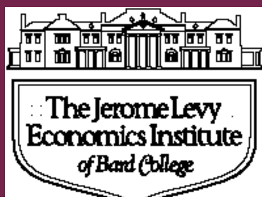

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Revisiting Bretton Woods

Proposals for Reforming the International Monetary Institutions

Raymond F. Mikesell

No. 24/1996

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Summary

The year 1994 was the fiftieth anniversary of the signing at Bretton Woods, New Hampshire, of the Articles of Agreement of the International Monetary Fund (IMF) and the World Bank. Many addresses at anniversary celebrations praised the contributions of the IMF and World Bank, but they were overshadowed by the widely held conviction that both institutions are seriously in need of overhauling. However, there is no consensus on how they should be changed. Some analysts believe that one or both have outlived their usefulness and should be abolished, while others believe that they should continue to operate, but with new responsibilities, new organization, and enhanced resources.

Underlying the proposals to alter or abolish these institutions is the belief that neither is able to deal with the world's current economic problems. The IMF has had virtually no influence on the international monetary system since the early 1970s, nor has it had a laudable record in promoting balance of payments equilibrium and financial stability in the developing countries. The World Bank has fallen short of achieving its primary goals of reducing world poverty and putting the world's poorest countries on the path to sustainable development.

In this *Public Policy Brief*, Raymond F. Mikesell outlines the original goals of the IMF and World Bank and the activities they have assumed as they evolved and evaluates the success of the institutions in meeting both past and subsequent goals. He analyzes the current debate about whether the IMF should play a more active role in managing the international monetary system, in managing currency crises (such as the one recently experienced in Mexico), and in providing credit to newly capitalist countries. Mikesell examines proposals that the World Bank do more to promote private investment in developing countries, make more loans for expanding social and economic objectives (such as reducing poverty, promoting greater equality of opportunity, improving health and education, and maintaining the environment), and improve the efficiency of its operations.

Mikesell cautions that he cannot state his conclusions with unequivocal conviction or passion; the issues are too complex, the arguments on both sides of the debate too persuasive, and the reputations of the debators too impressive. Given the large financial resources and the highly competent staffs of the IMF and World Bank, Mikesell feels that the two institutions should be doing a better job promoting trade and reducing poverty. However, because there is general agreement that there is a need for multilateral institutions to promote world trade and reduce world poverty, he feels that abolishing the institutions is not an appropriate response. Rather, he recommends that (1) the World Bank Group and IMF should be merged to form a single organization, the World Bank and Fund Group (WBFG), with one executive director for both institutions; (2) neither the IMF nor the WBG should be given responsibility for establishing and managing an exchange rate target zone system or for stabilizing the exchange rates of the major currencies; (3) the establishment of additional institutional constructs to deal with financial crises should be deferred; (4) the WBG should move rapidly to change the composition of its lending by making fewer loans to governments and state enterprises and increasing its loans to the private sector, including nongovernmental, nonprofit entities; and (5) the WBG should be gradually downsized by reducing the number of countries eligible for loans.

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Preface

The fiftieth anniversary of the 1944 Bretton Woods agreement caused many to reflect on the structure of the international monetary system and the usefulness of the institutions created by the agreement. Some, including former chairman of the Federal Reserve Paul Volcker, have called for the return to a managed monetary system in which exchange rates are not allowed to float freely, but are held within a set range of rates.

An argument for managing rates is that it would reduce the volatility of exchange rate movements, a volatility that introduces uncertainty into global economic decision making. Those who argue in favor of maintaining the current floating rate system assert that even if an appropriate range of rates could be determined and could be agreed upon by the leading industrialized nations, the size of currency interventions necessary to affect those rates is too large (relative to total market activity) for central banks to undertake. Moreover, in order to maintain exchange rates within a given band of values, central banks might have to sacrifice some freedom in their use of monetary and fiscal policies to achieve domestic objectives. Another issue is determining who would have oversight powers in such a system.

Some propose that the International Monetary Fund (IMF) be more active in the international monetary system, managing currency crises and providing credit to newly capitalist countries. Others, however, note that it has had virtually no influence on the international monetary system since the 1970s and its record in promoting balance of payments equilibrium and financial stability in developing countries is not laudable. According to such critics, the IMF should be abolished or at least its functions should be reduced or combined with those of the World Bank.

In this *Public Policy Brief* Raymond F. Mikesell analyzes the merits of these arguments, reviews the success of the institutions in accomplishing their original functions, describes other roles they have performed, and makes recommendations for reform. He notes that the IMF's functions changed after the 1970s, when the Bretton Woods par value system broke down and exchange rates were allowed to float. He proposes that, because some of the IMF's operations overlap those of the World Bank, the two institutions should be combined. One area of overlap is aid to Eastern European countries to assist them in the transformation to market-based economies. Mikesell notes, "the IMF's functions in these countries are not only far removed from those for which it was designed, but there is little to distinguish IMF efforts from those of the World Bank." Moreover, "the IMF's lending programs in Russia and some other newly capitalist countries have not been successful in promoting their transition to capitalism or improving their balance of payments."

There is a question of whether aid to the Eastern European countries to develop a capitalist economy should be provided by the IMF and the World Bank or directly by the governments of the Western industrialized nations. IMF loans are supposed to be conditional upon a country's success in changing the economic and political structure of its economy. However, the decision as to whether to grant a loan may be difficult for an international agency. This difficulty is best illustrated by the politics surrounding the approval of the pending $9 billion loan by the IMF to Russia. Although some economic progress (lower inflation and stabilization of the ruble within a narrow range) was seen in Russia during 1995, political changes have led to uncertainties about the direction of future market reforms. A refusal to grant the loan, based on these economic considerations alone, would be seen as a vote against the Russian leaders' ability to pursue market reforms and could cripple the Russian economy. Moreover, President Clinton has urged the IMF to approve the loan. If the United States and other Western nations feel that factors other than economic changes must be considered, it might be best, as some have suggested, that the loans be made directly by those governments. Mikesell's insights into these issues can serve as a basis for discussion of international monetary problems.

Dimitri B. Papadimitriou, *Executive Director*
February 1996

Proposals for Reforming the International Monetary Institutions

The year 1994 was the fiftieth anniversary of the signing in Bretton Woods, New Hampshire, of the Articles of Agreement of the International Monetary Fund (IMF) and the World Bank. The anniversary was celebrated at meetings in Washington, D.C., Bretton Woods, and Madrid.[1] As one of the few surviving participants of the Bretton Woods conference, I was privileged to attend the first two commemorations. The many addresses at the 1994 meetings praising the contributions of the IMF and the World Bank were overshadowed by the widely held conviction that both institutions are seriously in need of overhauling. However, there is no consensus on how they should be changed. Some analysts believe that one or both have outlived their usefulness and should be abolished, while others believe that they should continue to operate, but with new responsibilities, new organization, and enhanced resources.

