it complements other forms of liberalization and enhances the ability of developing countries to attract capital. Using these arguments, the IMF attempted, unsuccessfully, to have the goal of furthering capital account liberalization written into its constitution.

The IMF's stance on capital account liberalization quickly came under pressure following the 1994 Mexican peso crisis, when investors panicked and rapidly withdrew their portfolio investment from the

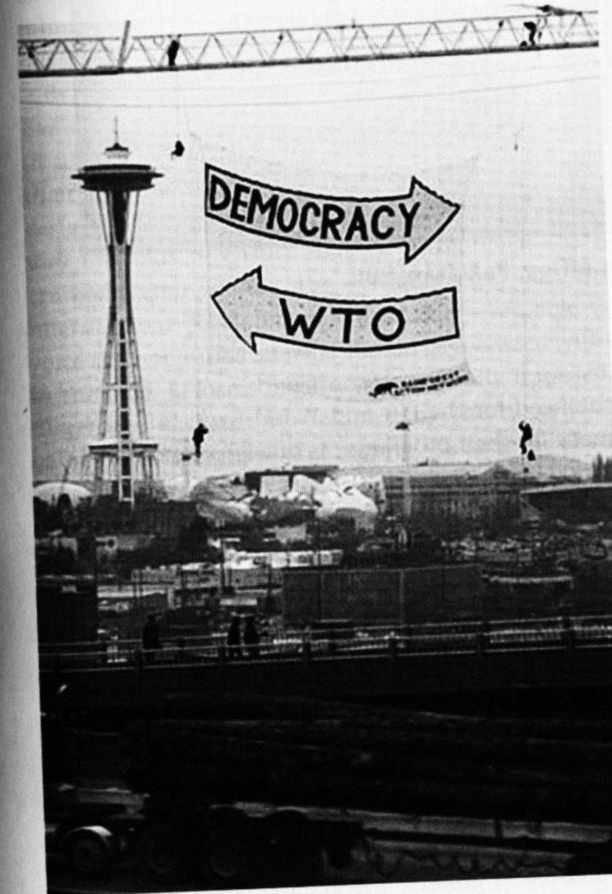

PHOTO 9.2 A Rainforest Action Network banner in Seattle at the time of the 1999 'Battle of Seattle' protests at the World Trade Organization meetings.
Source: Touhig Sion/Corbis Sygma

country, causing intense economic dislocation and social upheaval. Critics suggested that FPI is short-term, speculative, and prone to creating financial bubbles. Worse was to follow in 1997, when speculation on global financial markets against the Thai currency caused another crisis of confidence among investors, who quickly withdrew portfolio investments from across East Asia. Despite having been termed 'miracle economies' because of periods of relatively sustained and stable growth, countries ranging from South Korea to Indonesia faced a massive crisis. The crisis did not stop in Asia, and both Russia and Brazil faced capital flight and economic turmoil in 1998. The countries that were relatively least affected, however, were those that had either refrained from capital account liberalization or had quickly re-established controls on the movement of capital out of the country (Soederberg, 2004).

In response to the Asian crisis, the IMF claimed the problems were homegrown and placed the blame on 'crony capitalism'. According to the IMF, the murky relationships between East Asian governments and local businesses had made it impossible for foreign investors to judge the true conditions of the markets. This contributed to an overestimation of the strength of East Asian markets, leading to overinvestment and eventually financial panic once true market conditions were revealed. Good governance—i.e., openness, accountability, and transparency within East Asian governments—was prescribed as the solution, along with a series of new international institutions known collectively as the 'new international financial architecture'. These institutions were intended to promote financial transparency and co-ordinate actions among key nations at an international level.

Critics, however, lambasted the IMF's position. They pointed out that the Fund had praised the sound fundamentals of the East Asian countries just prior to the crash of 1997. The IMF, they claimed, had been cavalier in its approach to capital account liberalization, ignoring the potential risks by encouraging countries to liberalize rapidly without effective regulatory structures. This created the risk of rapid financial meltdown in countries with sound economies. Moreover, the immediate response of the IMF to the crisis was to make bailout loans conditional on reform measures similar to structural adjustment programs. The former World Bank chief economist Joseph Stiglitz is among those who argue that this IMF intervention

