Reforming the Bretton Woods Institutions*

To understand the Bretton Woods Institutions better one should recall how the OECD (1985, p.140) described their initial tasks: ‘The IBRD was there to guarantee European borrowing in international (North American) markets; the IMF was there to smooth the flow of repayments.’ As the IBRD's name still shows their present focus, Developing Countries, was not originally intended. The insistence of delegations from what is nowadays called the South on resources for development as well (Raffer & Singer 2001, pp.3ff) led to the addition of ‘and Development’ to the initial name International Bank for Reconstruction.

European economic recovery was - rightly, one may assume - seen as necessary for a non-communist future of Western Europe. However, aid programmes for Greece and Turkey, the Marshall Plan, the large US loan to the UK, and the newly-created UN Relief and Rehabilitation Administration (UNRRA), which took over some of the Bank's intended functions, financed recovery. In contrast to the IBRD the Marshall Plan operated almost entirely on a grant basis. Apparently, IBRD-loans were seen as inappropriate for the task of reconstructing Europe successfully, which raises questions about their appropriateness for fostering development in much poorer countries.

After the demise of the Bretton Woods system the IMF shifted totally to the South. During the last two decades no Industrialised Country has drawn on its resources. Nevertheless it has not adapted to the new situation. Calls for Reform of these two institutions have often been heard recently, inter alia during the Financing for Development process of the UN or from the ‘Meltzer Commission’. Both a changed global economy, the increased role of the Bretton Woods Institutions (BWIs) in international capital markets after 1982, and their more recent record show the urgent need of fundamental reforms. Arguing first that there is a need to enforce respect of statutory obligations - of bringing the Rule of Law to the BWIs - before any reform should be envisaged, even if and when major shareholders not affected by grave

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violations of the Articles of Agreement tacitly agree or even encourage this malpractice, the paper then discusses some reform proposals. One proposal is establishing minority rights similar to private sector corporations within the international public sector. But victims must also be compensated for damages done in and because of violation of the institution's own Articles of Agreement as well as because of negligent work. The grave systemic moral hazard problem that these institutions gain financially and institutionally at present from damages negligently done to their clients must be removed in favour of market-friendly arrangements. Regarding overindebted countries the paper refers to a proposal first made at the University of Zagreb in 1987, and taken up during the Financing for Development process, and by the UN Secretary General's *Millenium Report*: international debt arbitration based on US Chapter 9 insolvency. Anne Krueger's recent advocacy for emulating insolvency procedures for sovereigns has given this proposal considerable new momentum.

**Violations of Articles of Agreement**

Pursuant to its presently valid Articles of Agreement any IMF-member has the right to chose policies differing from the usual, fairly uniform IMF prescription. Article IV(3)(b) states

> These principles [= General obligations of members pursuant to IV(1)] shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.’ Para 7 of Schedule C demands: ‘The Fund shall not object [to changes in par values] because of the domestic social or political policies of the member proposing the change.

In contrast to conditionality foisted onto members in distress the IMF's constitution does not only allow capital controls, but even explicitly restricts the use of Fund resources to finance outflows. Art. VI(3) establishes the right of members to ‘exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions’. These are defined by XXX(d) as ‘not for the purpose of transferring capital’, including ‘Payments of moderate (emph. KR) amount of amortization of loans or for depreciation of direct investments’, or ‘moderate remittances for family living expenses’. Although this definition is somewhat opaque, even restricting such flows is a member's right.
Art. VI(1)(a) goes further. A ‘member may not use the Fund's general resources to meet a large and sustained outflow of capital except as provided in Section 2 of this Article [this refers exclusively to reserve tranche purchases] and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund’. Current transfers can be restricted with the Fund's approval. Although the IMF may but is not obliged to request controls these regulations clearly show that it is not supposed to press for liberalisation of capital movements in the way it has actually done. However, when it comes to protecting the rights of non-OECD members legal regulations and obligations are apparently insignificant. Clearly, Asian countries had not only the right to control capital outflows in 1997 - as the IMF had to admit when Malaysia exercised it (Raffer & Singer 2001, p.157) - but the Fund's forcing members to finance large and sustained outflows by speculators is definitely a violation of the IMF's own constitution.