Underlying the proposals to alter or abolish these institutions is the belief that neither is able to deal with the world's current economic problems. There is great dissatisfaction with the present international monetary system. The IMF has had virtually no influence on the system since the early 1970s, nor has it had a laudable record in promoting balance of payments equilibrium and financial stability in the developing countries. The World Bank has fallen short of its primary goals of reducing world poverty and putting the world's poorest countries on the path to sustainable development.

The World Financial System after Bretton Woods

The IMF and the World Bank were designed to help avoid the chaotic financial conditions that prevailed during the 1930s and to facilitate the transition to a post–World War II economy that would be characterized by stable exchange rates, the absence of exchange restrictions on trade, and readily available capital for financing postwar reconstruction and the development of poor countries. Under the 1944 agreement the IMF was expected to promote a new international monetary order by establishing and enforcing rules governing exchange rates and foreign exchange transactions and by providing assistance to help countries conform to these rules; the World Bank was expected to help reduce world poverty and to assist in economic development by promoting private and public capital flows into developing countries.

Owing to the magnitude of the financial requirements for reconstruction and to the balance of payments problems of the European countries, neither the IMF nor the World Bank played a significant role during the immediate postwar period. The Marshall Plan provided most of the financing for European recovery, while the European Payments Union (EPU) established a payments system that permitted multilateral intra-European trade and paved the way for the operation of the IMF par value system based on the gold-convertible dollar implemented in the 1960s.[2]

By the end of the 1960s the principal threat to the par value system was the weakness of the dollar itself. Worldwide economic recovery brought about a change in trade patterns and capital markets resulting in the replacement of the dollar shortage of the 1950s with a dollar surplus in the late 1960s. The termination of dollar convertibility into gold in 1971 and the abandonment of efforts to maintain fixed exchange rates by the major countries in 1973 left the IMF with little influence on the international monetary system. The Bretton Woods monetary system was dead, and few expected it to be revived.

The IMF found its niche in providing advice and making loans to developing countries under a variety of programs. These loans had little to do with exchange rate stability; in fact, the preloan agreements often required devaluation along with trade and exchange liberalization. Although some of the loans assisted countries during crises resulting from sudden declines in export income, most were designed to induce

countries to reform those economic policies that had contributed to balance of payments disequilibrium.

Since it began operations in 1946, the World Bank has been almost completely occupied with assistance to developing countries. Although the World Bank's charter emphasized its role in promoting the flow of private capital, the bulk of its loans have been made to governments. During the 1950s lending by the World Bank was hampered by a shortage of projects that met the standards of commercial bank loans as interpreted by successive World Bank presidents, all of whom, except for Robert McNamara, were products of the American banking community. In the beginning most World Bank loans were for specific infrastructure projects such as large dams, power, and transportation, but the idea slowly emerged that the World Bank should be a development institution concerned with social welfare and eliminating poverty.

The lending capacities of both the IMF and the World Bank increased steadily from their inauguration in 1946. By the end of fiscal year (FY) 1994 outstanding credits provided by the IMF totaled about $45 billion. In addition, the IMF has allocated to its members 21 billion special drawing rights (SDRs), which the members can use to buy the currencies of other members.[3] Most of the increases in the IMF's resources have occurred with periodic increases in member quotas, determining both the capital subscriptions to the IMF and how much members can normally borrow.

World Bank loans outstanding at the end of FY 1994 totaled $109 billion, with annual loans averaging $14 to $17 billion annually between FY 1990 and FY 1994. The World Bank also manages an associate organization, the International Development Association (IDA), which loaned about $6.6 billion in 1994. Another World Bank associate, the International Finance Corporation (IFC), provides equity and debt financing to private enterprise in developing countries; in FY 1994 it committed $2.5 billion. A third associate, the Multilateral Investment Guarantee Agency (MIGA), promotes foreign direct investment in developing countries by offering political risk investment insurance. Together these four institutions make up the World Bank Group (WBG). The World Bank and the IDA operate under the same management, but with different sources of funding. The IFC and the MIGA have both separate managements and separate sources of funding.

Alternative International Monetary Systems

The major proposals for changing the functions and organization of the IMF relate to its role in the international monetary system. One proposal is to give the IMF an important function in remodeling the international monetary system. A counterproposal is to merge the IMF and the World Bank because the IMF no longer plays a significant role in the international monetary system, and its assistance to developing countries duplicates the activities of the World Bank. The analysis of alternative international monetary systems in the following paragraphs provides a basis for evaluating these contrasting proposals.[4]

Managed Versus Floating Exchange Rates

Prior to World War I the gold standard provided a system of fixed exchange rates and automatic balance of payments adjustment by allowing gold movements to affect the money supply. During World War I most countries went on a managed currency system and several, including the United Kingdom and France, returned to a gold parity system in the 1920s. In the 1930s exchange rates were neither fixed nor freely floating, but were managed in a way that resulted in restricted and discriminatory trade. The United Kingdom abandoned the gold standard in 1931. In 1933 the dollar was allowed to float, but the United States went back on the gold convertible standard in early 1934. The Bretton Woods system of fixed but adjustable parities was a compromise between the gold standard and a managed system. Following the breakdown of the Bretton Woods par value system in the early 1970s, the major currencies were allowed to float with occasional attempts to manage them, a condition that continues to exist today.

There is substantial dissatisfaction with the current floating rate system. There have been large swings in exchange rates between major currencies, but these fluctuations have not promoted a satisfactory pattern of current account balances. In particular, there has been dissatisfaction with trade balances, which make up a substantial proportion of current account balances.[5] The fluctuations in exchange rates have occurred largely as a consequence of capital movements generated by interest rate differentials among the countries, cyclical movements in national business conditions,

and currency speculation. Freely fluctuating rates, with no attempt on the part of the central banks to influence them, are equilibrium rates in the sense that demand for and the supply of foreign exchange from all sources are equal, but such equilibrium rates may not be compatible with the current account balances that governments desire. For example, Japan may want a large trade surplus, but the United States and European countries may not want trade deficits. What governments would like to have is a combination of (1) equilibrium rates, (2) satisfactory current account balances, and (3) relatively stable rates. The controversy over managed versus freely floating rates is a controversy over which system will most closely approximate these conditions.

Milton Friedman (1953) has argued for half a century that exchange rates should be determined in free markets with no attempt to control them. Exchange rates determined in free markets will always be equilibrium rates, and if governments prevent inflation by properly controlling the supply of money, exchange rate fluctuations will be moderate. Friedman's position is echoed by many leading economists today. For example, in his address to the annual meeting of the American Economic Association in January 1995, George P. Schultz (former secretary of state and former University of Chicago professor of economics) stated that "We should stop worrying about the exchange system. We now have a dirty float. . . . The system would work better if it were cleaner, that is, with less government intervention. But the system does in fact work reasonably well and has done so over a twenty-year period during which the system has experienced and absorbed some tumultuous economic changes" (Schultz 1995, 3).