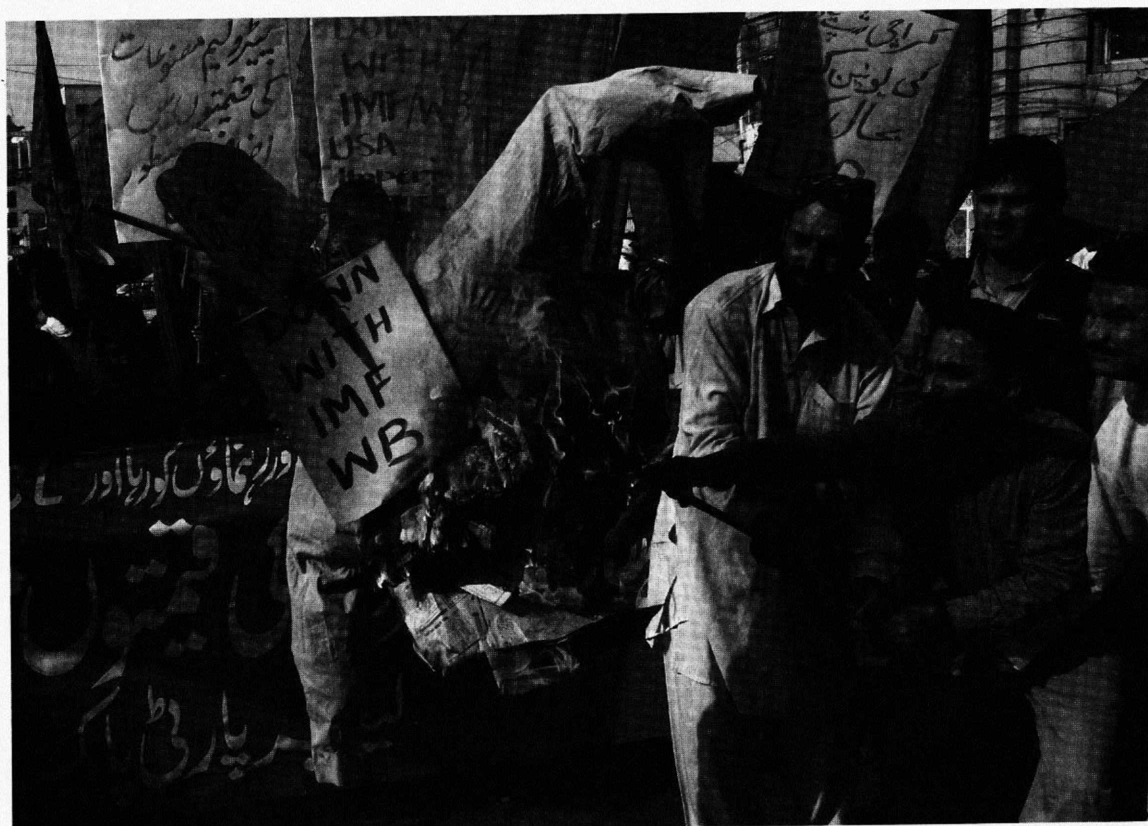

PHOTO 9.3 The IMF and World Bank are burned in effigy, Pakistan, 2011.
Source: AP Photo/Shakil Adil

was entirely inappropriate for the East Asian countries and greatly exacerbated the severity of the crisis. Besides denting the image of the IMF, another consequence of the Asian debacle has been the buildup of large foreign reserve stockpiles by East Asian countries in order to avoid having to turn to the IMF in the future.

INTO THE NEW MILLENNIUM: POVERTY REDUCTION AND COUNTRY OWNERSHIP

Stung by criticism over the Asian financial crises and facing large protests at their annual meetings, the IFIs entered the new millennium under mounting pressure. Their response has been to re-emphasize their role as global poverty alleviators and to restructure the form of their relationships with client countries. The emphasis placed on poverty reduction reflected the need for the IMF and World Bank to seek legitimacy for their programs. As one less-than-enchanted World Bank researcher put it, 'The poverty issue is so red-hot that IMF and World Bank staff began to feel that every action inside these organizations, from reviewing public expenditure to vacuuming the office carpet, should be justified by its effect on poverty reduction' (Easterly, 2001).

First and foremost, structural adjustment lending has been remodelled under the new motif of **Poverty Reduction Strategy Papers** (PRSPs). According to the IMF, these lending agreements have replaced the older 'structural adjustment facility' as the primary means of funding low-income countries to promote broad-based growth and reduce poverty. They formalize a clear division of labour between the IMF and World Bank, a relationship that World Bank president James Wolfensohn referred to as 'breathing in and breathing out'. While the IMF concentrates on a familiar range of macroeconomic policies

CRITICAL ISSUES BOX 9.7 **IFIS EMBRACING ANTI-POVERTY**

The ultimate systemic threat today is poverty.

Michel Camdessus, IMF managing director, OECD forum speech, 15 May 2001

Our dream is a world free of poverty.

World Bank mission statement (www.worldbank.org)

and objectives, the World Bank is now responsible for overseeing the 'social and structural' policies of participating countries.