Corrective measures affecting the balance of payments should be done ‘without resorting to measures destructive of national or international prosperity’ (Art. I(v)). This would have been easily possible in Asia if speculators would not have been bailed out by socialising their losses. Art. IV(1)(ii) requests the IMF to foster stability and a monetary system that does not produce ‘erratic disruptions’. The policy of high real interest rates forced on clients did the opposite. Real interest rates skyroketting beyond 40 percent are no doubt erratic disruptions as bankruptcies of domestic corporations and entrepreneurs prove. A price tag can be put to such policies. According to Standard & Poor Non-Performing Loans would have surpassed 30 percent of total loans, computed on a three-month basis, if Malaysia had not cut interest rates sharply (ibid.)

Minds more critical than I might even perceive crises to be in the institutional self-interest of the BWIs. During the Asian crisis the IMF's First Deputy Managing Director still argued - using Thailand and Mexico as supporting evidence - that the prospect of larger crises caused by capital account liberalisation would call for more resources for the IMF to cope with the very crises the IMF's proposal would create in the future (Fischer 1997). This is easily explained by the present lack of financial accountability, which is at severe odds with any market friendly incentive system. From the narrow point of view of institutional self-interest - which one of course hopes to be irrelevant - such crises are better than the use of contractual rights to capital controls, which would not require increased IMF resources.
The IBRD violates its own constitution to the detriment of its Southern members. By simply refusing to acknowledge default, even if countries have not paid anything for six or seven years (Caufield 1998, p.319) it creates damages by delaying relief. In 1992, when the end of the debt crisis was proclaimed and one could argue that insolvency relief was no longer necessary, the IBRD (1992, pp.10ff, stress in or.) acknowledged insolvency as the cause of the crisis, arguing ‘In a solvency crisis, early recognition of solvency as the root cause and the need for a final settlement are important for minimizing the damage. ... protracted renegotiations and uncertainty damaged economic activity in debtor countries for several years.’ It was conveniently forgotten that the BWIs themselves had ardently lobbied against debt reductions, arguing that countries would grow out of debts, supporting this with highly optimistic forecasts of future export earnings.

Caufield (1998, p.319) found out that the IBRD does not claim default as long as countries stay ‘in mutual respectful contact’ with the Bank. This does not only mock all acceptable accounting rules, but breaches the Bank’s own Articles of Agreement recognising default as a fact of life. Article IV(6) demands a special reserve to cover what Article IV(7) calls ‘Methods of Meeting Liabilities of the Bank in Case of Defaults’. The statutory procedure is described in detail. As the Bank is only allowed to lend either to members or if member states fully guarantee repayment (Article III(4)) the logical conclusion is that default of member states was definitely considered possible, maybe even an occasionally needed solution. Art. IV(4) allows - but does, strictly speaking, not oblige - the Bank to ‘relax’ conditions of repayment in the case of ‘acute exchange stringency’, viz. threatening default. Unaware of any preferred creditor status, a legal concept not found in its Articles of Agreement and not formally applying to the IBRD (ibid., p.323), its founders wanted it subject to market discipline, not totally exempt from it. Mechanisms allowing the Bank to shoulder risks appropriately were designed. Thwarting its founders’ intentions the IBRD has refused to use them, wrongly claiming this would make development finance inoperational. The IBRD's very statutes prove that financial accountability is necessary and possible. The European Bank for Reconstruction and Development writes off losses, and submits to arbitration (also foreseen for the IBRD), proving that Multilateral Development Banks can survive financial accountability and market risk.
Market-Friendly Reforms