The argument for managing exchange rates is that a freely floating rate system results in wide exchange rate fluctuations, which do not contribute to orderly balance of payments adjustments and may impair trade. Central banks can stabilize exchange rates to those approximating equilibrium over the intermediate run and can alter them when fundamental economic conditions render such rates incompatible with equilibrium. If a country has a trade or current account deficit, the central bank can adjust the exchange rate to reduce or eliminate the deficit. Thus, managed rates provide a means of adjusting the trade or current account, while freely fluctuating rates, which respond to speculative and other temporary forces, may at times be inappropriate for achieving the desired trade or current account balance. A change in the exchange rate

will affect the trade balance by changing the relationship between domestic and foreign prices of a country's exports and imports. For example, if Mexico reduces the value of the peso in terms of the dollar, peso prices of U.S. goods will rise, so that Mexicans will buy less from the United States. In addition, the dollar will buy more pesos, so that the prices of Mexican goods to U.S. consumers will decline and Mexico will sell more goods to the United States.

There are, however, some problems with this analysis. First, relative prices of many internationally traded goods do not immediately adjust to changes in exchange rates. If the U.S. dollar were to depreciate by 10 percent in terms of a composite of all foreign currencies, the dollar prices of imports would not immediately rise by 10 percent because some foreign suppliers in competition with domestic producers would not raise their U.S. prices by that amount. And some U.S. exporters would raise their dollar prices to maintain the foreign currency prices of their exports. Second, even when prices are adjusted to reflect a change in the exchange value of a currency, consumers are often sluggish in shifting purchases from foreign to domestic sources. Because of these two factors, the immediate effect of a currency depreciation may be to worsen the trade balance for a few months, after which improvement may take place gradually over a couple of years. This initial worsening of the trade balance after depreciation followed by a gradual improvement over time is sometimes called the J-curve effect (Krugman 1991, ch. 2).

A third reason why changing the exchange rate may not improve the current account balance relates to macroeconomic conditions. If a country's current account balance is to improve, there must be an increase in that country's total output relative to its total expenditures on consumption and investment. The current account balance must always equal the difference between national output and total expenditures. This identity may be expressed as

$$CA = Y - (C + I) - G$$

where CA is the current account, Y is national output, C is private consumption, I is private domestic investment, and G is government spending.[6] In order to improve the current account, there must be an increase in Y, a decrease in domestic expenditures ($C + I + G$) with more of the

output going into exports, or some combination of both. This will take place only if depreciation is accompanied by the appropriate macroeconomic adjustments, but appreciation alone will not automatically produce these adjustments. If depreciation stimulates inflation, domestic expenditures may rise relative to output. Also, inflation may nullify the effects of depreciation on the increase in import prices relative to the prices of domestic goods and on the decrease in export prices in terms of foreign currencies so that the trade balance will not improve. Under these conditions, currency depreciation may fail to improve the current account balance (Mikesell 1995, 12–15). For example, the U.S. current account deficit was $7 billion in 1991 and $68 billion in 1992, but rose to over $100 billion in both 1993 and 1994, despite a more than 40 percent decline in the value of the dollar in terms of the Japanese yen between 1990 and 1994 and a somewhat smaller depreciation of the dollar in terms of the German mark.

Other factors—such as a rise in private investment, a decline in personal saving, and a substantial budget deficit—contributed to the current account deficit. Over the long run a country's trade and current account balances will respond to a change in the real exchange rate (the nominal rate adjusted for relative changes in domestic versus foreign prices), but over the intermediate run the balance may be affected by a variety of macroeconomic factors.

Some analysts doubt the ability of central bankers and finance ministers to identify equilibrium exchange rates or to know how far rates ought to change to restore balance of payments equilibrium (for example, Krugman 1990, ch. 14.) With open capital markets and instant information about economic conditions affecting securities markets and interest rates, exchange markets react to changes in fundamental conditions that may affect the balance of payments almost as soon as the research staffs of central banks and finance ministries process the information. By the time governments get around to making policy changes, a substantial capital movement may have already occurred. An anticipated depreciation may result in massive capital flight, while an anticipated currency appreciation may induce inward capital movements and further appreciation accompanied by a larger current account deficit. These conditions greatly complicate the problem of setting target rates that are both consistent with equilibrium and likely to remain stable. Those who favor freely floating

rates argue that by allowing rates to be determined in the market, the rates will always be at the equilibrium level, and sudden large changes in rates, which may occur under a managed rate system, are more harmful to trade and investment than small movements under a fully floating system.

Instruments for Managing Exchange Rates

The principal instruments for managing exchange rates are (1) central bank intervention in the exchange market, (2) changes in short-term interest rates, and (3) fiscal policy. The first two are usually controlled by central banks, while fiscal policy is controlled by governments, both the administration and the legislature. Central banks do attempt to affect exchange rates with the instruments at their disposal, but governments rarely attempt to affect exchange rates with fiscal policy.

Central bank intervention in the exchange market is of two types: sterilized and unsterilized. In unsterilized intervention, purchases of foreign currencies on exchange markets with domestic currency or purchases of domestic currency with foreign exchange are allowed to have their full impact on the country's bank reserves and, therefore, on interest rates and quantity of money. However, most intervention is sterilized; that is, the effect of exchange market activity on the money supply is offset by central banks through open market operations. The record of success of sterilized intervention in keeping exchange rates within an agreed range is poor (Humpage 1993, 2–16; Obstfeld 1990, ch. 5). Although intervention serves as a signal to the market of the official view of the government on exchange rate policy, the volume of intervention tends to be too small in relation to total market activity to affect the rate substantially. For example, in the period from January to March 1995, during which the dollar was under substantial downward pressure, U.S. monetary authorities intervened in the total amount of $1.42 billion against the deutsche mark and the yen; nevertheless, the exchange value of the dollar continued to decline in terms of these currencies. In early March 1995 the Federal Reserve, in collaboration with a number of European central banks, intervened to support the dollar; the Fed purchased $450 million against the deutsche mark and $370 million against the yen. According to a report published by the Federal Reserve Bank of New

York (1995), "The dollar met aggressive selling by market participants and proceeded to trade progressively lower." Such small interventions cannot have much effect on a world currency market with daily transactions currently exceeding $1 trillion. A truly massive intervention could almost certainly stabilize the dollar for a time, but could prove costly if the stabilized rate proved to be untenable.

Short-term interest rates are sometimes increased by central banks in order to support the exchange value of a currency. The German Bundesbank cut its discount rate from 4.5 percent to 4.0 percent on March 30, 1995, to support the dollar (Federal Reserve Bank of New York 1995, 9). A similar reduction taken at the same time by the Bank of Japan was probably for the same reason. There is little indication that recent U.S. Federal Reserve interest rate policy has been motivated by a desire to support the dollar.[7]

International Coordination to Manage Exchange Rates

Efforts to manage exchange rates are likely to be more successful when several countries coordinate their policies than when a country acts alone. Assuming the major economic powers were to reach an agreement on a set of desirable exchange rates, they could coordinate their monetary and fiscal policies and central bank operations in an effort to support these rates or to maintain them within a specified range. Countries with strong currencies would reduce their short-term interest rates and their budget surpluses, while countries with weak currencies would increase their interest rates and eliminate their budget deficits. But such measures might well be in conflict with the domestic objectives of the countries trying to coordinate.