The first innovation in the PRSP model was the introduction of 'ownership'. According to Wolfensohn (1999), president of the World Bank from 1995 to 2005, ownership means that '[c]ountries must be in the driving seat and set the course. They must determine the goals and the phasing, timing and sequencing of programs.'

By applying the concept of ownership, the World Bank suggests that policies are no longer fashioned in a top-down manner by the IFIs but must find their initiative in the country itself. Moreover, when designing policies, governments must use participatory methods to ensure that all stakeholders—government, civil society, the private sector, and the international development community—are able to voice their opinions on what should be included within the PRSP. Reforms must not be centrally imposed, therefore, but must be designed by the borrowing country's government and require the support of all affected social groups.

Although it was introduced to counter criticism of conditionality, the notion of 'ownership' has caused controversy. The concept is taken from management theory, where it was developed to strengthen the commitment of employees to company projects. In that sense, the practices associated with 'ownership' are constituted within power relationships between international finance providers and national governments. On the one hand, ownership aims at improving the viability and efficiency of program design by allowing national governments to take the lead in establishing reforms that respect local conditions that they would be in a privileged position to comprehend.

On the other hand, since both IMF and World Bank boards must approve all PRSPs before funding is granted, it is highly improbable that the reforms will be allowed to diverge far from Bank and Fund orthodoxy. On the contrary, given the wide propagation of what the World Bank considers 'best development practice', national governments are expected to internalize these lessons if they are to receive funding. Thus, ownership can also be viewed as a modification and extension of conditionality. Indeed, some critics have suggested that the ownership concept resembles the situation of a taxicab. The developing country is in the driver's seat, yet it goes nowhere until the World Bank gets in, announces where to go, and pays the fare (Pincus and Winters, 2002).

Beyond the notion of 'country ownership', the World Bank widely championed a new approach to poverty reduction in 2001. Poverty, it suggested, represents not just a lack of income but also is manifested in the conditions of 'voicelessness' and 'vulnerability'. Poor people suffer from an inability to influence political processes (voicelessness) and, because of a lack of assets, are unable to adapt to sudden shocks, such as the illness or unemployment of a primary wage earner (vulnerability). The Bank saw these three dimensions of poverty interacting and reinforcing each other. Despite the new emphasis, however, the approach remains a market-centred one. For the IFIs, only markets provide opportunities for poor people to find employment, and the efficient provision of health and education better equips them to make use of those opportunities. The persistence of poverty within countries undergoing PRSPs, therefore, is explained by institutional and social barriers that prevent poor people from participating in markets. In the words of the World Bank (2000: 61), 'Societies have to help poor people overcome the obstacles that prevent them from freely and fairly participating in markets.'

To combat vulnerability, the World Bank has lauded the concept of 'social capital' as a 'missing link' in development theory. Social capital is a concept used to identify the networks and linkages an

individual or household can use to gain access to resources. A household with high levels of social capital has greater support networks through family, friends, and the local community. These linkages facilitate access to extra assets—for example, money to help pay medical bills or to counter a sudden loss of employment. For the World Bank, the theory of social capital helps to explain the social dimensions of why some individuals and groups are more successful in gaining the assets to participate effectively in markets and also are less vulnerable to market fluctuations and other unforeseen events, such as ill health. As a consequence, the institution now funds programs designed to build up the social capital of the poor (see Chapter 12).

In addition, to combat voicelessness, the Bank suggests that it needs to 'empower the poor'. It presents **empowerment** as a process through which the poor are mobilized to assist in generating reforms that reduce constraints on their economic activities and upward mobility. Corruption, such as officials demanding bribes in return for letting people sell their goods, is seen as blocking market access. Similarly, unaccountable officials frustrate the growth of market activity by failing to provide poor people with the physical (roads, electricity) or social (health, education) infrastructure necessary for market activities. The solution, according to the Bank, is to empower poor people by giving them voice: first, by promoting democracy and the rule of law; second, by promoting education; and third, through technical assistance to civil society groups in forming 'pro-poor coalitions' that can enforce good governance.

In many respects, however, this is a very limited notion of 'empowerment', one that is constrained by its ultimate goal: facilitating markets. Forms of empowerment that are not seen as market-facilitating—such as the creation of trade unions or movements aimed at the redistribution of wealth within society—are given short shrift within the World Bank's framework, despite the important role they played in poverty alleviation in some Western countries. Most important for the critics, the Bank refuses to acknowledge that participation in markets, in some cases, can perpetuate or even deepen poverty. For example, jobs in the global textile industry are often characterized by extremely low wages, no job security, and repressive working conditions.

A NEW CRISIS OR A NEW BEGINNING?

