A brief guide to the World Bank, IMF, and WTO

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25 March 2003

Summary

Be informed! The problems around the World Bank (WB), the International Monetary Fund (IMF), and World Trade Organization (WTO) are rather esoteric and difficult questions about development economics. They can't be discussed in a sound byte, so this paper goes into some detail about what you need to know about these organizations and the important questions they raise. Development, by definition, involves the destruction of the status quo; how can this be done in a manner that maintains stability in developing countries?

1 Introduction

The intent of this paper is to give a factual description and some context regarding the Bretton Woods institutions: the World Bank, World Trade Organization, and the International Monetary Fund. These organizations, by their mere existence, raise some serious questions about how the developing world should go about developing, and how the wealthier part of the world should go about helping the poorer parts live better. Unfortunately, these questions are rarely asked.

Many people seem to believe that the World Bank is a big-business conspiracy which exists in plain daylight and will not rest until the entire world is one big office complex. But, unexcitingly enough, there is no conspiracy.

Just as people who chant 'down with the government' are excluding themselves from discussion about how we can make our government better, people who believe the conspiracy theories about the Bretton Woods institutions exclude themselves from debate about the problems and open questions regarding development and trade between rich and poor.

The two main problems with the institutions as I see them are a too-faithful devotion to Neoclassical economics, and the mundane problems of bureaucratic organization which plague every organization bigger than a dozen people.

The open questions are about the concept of development. Humans destroy the environment. People like electricity, but there is currently no way to generate it without damaging the environment in some way. People love cars, but they spew endless pollution and require roads that divide ecosystems in half.

Bringing in a technology expert from the USA means that the host country will be a little more technologically advanced than it was before—and will look a little more like the United States. A country needs to trade with other countries to grow, but in so doing the distinctions and diversities that make that country unique erode.

People in the developing world want electric lights and fans and, if they can afford it, cars. Their taste for exotic American goods is as strong or stronger than Americans' tastes for Turkish coffee or pad Thai. What should the wealthier nations' responsibilities be in helping the world's poor achieve their desires?

I will begin with a few brief and hopefully painless economics lessons. Currency stability and trade negotiations may seem like distant topics, but they have a real, important impact on whether people eat

*Thanks to Jesi Morgan for revisions. A version of this paper is currently available at `http://fluff.info/blog/pdfs/bretton_woods.pdf` .

and how long they live, which I hope will be clearer by the end of this paper.

The impatient and economically savvy may want to skip to section 3, which discusses the Bretton Woods institutions themselves, skimming over their history, their goals, and a few key features of how they work today.

Section 4 will give a few case histories which will help put things into context.

2 Theory

Before getting to the institutions themselves, some background is in order.

2.1 Neoclassical economics in one easy lesson

Neoclassical economics, often known as 'Chicago school' economics, is based in a belief that people approximate perfectly rational beings, who are very good at working out what's in their best interest. It was forcefully advocated by Milton Friedman, who was then at the University of Chicago and who is still referred to as 'Uncle Milt' by U of C Economics professors. The title of his popular book, Free to Choose, does a good job of summarizing the whole theory: if you let people choose among a set of options, then they'll pick the choice they like best, so our best policy option is to leave people alone to make their own choices.

If you were to restrict the decisionmaker's choices, she'll do one of two things: either her old choice is in the restricted set of choices so she'll stick with the choice she had made before, meaning the restriction was irrelevant; or she'll switch to something she didn't like so much when she wasn't restricted, in which case the restrictions made her worse off. [This is an informal description of the Kuhn-Tucker conditions.]

In short, restrictions are bad.

Here in the real world, restrictions take the form of laws. If I want to buy a cheap car that doesn't have all those new-fangled safety features like seat belts, then I should be able to make that choice. Restrictions on markets, like taxes or trade barriers, are also bad, because unrestricted markets can also be shown to be [Pareto] optimal, as in what is hubristically referred to as the First Theorem of Welfare Economics.

The logic is very simple, and hard to argue with. But here in the real world, laws can be a good thing. If I'm too cheap to buy brakes that meet a minimum standard, you may suffer when I slide into your car one rainy day. And it's far-fetched to claim that the road we were on could have been built without a public works department and a tax system to support it.

2.2 Macroeconomics in one easy lesson

Macro is concerned with a really hard philosophical question: where does value come from? Since these are economists and not philosophers, the Macro question becomes: where does money's value come from?

The easy answer is to say that we can exchange a dollar bill for a loaf of bread, and so the dollar's value is equal to the value of a loaf of bread. But if I cross town, I may be able to get a nicer loaf with the same dollar. This is a pretty minor detail within one town, but if I take that dollar to Brazil, I may be able to buy a half-dozen loaves with that dollar and still have change left over.

There are two ways that this is reconciled. The first is via the open market: I can sell somebody who's holding Brazilian royals[1] some of my US dollars. Just as the bread market eventually reaches a price for bread, the royals market will also eventually reach a price which we can take to represent the value of a royal in US dollars.

The other method is by government fiat. This is the true case with royals: the government of Brazil declared that you can buy exactly two royals for one US dollar. But it's a free world, and what keeps

[1] Although the name of the currency is typically not translated, I felt that leaving it as 'real' was just too darn confusing.

me from finding somebody who really wants dollars and taking three royals for my dollar? The answer is that the government takes an active role in foreign exchange (aka forex). If the value of the royal declines on the forex desks of the world, then the Brazilian government will start buying royals, which will drive the price back up. This is known as 'defending the currency'.