Monetary and fiscal coordination is provided in the Maastricht Treaty (signed by the members of the European Union, or EU), which looks toward the establishment of a European Monetary Union (EMU). However, coordination is much more difficult for countries outside the EU because they do not have the same arrangements for mutual assistance or the common political and economic goal of monetary union. Coordinating financial policies in the interest of stabilizing exchange rates raises the question of whether and to what extent nations should

compromise their domestic objectives by such coordination. Are the gains from exchange rate stabilization worth the sacrifice of domestic objectives? Empirical evidence is not conclusive and most governments do not favor sacrificing domestic objectives to promote exchange rate stability. This has been an issue even in efforts to form the EMU. Some countries, notably France and Germany, seem willing to subordinate domestic objectives to achieve permanently fixed exchange rates and a common currency, but the United Kingdom has been unwilling to do so.

Proposals for Changing the Functions and Organization of the IMF

Traditional Role of the IMF

The traditional purpose of IMF assistance has been to help countries achieve balance of payments equilibrium without resorting to trade or exchange restrictions on imports of goods or services, defaulting on international debt, budgetary actions falling heavily on the poor, or reducing investments important to economic growth. Over the past decade the IMF introduced two new loan facilities that differ from its traditional assistance. One is the structural adjustment facility (SAF), which provides loans on very liberal terms—an interest rate of only 0.5 percent and repayments over 5 1/2 to 10 years—in support of macroeconomic reforms and structural adjustments. SAF loans are accompanied by detailed agreements on programs that the borrowing country may engage in, such as the allocation of domestic credits, the privatization of state enterprises, price controls, and trade regulations, all of which go beyond the usual macroeconomic adjustments.

Not all of the SAFs have succeeded in achieving balance of payments improvement and satisfactory economic growth. There have been several outright failures, especially in the African countries, notably Zambia and Zaire. In some of these countries economic progress has been impaired by civil wars and irresponsible dictators. As of FY 1994, IMF obligations in arrears totaled 2.9 billion SDRs ($4.3 billion). Many

countries would probably default on their repurchase agreements to the IMF if they could not continue to receive new loans. Hence, repayments are not being made from improvements in the balance of payments. According to Peter Kenen (1994a, 34), "It is time to concede that the [International Monetary] Fund and the [World] Bank have been involved in the de facto rescheduling of their claims on a number of developing countries that cannot possibly repay them." Assistance from the IMF has undoubtedly helped some countries, such as Korea, liberalize their economies and achieve reasonable growth rates. On the other hand, it may be argued that the absence of financial assistance from the IMF might force countries to institute economic reforms more rapidly and avoid accumulating external indebtedness.

The second IMF facility, the "systemic transformation facility," was created in 1993 to assist former Soviet countries with transforming their economies to private enterprise and free markets. Such assistance involves problems quite different from those in most developing countries, in which private economies with established markets, credit institutions, and reasonably functioning systems of monetary control already exist. An IMF task in assisting the former Soviet countries has been to formulate national plans for establishing new financial institutions to mobilize and allocate credit and for creating the capital markets required for transferring ownership from the state to the private sector. The IMF's functions in these countries are not only far removed from those for which it was designed, but there is little to distinguish IMF efforts from those of the World Bank, which is operating in the same countries.

The IMF's lending programs in Russia and some other newly capitalist countries have not been successful in promoting their transition to capitalism or improving their balance of payments. Privatization has been slow and trade has fallen sharply, partly as a result of the collapse of ruble-based trade and the shortage of foreign exchange to finance trade (Black 1994, 265–272). However, since chaotic political and social conditions seem to have been the major barriers to a smooth transition, such a transition may perhaps be more a political than an economic matter. Therefore, it might be argued that coordinated assistance from the NATO countries is more appropriate than IMF (or World Bank) assistance.

Exchange Rate Management as a Multilateral Effort

Proposals for giving the IMF a more active role in the international monetary system involve the question of whether exchange rate management should be a multilateral effort. Every country's exchange rate is, by definition, of concern to its major trading partners. Attempts to stabilize or otherwise control an exchange rate require international cooperation, since the action of an individual country to lower the exchange value of its currency could be countered by other countries.

If there is to be multilateral action to control exchange rates, the selection of any exchange rate to be maintained or kept within a particular range should be made within the context of an agreed upon pattern of rates of all major currencies. Moreover, the agreed pattern must take into account the pattern of current account balances with which the rates must be consistent. For example, the United States has expressed dissatisfaction with its large bilateral deficit with Japan, but if this deficit is to be reduced within a system of managed rates, Japan will have to reduce its overall bilateral current account surplus or shift that surplus to developing countries by exporting more capital to them. Those who argue for a multilateral agreement on stabilizing exchange rates must take into account the negotiating problems involved in reaching a consensus on the pattern of current account balances and the willingness of the countries to adopt monetary, fiscal, and other policies consistent with the agreement.

The IMF's Role in a New International Monetary System

The two most frequently discussed proposals for an active role by the IMF in reforming the international monetary system are the proposals of the Bretton Woods Commission and the target zone system put forth by economists associated with the Institute for International Economics (Williamson and Miller 1987, Williamson and Henning 1994, Bergsten and Williamson 1994). According to the Bretton Woods Commission report (1994b, A4–5), "(1) The major industrial countries should strengthen their fiscal and monetary policies and achieve greater overall macroeconomic convergence; (2) these countries should establish a more formal system of coordination, involving firm and credible commitments, to support these policy improvements and avoid excessive

exchange rate misalignments and volatility; and (3) the IMF should be given a central role in coordinating macroeconomic policies and in developing and implementing monetary reform."

The report suggests that the G-7 countries should grant operating authority to the IMF for stabilizing exchange rates. However, the report is vague regarding the nature and implementation of the new international monetary system; it merely recommends that the system should promote exchange rate stability and avoid misaligned rates. Without formally endorsing a target zone system, the report appears to favor allowing some flexibility in exchange rates rather than fixing rates at particular levels. It states that the G-7 countries would need to negotiate agreements among one another as to their obligations for promoting exchange rate stability, but the report does not say how agreements would be reached on the pattern of rates to be stabilized. Presumably, an important function of the IMF would be to prepare a detailed plan for approval by the G-7 countries.

According to the target zone system outlined by Williamson and Henning (1994), exchange rates would be maintained within a zone of fluctuation based on fundamental equilibrium exchange rates (FEERs).[8] The FEERs would be consistent with the current account balance of each country and with its domestic objectives of full employment and price stability. The finance ministers and central bank managers of the G-7 countries would be "at the center of international monetary management." The IMF would provide the secretariat and the forum in which the ministers of the G-7 countries would meet to make basic policy decisions. The G-7 countries would set targets for the current account balances of the participants in the target zone regime, identify the FEERs, and establish procedures for realigning target zones in response to developments calling for balance of payments adjustments (Williamson and Henning 1994, 104). The IMF would have the power of surveillance over the exchange policies of its members. However, it would be a council of G-7 finance ministers that would establish the target zones for the exchange rates and determine the changes in monetary and fiscal policies needed to sustain them.