One main shortcoming of present development co-operation is that recipients of development finance are denied any form of protection usual in all other cases. This shows in cases of violation of membership rights as well as regarding professional best practice. Damage done by grave negligence must always be compensated unless done in the context of development co-operation. Donors and multilateral institutions are totally exempt from any liability. The increased role of the BWIs in international capital markets since 1982 contrasts sharply with a total lack of financial accountability. They may and often do gain institutionally and financially from crises or from their own errors and failures, even if they cause damages by grave negligence. Another loan may be granted to repair damages done by the first loan, increasing the BWI's income stream (Raffer 1993) - a severe moral hazard problem and an economically totally perverted incentive system.

Like consultants the BWIs give economic advice - to the point that ‘ownership’ becomes a problem. Unlike consultants they cannot be held liable. This victims-pays-principle is a unique arrangement, which cannot be justified by economic or legal reasoning (ibid.). Under market conditions international firms do sue their consultants successfully in cases of negligent advice. Damage compensation is even awarded to private individuals in the Anglo-Saxon legal system if banks go beyond mere lending. A British couple borrowing money from Lloyds sued the bank successfully, because its manager had advised and encouraged them to renovate and sell a house at a profit. The High Court ruled that the manager should have pointed out the risks clearly and should have advised them to abandon the project. Because of its advice Lloyds had to pay damages when prices in the property market fell and the couple suffered a loss (Financial Times, 5 September 1995). With comparable standards regarding Southern debtors there would be no multilateral debt problem.

Raffer (1993) argued that International Financial Institutions (IFIs), such as the BWIs, must be held financially accountable, differentiating between programmes and projects. To increase BWI-efficiency and to improve their role in capital markets, market incentives must be brought to bear. The international public sector must become financially accountable for their own errors in the same way consultants are liable to pay damage compensation if/when negligence on their part causes damage or OECD-governments are if they create damages by negligence or violating laws. By contrast, the IMF has been allowed to violate its own statutes with impunity. The present privileged position of international public creditors discriminates
unfairly against private creditors suffering avoidable losses because of BWI-privileges when countries are unable to service their debts.

Projects

In the case of projects errors can often be isolated and proved with less difficulty. The BWIs should be liable for damage done by them like private consulting firms. If a project goes wrong the need would arise to determine financial consequences. In the simplest case borrower and lender agree on a fair sharing of costs. If they do not the solution used between business partners or transnational firms and countries in cases of disagreement could be applied: arbitration a concept well introduced in the field of international investments. If disagreements between transnational firms and host countries can be solved that way - the International Chamber of Commerce offers such service, or ICSID, an institution of the IBRD-group, was established for this purpose - there is no reason why disputes between IFIs (or donors) and borrowing countries could not be solved by this mechanism as well. Ironically, the IBRD's General Conditions (Section 10.04) foresee arbitration to settle disagreements with borrowers, be they members or not, inter alia for ‘any claim by either party against the other’ not settled by agreement. The procedural provisions how to establish the panel are nearly identical to my proposal of debt arbitration based on the principles of US Chapter 9 insolvency, initially made at a Conference at the University of Zagreb in 1987 (Raffer 1989).

A permanent international court of arbitration - different from ad hoc arbitration panels preferred for practical reasons in the case of debt arbitration - would be ideal. If necessary this court might consist of more than one panel. It decides on the percentage of loans to be waived to cover damages for which the BWIs are responsible. The right to file complaints should be conferred on individuals, NGOs, firms, governments and international organisations. As NGOs are less under pressure from the BWIs or member governments their right to represent affected people is particularly important. The court of arbitrators would of course have the right and duty to refuse to hear apparently ill founded cases. The need to prepare a case meticulously would deter abuse. The possibility of being held financially accountable would act as an incentive for donors and the BWIs to perform more efficiently and protect the poor from damages done by ill-conceived projects (cf. Raffer 1993; 1999).
Programmes