More than six decades have passed since the creation of the IMF and the World Bank. Despite the constant evolution of their roles, they have not been able to shake controversy and debate. Immediately prior to the current world economic crisis, their very relevance was under scrutiny. With ever-larger flows of private investment circulating within the global capitalist economy, analysts questioned why the Bank still made loans to middle-income countries such as China and India, which have seen no shortage of private investment over the past decade. It was suggested that the World Bank should be scaled back to aid simply the poorest countries. Similarly, given the wide criticism of the IMF for mishandling the East Asian crisis, many countries in that region built up considerable reserves to avoid having to draw on the IMF's resources. By 2007, Turkey was the only major borrower from the IMF and the institution even had trouble covering its own running costs.

This context of gathering irrelevance, however, quickly dissipated as many countries across the Global South were faced with considerable fallout from the worldwide financial crisis of 2008. Despite its origins in the West, a number of factors conspired to hurt developing economies, including the collapse of important commodity prices, diminishing demand for exports, declining investment flows, the reneging on aid promises by Western countries, and a considerable drop in remittances from migrant workers based abroad. Moreover, unlike Western countries that used large-scale deficit financing to attempt to prop up consumption and alleviate unemployment, many southern countries do not possess such means. They faced profound economic contraction with unsettling implications for wages and employment, as well as growing pressures on financing for social programs and other public-sector expenditures. These factors, moreover, act in combination with the elevated prices of foodstuffs that, despite falling from their 2008 peaks, remain above the levels established during the preceding decade. Indeed, this food crisis alone was judged to have thrust a further 100 million people into poverty during 2008 prior to the unfolding of the present economic debacle.

Under these circumstances, the IMF and World Bank sought to promote a renewed relevance as lenders to the South. To address the urgent financing needs of countries facing financial stress, the G20 boosted the Fund's concessional lending capacity to a level that, by 2014, will be 10 times higher than before the crisis. Two new aspects were promoted as important to this resurgence: (1) a less doctrinaire approach from the IMF that could be more flexible in dealing with the crisis than in the 1980s and 1990s; and (2) internal reform of both the IMF and World Bank to change voting structures and the balance of power on their boards of governors.

With regard to both issues, the jury is still out. At the start of the crisis, the IMF trumpeted a reduction in the strictness of its policy requirements as compared to the original structural adjustment programs. Unlike countries in the West, which were encouraged to spend their way out of recession with deficit-financed public spending and bailouts, however, countries in the South that borrowed from the IMF were given constraining targets for budget deficits and monetary policy. The shift within the IMF was towards a slightly more flexible approach rather than a substantive change of direction. Indeed, while some critics had hoped for a policy switch from export-oriented private-sector growth to a broader public-financed development strategy, this was not forthcoming. In a review of IMF lending to 13 low-income countries, one frustrated NGO document declared: 'The traditional biases of the IMF continue to support macroeconomic frameworks where private interests supersede public interests and the role of the state, where the financial sector takes priority over the productive sector, and where foreign investors and corporate interests override those of domestic actors' (*Third World Resurgence*, 2010).

The second aspect of change centred on the governance of the institutions themselves. As addressed above, voting rights and seats on the boards of governors for both institutions are heavily weighted in favour of the Western countries. Negotiations are currently ongoing to give greater presence to developing countries in terms of voting rights and seats on the board of the IMF. This process, however, is fraught with conflict because various European countries—which stand to be the prime losers in the process—have blocked several proposals for change. With the US supporting change, a compromise on reform will undoubtedly be pushed through and this will give more voice to those countries, such as China, Brazil, and India, that today play a greater role in the global economy. That said, the present proposal seeks to redistribute just 5 per cent of voting rights, so any changes will be incremental and unlikely to alter fundamentally the operating structure of the IFIs. For a number of civil society groups seeking to overhaul both the policies and operating structures of the IFIs in a way that promotes a greater degree of influence for countries of the Global South, the reforms currently proposed are an opportunity lost rather than a success to be celebrated.

SUMMARY

This chapter examined the history and policy prescriptions of two international financial institutions that have had a profound impact on international development over the past 60 years: the International Monetary Fund and the World Bank. Although both institutions were set up under the auspices of promoting international economic stability, growth, and development, their governance structure, policies, and conduct have been shrouded in controversy. In examining their subsequent evolution and expansion from the time of their establishment at the Bretton Woods Conference in 1944, the chapter has focused on the role of both institutions in promoting structural adjustment programs (SAPs), which have proved to be particularly controversial since the 1980s. It explored how the institutions responded to criticisms during the 1990s, with specific reference to their changing approaches to tackling poverty during this period. Finally, the chapter addressed how the institutions have reacted in the face of the global economic crisis emerging in 2008 and looked at recent reforms that are intended to increase the voice of developing countries within both institutions.