Supporters of the target zone system apparently assume that the band within which exchange rates fluctuate will be wide enough to accommodate

pressures arising from speculative capital movements and that such capital movements will tend to reverse when an exchange rate approaches either end of the band. One problem with this assumption is the difficulty of defining the width of the band. A wide band, say, 20 percent, would contribute little to reducing exchange rate fluctuations; a narrow band would make it more difficult to maintain rates within the zone. There is also the question of how frequently and under what conditions the band would be changed. If the band is not changed quickly after the market perceives that fundamental conditions are inconsistent with maintaining rates within the band, the resulting large capital movements would require large offsetting interventions. On the other hand, if the band is changed frequently, the system will lose credibility and there will be little exchange rate stability (Kenen 1994a).

Opposition to a substantial role for the IMF in a new international monetary system has been expressed by both economists and government officials (Mikesell 1995, 26–28). Most of the opposition concerns the desirability or feasibility of managing exchange rates, either unilaterally or multilaterally. One objection is that exchange rate management is likely to be more harmful than beneficial because governments will tend to support improper (disequilibrium) exchange rates or will continue to support rates long after fundamental conditions change. A second objection is that the cost of the loss of freedom to use monetary and fiscal policies for promoting domestic objectives outweighs any possible benefits of currency stabilization. Some doubt that currency fluctuations significantly impede trade since the cost of hedging contracts in foreign currencies is relatively small. A third objection is that neither the IMF nor the G-7 countries will be able to determine FEERs accurately or to recognize when conditions dictate a change in FEERs. A fourth objection is that central bank intervention cannot maintain exchange rates in the face of large speculative capital movements. A fifth objection is that it may not even be possible for the major countries to reach agreement on the pattern of exchange rates they would support, either because the rates may not be consistent with their trade objectives or because the monetary and fiscal policies required to support the rates are inconsistent with domestic economic objectives.

Representatives from the governments of major countries who attended the 1994 Bretton Woods conference in Washington were not enthusiastic

about either multilateral coordination or a dominant role for the IMF in creating a new international monetary system. Larry Summers, currently U.S. deputy secretary of the treasury, expressed doubts regarding the feasibility of policy convergence in light of the EU experience (Bretton Woods Commission 1994a, 19). Kosuke Nakahira, the Japanese vice minister of finance for international affairs, also played down a future role for the IMF, stating that "What is important, in my view, is to have frequent and informal contacts among policy makers, ministers of finance, and central bank governors or their deputies, say, through G-7 meetings or other appropriate forums, rather than to formalize or institutionalize the coordination process" (Bretton Woods Commission 1994a, 23). Gert Haller, the representative of the German Federal Ministry of Finance, rejected international coordination of monetary and fiscal policies and target zones on both theoretical and policy grounds (Bretton Woods Commission 1994a, 21).

Since the termination of the dollar convertibility into gold in 1971, the U.S. government has had relatively little interest in stabilizing the foreign exchange value of the dollar, showing concern only when the dollar depreciated sharply. During the first Reagan administration the Treasury Department was against intervention in the exchange market and any other action to reduce the value of the dollar, which in 1984 was generally regarded as substantially overvalued.[9] When James Baker became Secretary of the Treasury in January 1985, there was a shift in the Treasury Department's position on the dollar. At a meeting of the G-5 countries at the Plaza Hotel in New York in September 1985, the U.S. Treasury, in cooperation with the other G-5 governments, agreed to reduce the external value of the dollar by means of intervention, and the dollar depreciated from 1985 to 1987 (Obstfeld 1990). The Louvre Accord—an agreement among the G-7 countries on collective action to stop the fall of the dollar and to stabilize G-7 currencies within reference ranges—was reached in February 1987, but there was little willingness on the part of the governments to change their monetary and fiscal policies (Obstfeld 1990). After rallying in 1988, the dollar resumed its decline in 1989 and continued to fall during the first half of the 1990s.

Barry Eichengreen (1995) contends that there is no middle ground between freely floating rates and a unified monetary system with a common currency, such as the EU is seeking to achieve. In his view, stabilizing

exchange rates through policy coordination or convergence is not possible. Monetary unification requires a high degree of political integration, which seems far in the future, even for the EU countries. Richard Cooper (1994) takes much the same position as Eichengreen in his criticism of the target zone system. He suggests that "in the long run, but not for the next few years, we will desire irrevocably fixed exchange rates among the major currencies—in effect, a common currency among the industrialized democracies" (Cooper 1994, 112–116). Thus, we find a fundamental conflict in the positions taken by leading international economists about the possibility of forming an international monetary system in which there is multinational coordination to stabilize exchange rates.

Without specific commitment by governments to support an exchange rate stabilization program in which the IMF would play a major role, the IMF's influence on the international monetary system is limited to preparing financial analyses, carrying on "formal" annual consultations with individual members, and admonishing the finance ministers of leading countries to take measures the ministers find incompatible with domestic objectives. Such a limited role raises the question of whether these functions alone justify the existence of such a large institution or constitute a convincing argument for expanding the IMF's resources.

One current IMF function that should be retained is enforcement of the rules on exchange restrictions on current transactions and on the use of multiple exchange rates in the Articles of Agreement. These rules have their counterpart in the rules of the General Agreement on Tariffs and Trade (GATT) on trade restrictions and on import subsidies and countervailing duties. Exchange restrictions can be used to accomplish the same purposes as trade restrictions, and the rules for both should be monitored and enforced. If the IMF were to be abolished or merged with the World Bank, one way of preserving its enforcement function would be to transfer responsibility for enforcement to the World Trade Organization (WTO).

The IMF's Role in Crisis Prevention

Participants in the Halifax Summit of the G-7 countries in June 1995 proposed a new role for the IMF in dealing with financial crisis prevention

and emergency assistance. The proposal calls for (1) "an early warning system" for countries in danger of financial crises, including the publication of key economic and financial data; (2) policy advice to the governments; and (3) an emergency financing mechanism that would provide "faster access to Fund arrangements with strong conditionality and large up-front disbursements in crisis situations" (International Monetary Fund 1995). To finance the new role, the Halifax proposal requested that wealthier nations double the $28 billion in funding now available to the IMF under the General Arrangements to Borrowing, or GAB (an agreement between the IMF and a group of wealthier countries), and suggested that consideration be given to increasing IMF quotas.

The Halifax proposal was initiated by the U.S. government in response to the Mexican financial crisis of December 1994, which led to the mobilization of some $50 billion in credits for the Mexican government. Of this amount, about $20 billion was made available from the U.S. Treasury Stabilization Fund, a similar amount from the IMF, and the remainder from other countries. The IMF has responded to financial crises before, but never with such a large amount for an emergency created by massive private capital outflows.