As it is practically impossible to determine the fair share of one or more IFIs in failed programmes, symmetric treatment of all IFIs in the case of Chapter 9 based sovereign insolvency (cf. Raffer 1989; 1990, Raffer & Singer 2001, pp.192ff; papers or http://homepage.univie.ac.at/Kunibert.Raffer) provides a clear and simple solution, finally ‘bailing-in’ the public sector. Under Chapter 9 US laws protect both the debtor's governmental powers, and individuals (a municipality's inhabitants) affected by the plan, giving them a right to be heard to defend their interests. Debt service payments have to be brought into line with the debtor's capacity to earn foreign exchange. It is mandatory that schemes to protect a minimum standard of living be part of any international composition plan. Creditors are to receive what can be 'reasonably expected' under circumstances. The living standards of the indebted municipality's population are protected. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended. This demonstrates the appropriateness for sovereigns. Creditors and the debtor are two parties - in contrast to present practice, where creditors dominate absolutely, being judges in their own cause, determining debt reductions. The Rule of Law demands a neutral unit presiding procedures. Internationally, this should be a panel of arbitrators. Thus my proposal of an international Chapter 9 is nowadays often called a Fair and Transparent Arbitration Process (FTAP).

Accumulated bad projects financed by loans or a string of unsuccessful programmes would eventually lead to sovereign insolvency reducing all private and official creditors' claims by the same percentage. This would automatically introduce an element of financial accountability of the BWIs. As the BWIs - like donors - control the use of loans, this would be highly positive. This point is also stressed by private creditors occasionally. In their publication Emerging Markets this Week no. 26/1999 (15 October) the German Commerzbank sees the BWIs more concerned with protecting their own balance sheets than with fair burden sharing - to the detriment of other creditors. This publication demands IFIs to ‘accept accountability for their past lending’, by sharing the burden of debt reduction via arbitration in cases of extreme borrower distress.

While the importance of decisions by official creditors may vary it has always been particularly great in the poorest countries. Lack of local expertise and high dependence on aid are the reasons. This is a fundamental difference to private creditors usually limiting
themselves to lending without any additional consulting activities. As the shares of multilateral debts are relatively higher in the poorest countries, protecting IFIs from losses is done at the expense of particularly poor clients, often extremely dependent on solutions elaborated by IFI staff.

The urgent need for change is clearly shown by Stiglitz (2000). Within the IMF

[C]ountry teams have been known to compose draft reports before visiting. I heard stories of one unfortunate incident when team members copied large parts of the text for one country's report and transferred them wholesale to another. They might have gotten away with it, except the “search and replace” function on the word processor didn't work properly, leaving the original country's name in a few places. Oops.

Legal implications - including consequences under penal law in most countries - are absolutely clear in the case of normal consultants. The IMF's reaction to the so-called Blumenthal Report is another example. In 1982 the German expert Erwin Blumenthal, seconded by the BWIs to Zaire's central bank, warned most outspokenly and in writing that Zaire should not get any further money because of the prevalent corruption. In 1983 the IMF allowed Zaire the largest drawing by an African government so far. As predicted, the money disappeared. Until 1989 the IMF trebled the volume of Zaire's drawings. Under the existing biased anti-market system it was good business for the Fund and marvellous for Mobutu's clique, but not for Zaire.