In appraising the proposed role for the IMF, it is necessary to consider whether increased IMF surveillance and the requirement that countries make public all the relevant information on their current financial condition will reduce the incidence of financial crisis. Mexico had been receiving economic assistance and was being scrutinized by the IMF before the crisis, a fact that raises the question of whether the IMF can provide an effective early warning system. The IMF held consultations with Mexico just before the crisis and there is no evidence that the IMF advised depreciation of the peso or other changes in Mexico's financial policies (International Monetary Fund 1994, 81). Moreover, there is a need to assess whether a large aid package is the most beneficial use of public international capital. Private capital imports do not necessarily finance productive investment that will strengthen a country's balance of payments position. If emergency assistance is used as it was in the Mexican case, much of it would be used to help the country meet external debt obligations. Only if the capital outflow were reversed could the IMF be repaid within a short period, but this is by no means assured. A case has yet to be made that large financial bailouts are an optimal use of scarce public international funds.

A New Allocation of SDRs

Included in the multilateral sources of financial assistance to developing countries under the jurisdiction of the IMF is the allocation of SDRs (Bretton Woods Commission 1994b, 16). The managing director strongly advocates creating more SDRs. One argument is that new IMF members that missed the most recent allotment should be provided with SDRs. This argument seems to consider SDRs an entitlement, which should be made available to the former Soviet countries that recently joined the IMF.

One argument originally backing the creation of SDRs was that a shortage of international reserves would limit world trade. The argument against creating additional SDRs is that there is no need for an increase in world reserves and that it would not promote world trade. The idea that global reserves may at times be inadequate originated during the early postwar period when dollars and gold constituted the bulk of international reserves; however, several major currencies now serve this function and there is certainly no shortage of convertible currency. In addition, the central banks have negotiated agreements for borrowing large sums from one another. Shortage of reserves is a problem of individual countries, not of the world at large. General expansion of SDRs would be a poor form of foreign aid as they are not targeted to specific purposes or to specific countries in need of assistance. Expanding the total volume of international liquidity serves no global function and might contribute to world inflation.

Proposals for Changing the Functions and Organization of the World Bank Group

Although there are a number of proposals for changing the policies and operations of the World Bank Group, few advocate abolishing it. The proposed changes fall into three categories. First are recommendations that the World Bank do more to promote private investment in developing countries. This could be done by reducing its loans to state enterprises and encouraging privatization of these enterprises. Also, the World Bank should divert more of its resources to the IFC, since the World Bank is not permitted to make loans to private entities without a government guarantee (Bretton Woods Commission 1994b, A1–A9 and A21–A31).

Second are proposals that the World Bank expand its social and economic objectives, such as reducing poverty, promoting greater equality of opportunity, improving health and education, and maintaining the environment. These objectives could be supported through loans to small farms and business enterprises and wherever possible to nongovernmental cooperative institutions. Also, loans for infrastructure projects should be provided in a way that reduces income inequality and avoids harm to the environment. In particular, this means not making loans for multipurpose dams that displace small farmers, impoverish river communities, and produce highly subsidized power for the urban upper class (Rich 1994, Mikesell and Williams 1992).

A third category of proposal has to do with improving the efficiency of the World Bank's operations. These proposals include eliminating activities that duplicate those of the IMF and improving cooperation and division of labor with other development institutions, such as the regional development banks and UN agencies (Wapenhans 1994, C289–C304).

The World Bank's management does not, in general, oppose any of these proposals and it supports their objectives. The World Bank's new president, James D. Wolfensohn, has specifically addressed facilitating private capital flows to developing countries; making more loans directly to the poor; increasing resources for education, health, nutrition, and family planning programs; and avoiding making loans for infrastructure programs that may damage the environment (Bretton Woods Commission 1995). The World Bank's management would disagree with proposals that it cease making any loans for large infrastructure projects and that it devote all of its assistance to poverty reduction and social services (Rich 1994).

Promoting Private Investment

The World Bank is handicapped in making loans to private enterprise by the provision in its charter requiring that all loans to private entities be guaranteed by a member government. Private firms are often reluctant to borrow from the World Bank because to grant the guarantee, the government may impose conditions on the firm. The International Finance Corporation was organized in 1956 as an affiliate of the World Bank to overcome this handicap, but it got off to a slow start. Today the IFC is

the fastest growing of the three independent loan organizations of the World Bank Group, but as recently as FY 1994 its loans made up only 13 percent of total WBG loans. If the IFC's lending, equity financing, and loan guarantee capacity is to be expanded, it needs more capital. One proposal calls for the World Bank to provide additional financing to the IFC to enable it to expand operations. Another proposal seeks to permit the IFC to increase its subordinated debt (Bretton Woods Commission 1994b, 28). Both these alternatives could expand IFC operations without obtaining new general capital from its shareholders—the major industrial countries. It might be possible for the World Bank to use its own borrowing capacity to raise funds for loans to the IFC, but this would probably require an amendment to the Bank's Articles of Agreement, a near-impossible task.

Expanding Social and Economic Objectives

A common criticism of the World Bank is that it has been unsuccessful in reducing world poverty, a goal it now claims as its major objective. Conceivably, the World Bank could direct most of its assistance to small farmers and to creating jobs for the urban unemployed; stop making loans for natural resource development and irrigation systems that benefit large commercial farmers; and devote more resources to supplying clean water, health services, sewage disposal, and housing in small villages. The difficulty with this approach is that social welfare cannot improve unless productivity and national output increase. Improvement requires more goods and services provided by agriculture, industry, technology, and imports. In poor countries social welfare cannot be improved simply by a transfer of income from the rich to the poor. Without sufficient power and transportation, there will be little foreign investment and domestic savers will move their capital abroad. There must be large-scale irrigation to expand agriculture for both domestic consumption and export, and there must be new agricultural and industrial technology to make exports competitive. It may well be that the World Bank does not have the right balance between projects that contribute to social well-being and poverty reduction on the one hand and productivity and growth on the other, but there is no question that it cannot promote sustainable development by devoting all its efforts to the former.

Probably the most publicized criticism of the World Bank is that it has financed environmentally destructive projects, such as large dams that displace poor people, logging operations in tropical forests, livestock projects that erode the soil, and resettlement projects that destroy forests and the habitat of indigenous people (Mikesell and Williams 1992). The World Bank has admitted that it has made many environmental mistakes in the past and, over the last several years, has made considerable progress not only in avoiding those mistakes, but in taking positive steps to assure a sound environment. Most of its project loans now are subject to environmental impact assessments and, through its participation in the Global Environment Facility (GEF), in cooperation with the UN Environment Programme and the UN Development Programme, it subsidizes investment in projects deemed beneficial to the global environment.

Some environmentalists argue that the World Bank creates a strong incentive for developing countries to overexploit their forests and other natural resources because the external debt created by the loans must be serviced by expanding natural resource exports (Rich 1994, Pearce et al. 1995); the development lending institutions should therefore stop creating additional developing country indebtedness. To a considerable degree, this is an argument against development itself rather than against international lending organizations. All development requires increased imports of goods and services, which in turn must be paid for by increased exports, which in the case of poor countries generally take the form of natural resources. Poor countries need external capital to supplement their low saving, and both external loans and direct investments increase external liabilities. Developing countries will export their natural resources whether or not the international banks lend to them, and it is often more advantageous to have those projects financed by international development banks, which insist on environmental standards, than to have the projects designed without such oversight.

An important argument in favor of increasing the resources of both the World Bank and the IMF is that such funding would enable them to meet a portion of the enormous demand for capital in the former Soviet countries and those countries that came under Soviet control after World War II. Unlike developing countries, which have a tradition of private enterprise, commodity and financial markets, property and

transactions law, and a commercial credit system, the former Soviet countries need to develop all of the elements that define a modern capitalist economy. Private firms that operate in competitive markets, service debt, attract private capital, and earn profits must be created, often from former state-owned enterprises.

The first task of an external lending institution would be to provide advice and technical assistance for creating an institutional and policy environment in which a capitalist enterprise could operate. Loans should be conditional on performance in changing the economic and political structure of the economy. This is difficult for an international agency. It is easier for the World Bank to tell Bolivia or Kenya to stop controlling prices or reduce fiscal deficits as a condition for a loan than it is to impose such conditions on Russia for a large loan. A large loan to Russia has political significance, both internally and externally, because of its possible effects on the strategic interests of the leading Western powers. Because of this significance, the lending standards of multilateral institutions may well be compromised. Both the World Bank and the IMF have been criticized as being either too tough or too soft in imposing conditions on loans to Eastern Europe. Therefore, an argument can be made that transition assistance to the countries of the former Soviet Union should take the form of either direct assistance from Western countries or assistance through the European Bank for Reconstruction and Development, which was specifically created to assist these countries. In discussing this question, Kalman Mizsei (1994) observed, “While it is obviously true that there is good cause to treat Russia differently (i.e., because it is a country that has the military capability to destroy the world), if Western governments decide that Russia should be treated preferentially, the necessary funds for Russia should come from those governments directly.”

Improving Efficiency of Operations

Several proposals have been made for improving the World Bank’s efficiency: eliminate activities that duplicate those of the IMF, improve cooperation and division of labor with other development institutions, and determine if certain existing World Bank activities exceed their mandate.

The World Bank makes loans with IDA funds for much the same purposes as it makes loans from its own resources, which means that most of the criticisms of World Bank operations and loan priorities apply to the IDA. Special criticisms of the IDA relate to the generous terms on which assistance is made available. IDA credits have a 50-year maturity, with repayments required no earlier than 10 years after the loan has been made. No interest is charged, but there is a 0.75 percent administration fee. Given these terms, IDA loans (based on a 12 percent rate of discount) are nearly 90 percent grants. Only the poorest countries are eligible for IDA loans, as eligibility is based on per capita income. It may be argued that since any capital investment should yield a return at least equal to the cost of borrowing, foreign aid that is virtually a grant is likely to be used to finance low-yield projects and, therefore, may constitute a misallocation of resources. Countering this position is the argument that poor countries need social projects that will yield positive returns from higher productivity only after a long period of time; therefore, these projects should be financed by the IDA or by outright grants.

Critics have argued that the IMF and the World Bank should not both be engaged in providing financial assistance to developing countries. IMF officials insist that SAFs do not constitute development aid because such financing promotes balance of payments adjustments that are compatible with development objectives. This argument is largely semantic. While the conditions attached to the IMF's SAFs tend to emphasize monetary, fiscal, and exchange rate policies and the World Bank's structural adjustment loans give greater emphasis to the allocation of capital among economic sectors, both institutions seek to realize development objectives that require a combination of governmental policies and initiatives.

Not only is there considerable overlap between the IMF and the World Bank in these development operations, but a few cases of actual conflict have been documented.[10] As stated by Gustav Ranis (1994, C75), "the Bank used to concentrate on projects, leaving balance of payments issues and related macro advice to the IMF . . . it has lately become increasingly difficult to tell the difference between the two institutions." According to George Schultz (1995, 5–6), "the overlapping activities of the Bank and Fund, a change in the traditional mission of the IMF, and the need to use scarce resources carefully all argue for a merger of these institutions." Schultz would transfer the functions of the IMF to the World Bank.

The Bretton Woods Commission report rigorously opposes merging the institutions on the grounds that the IMF can provide unique services to developing countries (Polak 1994). Nevertheless, the report recognizes the need for a more clearly defined division of labor. The report recommends that the IMF "focus squarely on short-term macroeconomic stabilization" and "the Bank should not duplicate the Fund's macroeconomic analysis, but should rely on it in its program planning and project design. The IMF, in turn, should depend on the WBG to provide financial and technical assistance to the recipient countries to mitigate the impact of macroeconomic adjustment on the poor and the environment." The commission was concerned that duplication of effort could become a serious problem "when a country's financial imbalance is structural and, therefore, longer term in nature." In these cases, the IMF "should not pursue independent programs, but its macroeconomic advice should become part of a longer-term adjustment strategy led by the WBG" (Bretton Woods Commission 1994b, B19).

A complete merger of the IMF with the WBG would require either redrafting the charters of both institutions or terminating the IMF and restructuring the World Bank. Approval by the legislative bodies of member countries would be extremely difficult to obtain.[11] The easiest way to accomplish a merger of their current activities would be to bring the IMF into the WBG as a separate entity, similar to the IFC. Integrating the IMF and WBG could be accomplished by having a single set of executive directors for the IMF and the World Bank. The task of integrating research staffs and administrative bureaucracies could be left to the executive board, but the sources of funds for the IMF and the World Bank could remain as stated in their charters. Such a merger could be accomplished by a simple amendment to the charters and without comprehensive redrafting.

Since the objective of the World Bank and the IDA is to help all developing countries become developed, they should eventually go out of business. Rupert Pennant-Rea, deputy governor of the Bank of England, recently stated, "In applauding much of what the Bank has done in its fifty years, I add the hope that it will not live for another fifty years—because it won't need to" (Bretton Woods Commission 1994a, 46).

One way of reducing financial assistance from the World Bank and the IDA is to "graduate" members who are currently receiving loans.

Considering that the IDA has never been regarded as a permanent arrangement but, rather, was designed to help the poorest countries achieve a condition of positive growth, indefinite dependence on IDA funds suggests a failure of the program. "Graduated" countries could still receive World Bank loans for a time, but that form of assistance also would eventually be cut off. A number of countries, for example, Korea and Taiwan, no longer receive loans from the World Bank, and the number of countries eligible for World Bank loans could be reduced. However, downsizing the World Bank raises questions about the distribution of assistance; that is, if a downsized World Bank provides substantial financing to Eastern Europe, it may have little left to lend to developing countries.

Conclusions

My conclusions on the proposals for reforming the Bretton Woods institutions cannot be stated with unequivocal conviction or passion. The issues are too complex, the arguments in favor of opposing positions too persuasive, and the reputations of those holding conflicting views too impressive. Most financial specialists who have considered the future of the WBG and the IMF accept the principle that there should be multilateral institutions to promote world trade and reduce world poverty (see, for example, Kenen 1994b). The Bretton Woods institutions, the WTO, and the GATT are the principal institutions created for these purposes. Given the large financial resources and the highly competent staffs of the IMF and the World Bank, they should be doing a better job promoting trade and reducing poverty. To this end, I propose the following changes in their policies, structure, and operations.