Arguably an even graver problem was shown by the Asian Crisis 1997. Until the crisis broke both BWIs encouraged further capital account liberalisation. The IMF wanted to change its Articles of Agreement to allow it to do what it had done in open breach of them already. Wade (1998) gives examples that warning signs were ignored. IBRD staff trying to ring the alarm bell were overruled. During a visit to Indonesia in the autumn of 1997 the IBRD's president Wolfensohn himself removed a passage by the resident mission that warned of serious problems, ‘substituting it by even more fulsome endorsement of Indonesia as an Asian miracle.’ According to Wade one typically did not want to hear news going against one's ideological preferences - free private capital markets had to be proved right by Asian countries.
In 1999, though, the IBRD (1999, p.2) acknowledged having known ‘the relevant institutional lessons’ since the early 1990s. An audit report by its Operations Evaluation Department (OED) ‘on Chile's structural adjustment loans highlighted the lack of prudential supervision of financial institutions in increasing the economy's vulnerability to the point of collapse.’ (sic!, ibid.) The OED's ‘key lesson’ that ‘prudential rules and surveillance are necessary safeguards for the operation of domestic financial markets, rather than unnecessary restrictions’ (ibid.) did not make ‘policy makers and international financial institutions give these weaknesses appropriate weight’. In spite of what was already known they encouraged the same policies in Asia. According to the Bank they were ‘guided’ by ‘the lessons of the general debt crisis’ (whatever that might mean), not by the ‘more relevant’ cases of Chile and Mexico 1994-5. The neglect of proper sequencing and institution building ‘featured prominently in the Chile and Mexico crises.’ (ibid.) Briefly, the problem was known years before the crash, and the unfolding of the Asian Crisis could be watched like a movie whose script is known. The Argentine crisis of 1995 goes unmentioned although of a similar variety as Asia, namely triggered by private sector debts. Why did the BWIs (not normally known for their restraint in giving advice) not warn those countries to proceed more slowly with cautious sequencing - as they do presently - pointing at already available evidence instead of once again applauding too quick liberalisation and inflows of volatile capital? Before 1994-5 the BWIs had applauded and encouraged inflows to Latin America, presenting them as proof that the debt crisis was over, although their own published statistics proved this wrong. The region amassed huge arrears, Brazil and Argentina, e.g., only honoured about a third and a fourth of payments due according to the last data published before the crisis (Raffer 1996). Like in Asia, official euphoria must certainly have fuelled inflows further. In the case of any consultant courts would look into the matter to decide whether the consultancy firm had obeyed professional duties by not making essential knowledge they had available to their client - with fairly foreseeable results. The same market discipline of connecting actions and risk must be brought to the BWIs. In parentheses it should be added that Northern regulatory measures increased speed and volatility, thus fostering crises. The risk weight given by the Bâle Committee to short run flows to banks outside the OECD region, or regulatory changes necessary to allow institutional investors to invest in Mexican tesobonos before 1994-5 illustrate this point. The costs of these changes had to be borne mainly by the South.
Financial Implications

The IBRD argues that acknowledging default and reducing debts would deteriorate its rating, making loans more expensive. Like all multilateral development banks the IBRD has formed loan loss reserves. Using these as foreseen cannot deteriorate ratings, particularly so if the present ‘mutual respect’ practice has not done so. It cannot increase the costs of future lending, as existing reserves have already been financed by borrowers. In spite of preferred protection the Bank charges for loan loss provisioning, thus having its cake and eating it. Borrowers are supposed to continue paying mark-ups for provisioning without ever getting the benefit of the relief option they finance. There might be at worst a marginal effect if interest income from reserves were used to cheapen lenders’ margins. However, given the volume of loans, reserves and possible interest income that might be used, this does not seem to justify the IBRD’s concerns taken up, e.g., by the Zedillo Report (Zedillo et al. 2001, p.52). After rightly pointing out that ‘Accountants have recently argued that their triple-A credit ratings could survive such use of the MDB [multilateral development banks] reserves. This is doubtless true’ the Report unfortunately reproduces the IBRD's usual argument ‘but one would still have to anticipate a widening of the spreads on MDB borrowing, and that is a cost they would have to pass on to their borrowers.’ Economically that means that MDBs are expected to charge twice for the same provisions.