1. The WBG and the IMF should be merged, with each executive director (currently there are 24 for the World Bank and 23 for the IMF) serving as an executive director for both institutions.

I suggest that the new organization be called the World Bank and Fund Group (WBFG) to preserve the identity of the two major institutions. The WBFG would also include IDA, IFC, and MIGA. Nothing in the charters of either institution would prohibit such a change. The chair of the joint board would serve as the CEO of the combined

organizations and would be responsible for coordinating their activities. (The members of the boards of governors of the World Bank and the IMF, who are in most cases the ministers of finance of the member countries, have always served as governors for both institutions.) Since both the World Bank and the IMF would still operate in accordance with their respective charters, it would not be necessary to renegotiate the Articles of Agreement. The financial accounts of each organization would be kept separately and all financial transactions would be in accordance with the charters of the individual organizations. The staffs of the two organizations would be completely integrated, although paid from different sources. The president of the World Bank, the managing director of the IMF, and the chair of the joint board would serve as the governing council. Responsibility for enforcing the IMF's rules on exchange restrictions and multiple exchange rates would be given to the WTO.

2. The IMF should not be given the responsibility for establishing and managing an exchange rate target zone system or for stabilizing the exchange rates of the major currencies.

Proposed changes in the international monetary system involving multilateral control over the exchange rates of the major countries are unlikely to succeed for three reasons. First, it is unlikely that the IMF or any other agency would be able to determine a pattern of FEERs that would be consistent with a given pattern of current account balance targets. Second, it is unlikely that any set of procedure and policy guidelines could maintain market exchange rates in reasonable proximity to a pattern of exchange rate targets without frequent changes in the pattern or without very large commitments of reserves for intervention in the exchange markets. Third, it is highly unlikely that the major countries could agree on a pattern of target exchange rates or adopt the policies necessary to control market rates when these policies were not in accord with their domestic objectives.

Moreover, even if an acceptable pattern of rates could be established, the IMF would not be the appropriate institution to enforce that pattern. First, the IMF has little or no influence over the policies of the major powers and should not be asked by the G-7 countries to undertake responsibility for creating an international monetary system that

the G-7 countries themselves have thus far been unable to establish. Second, coordination of monetary and fiscal policies for achieving exchange rate objectives is not possible for sovereign nations, except perhaps for those forming an economic and political union.

3. The establishment of a special IMF facility to deal with financial crises should be deferred.

I have reservations regarding the special facility proposed at the Halifax Summit for assisting countries experiencing financial crises. The IMF already has the authority to assist countries experiencing financial shocks from whatever source, but it should not devote large amounts of its resources for crises engendered by capital flight. Free capital markets inevitably involve risks to both creditors and debtors; efforts to lessen these risks with public international funds may result in the unproductive use of scarce resources.

4. Development success has been shown to be closely associated with private investment. Therefore, the WBG should move rapidly to change the composition of its lending by making fewer loans to governments and state enterprises and increasing its loans to the private sector, including nongovernmental, nonprofit entities.

The World Bank should increase the proportion of its profits invested in the IFC. The capital of the IFC should be increased, either by additional subscription or by arrangements under which the World Bank would borrow funds from the market to relend to the IFC.

5. There should be a gradual downsizing of the WBG by reducing the number of countries eligible for loans.

As countries reach a path of sustained development, they should no longer be receiving multilateral financial assistance. Also, the United States and other governments are more likely to reduce than to increase their contributions to multilateral development organizations in the future. Therefore, the number of countries eligible for WBG loans should be decreased. IDA replenishments should be gradually reduced, working toward eliminating the IDA within the next couple of decades.

A possible constraint on reducing (or not increasing) the resources of the World Bank is the role the WBG is expected to play in the transition of the former Soviet bloc countries to capitalism. This financial constraint poses a political question that ought to be faced by the G-7 countries. In my view, financial assistance for the transition should be provided by the major Western powers and the European Bank for Reconstruction and Development. Financial assistance from the WBG should be delayed until these countries have achieved political and economic stability and have acquired the institutions, markets, and degree of privatization that would define them as functioning private market economies.

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Notes

1. The Washington, D.C., conference was sponsored by the Bretton Woods Commission and was held at the U.S. Department of State on July 20–22, 1994. A conference sponsored by the Institute for Agriculture and Trade Policy was held at the Mt. Washington Hotel in Bretton Woods on October 15–17, 1994. Madrid was the site of the annual meeting of the Board of Governors of the IMF and the World Bank in October 1994.

2. The IMF par value system required each member to define the par value of its currency in terms of gold or of the U.S. dollar in terms of the gold content in effect in July 1944 (1/35 of an ounce). Members agreed to maintain their exchange rates within a range of 1 percent above and below parity.

3. SDRs are allocated to the members of the IMF in accordance with an amendment to the Articles of Agreement in May 1968. An IMF member wanting to acquire the currency of another member may transfer SDRs to that member in exchange for that member's currency. Each member has an obligation to accept SDRs up to an amount equal to twice its own SDR allocation. Normally, only developing countries use SDRs to obtain convertible currencies. The first allocation of 9.5 billion SDRs was made over a three-year period starting January 1, 1970, and the second over a three-year period starting in 1979, for a cumulative total of 21.4 billion SDRs. As of May 1995, one SDR = $1.47.

4. For a review of alternative exchange rate arrangements, see Frankel (1994, Ch. 5).

5. The current account includes services and investment income as well as trade.

6. Taxes are not included because taxes are transfer payments that are not a part of output. Taxes (T) tend to reduce both C and I. If G increases while T remains constant, $C + I$ will not decrease to offset the increase in G and, therefore, CA will decrease or perhaps become negative. If G is greater than T, there is a budget deficit, $G - T$. The larger the budget deficit, the lower (or more negative) CA will become, unless there is an increase in Y.

7. In November 1977 the Fed and Treasury Department launched a massive program to reverse the sharp decline in the dollar with a combination of foreign exchange intervention and credit restraint (in the form of an increase in the discount rate). This action, however, was not necessarily at variance with President Carter's antiinflationary program underway at the time (Mikesell 1995, 18–19).

8. FEERs are not, strictly speaking, "equilibrium" rates, but are as close to equilibrium rates as can be surmised, given that the other, specified conditions are met.

9. The Council of Economic Advisers (1984) estimated that the dollar was overvalued by more than 30 percent. This view was rejected by the Treasury Department, whose officials believed that a strong dollar was desirable and that a U.S. trade deficit was not a problem to be concerned about.

10. In 1988 the World Bank announced a $1.25 billion loan package for Argentina at the same time it was known that the IMF considered the country's policies inadequate for a new standby arrangement with the IMF (Polak 1994, C153).

11. To gain legislative approval would require opening the Articles of Agreement of both institutions to change by the legislative bodies of member countries. This could result in demands for further changes and, in the case of the present U.S. Congress, a possible move to abolish both institutions.

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