Poor countries are usually soft window clients. IDA can simply waive repayments without any economic problems, reducing, however, future loan volumes unless new money is paid in. The Zedillo Report (ibid.) observes that countries whose credit volumes decline more than IDA-debt-service would be paying for debt relief of others. This is a problematic statement, particularly if one concurs with the Report that present IDA-terms need substantial softening to avoid HIPC III - which means that volume and terms of IDA credits create rather than solve problems presently - and that $1 of debt reduction is worth more than $1 in aid. The discussion on ‘ownership’ suggests that countries are not necessarily keen on all projects - economic results of lending suggest, rightly so (Raffer & Singer 2001, pp.246f) Finally, taking attached conditionality and economic efficiency into account, IDA credits are not as cheap as they appear at first sight. If programme lending and particularly new loans enabling debtors to repay earlier loans ceased - as they will after debtors get a fresh start - demand for IDA resources would in all likelihood fall. Introducing financial accountability would prevent quite a few disastrous projects, which cannot but be in the interest of debtors having to pick up the bill. If - against expectations - credit demand should still exceed supply, countries that
got proportionately more debt relief (thus reducing refluxes proportionately more) might reduce their credit demand proportionately, but not by more than the amount of actual reductions they received. As a dollar in relief is better according to the Report than a dollar in new loans they would still be better off.

The IMF poses some difficulties. As conditionality was initially not foreseen, loan loss provisions were unnecessary. When conditionality was introduced, no appropriate changes regarding accountability for the Fund’s decisions affecting its clients were made. This became particularly problematic once it started massive debt management operations. Introducing financial accountability for its own decisions is thus all the more important. Losses are one way to do so. The IMF – whose exposure is much smaller - could cover losses by gold sales (revaluation).

**Emulating the Private Sector**

Buira (2001) sees the application of principles of corporate governance to the BWIs as a promising approach, highlighting important corporate governance notions of external auditing, transparency and accountability of Fund operations, particularly at country level. Perhaps the main limitation is that for minority shareholders feeling their rights to be infringed on: ‘there is no judicial remedy, only resort to political fora whose neutrality is not assured, such as the Executive Board where the existing power structure, may or may not provide an appropriate remedy.’ *(ibid.)* Violations of Articles of Agreements to the detriment of smaller members illustrate Buira's point well.

There is an easy solution, though. The court of arbitration proposed above for projects could easily handle complaints by minority shareholders as well. The fact that both BWIs now resemble private corporations more than in 1944 - when the share of basic votes was much larger - is a further reason to introduce established and tested mechanisms from the private sector. Although details remain to be discussed, this principle could be introduced without problems. Naturally, proposals such as changes in quotas - e.g. re-establishing the weights of groups in 1944, or revising quotas on a purchasing power parity base *(ibid.)* – or changing the share of Southern EDs would also increase the weight of borrowers. So would reconsidering the use of special majorities (Woods 2000) or the introduction of double majorities differentiating between the stakes countries hold in the institutions *(ibid.)* But these feasible changes are of a more political nature. They are unlikely to be accepted by the North that may
be expected to bring up political counterarguments. Introducing minimal standards of correct business governance is all the more indicated and can hardly be denied on economic nor on political grounds.

**Conclusion**

To force the BWIs to respect membership rights and to abide by their own constitutions in order to avoid damages to poor countries it is necessary to introduce damage compensation. Violations of membership rights must have appropriate financial consequences. Like anyone else the BWIs must be liable for damage illegally inflicted. At present they gain from their wrong behaviour. New and larger crises increase their importance. Their record since 1982 illustrates this quite clearly. Negligently designed and implemented projects creating damages may lead to new loans to redress these damages, leaving the country with more debts and the BWIs with a higher income stream, increasing their importance as trouble shooters: ‘IFI-flops create IFI-jobs’ (Raffer 1993, p.158). This is a wrong incentive structure in severe need of correction, creating huge moral hazard problems. Minimal standards of the Rule of Law and of economic reason are urgently needed. Only thoroughly reformed BWIs should have a role in the future.

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