2.2.1 How currency conversions affect people's lives

The currency exchange rate matters because people import and export goods. Many countries, for example, do not grow enough food to feed the entire population, and must import food to keep their citizens alive. The price at which they import the food will depend on the value of the currency: if it takes a lot of royals to buy a dollar (that is, the royal is weak), then it will take a lot of royals to buy Illinois corn which is priced in dollars.

However, this is good news for Brazilian exporters: people in Illinois may buy a bag of Brazil nuts for a dollar, and then the Brazilian exporter can take that dollar and buy many royals.

If the royal is strong, the story reverses. A Brazilian won't need many royals to import corn, but the dollar the exporter got for his nut-picking efforts isn't worth so many royals.

It's a hard call as to whether a strong or weak currency is preferable. The word 'strong' sounds better than 'weak', but a country which is basically self-sufficient and has a lot that's worth exporting to the rest of the world wants to have a weak currency. The strategic decision of where along the scale a currency should be depends on the social, economic, and astrological conditions of the country in question.

Stability is a good thing. One thing that is always true is that (almost) everybody wants the exchange rate to be stable. When a volatile currency swings toward the weak, all the people who rely on imports go out of business; when it swings toward the strong, all the people who rely on exports go out of business; and in the end the economy is a mess. Farmers need to decide a year in advance whether to plant crops they will sell domestically or internationally. If the currency is stable, they can make that decision without worrying about being ruined half the time.

3 Bretton Woods institutions and what they do

Bretton Woods is an area in New Hampshire, known for its skiing and a meeting of 45 governments held in July 1944, aimed at tackling two problems: Europe was a smoldering hole in the ground that needed to be rebuilt, and exchange rates had become systematically unstable.

The rebuilding problem was handled by the establishment of the International Bank for Reconstruction and Development (IBRD), whose goal was to coordinate and assist in getting the money together for the rebuilding. Later, the IBRD merged with a few other like-minded organizations with like-sounding acronyms. The larger organization's expanded mission was to finance development projects the world over, and was named the World Bank (WB).

The international finance problems were solved by the establishment of the International Monetary Fund (IMF), and by an imposition of a gold standard. The way the gold standard was implemented was to proclaim that any central bank anywhere in the world could sell gold to the US Treasury for $35 per ounce. Individual countries fixed the value of their own currency in terms of gold, and a reliable international gold standard was born.

The General Agreement on Tariffs and Trade (GATT) was also established to assist in the negotiation of trade barriers such as tariffs. The GATT has expanded into the World Trade Organization (WTO).

The goals of these organizations are aimed at unification and equality. The WTO aims for a world without trade barriers; the IMF seeks a world where all currencies are equal and stable; the WB hopes to narrow the gap between the most-developed and least-developed. Depending on your spin, the aim is an equitable world or a homogenized, Americanized world.

To say more, we need more detail about the individual organizations as they are today.

3.1 The WTO

The WTO is basically a meeting place for the discussion of export and import taxes. It is legally powerless. Really.

"The WTO is a fractious club of 144 member countries [...] The job of heading the organisation is more like managing a bickering professional association than running a global government." ["Globalization's New Cheerleader", The Economist, 5 Sept 2002]

However, informally, the general goal of the organization is Neoclassical in flavor: it hopes to remove tariffs and barriers, and produce as free a market as possible.

"[...] the WTO's boss is the single most visible advocate for freer trade. His is the best pulpit from which to goad rich and poor countries alike into tearing down trade barriers. [...] Though he cannot force any compromise, a politically astute WTO director-general is in a strong position to squeeze deals out of recalcitrant negotiators." [*ibid*]

3.1.1 Discussion

A few lines of math will suffice to prove that a freer market will expand the total efficiency of the world economy. But especially among smaller economies, breaking down trade barriers can create problems.

Say that in a small country without much in the way of technology, a large part of the population works in growing soybeans. Meanwhile, a farm in Iowa may be able to grow orders of magnitude more soy using a fraction of the effort and cost, thanks to machinery and chemicals that the peasant farmer can only dream of [not to mention farm subsidies by the US government]. If Iowans are allowed to freely export soybeans to the poor country, then everybody in the country will be paying less for soybeans, and the peasant soybean growers will instantly go out of business. In a perfect world, they will switch to earning their living in another industry, but in practical terms, this is often impossible.

The avowed goal of removing trade barriers could be harmful if an economy does not match the Neoclassically ideal market—that is, in poor and underdeveloped countries where switching a large portion of the population from one industry to another is a difficult task. Also, in situations where there are other market distortions at work, open trade may also be harmful; here I have in mind situations where the wealthier countries subsidize their producers, so they can put their goods on the market at a lower cost. The U.S.A. gives billions of dollars to cotton farmers, and the U.S.A. and EU both give billions of dollars to sugar farmers. Such a situation turns arguments about comparative advantage on their head—Brazilian farmers can produce sugar more cheaply, but U.S. farmers have the lower price, thanks to subsidies. Entirely open markets would indeed bring cheaper cotton and thus cheaper clothing to Brazilians, but it's entirely unclear whether there is net benefit to Brazil or the world overall under such a subsidies-plus-open-trade regime.

In this case, the question of what is involved in "goad[ing] rich and poor countries alike" and "squeez[ing] deals out of recalcitrant negotiators" becomes an important one. The negotiation of trade barriers is a good thing, so long as it is done without threats or bullying; whether bullying does indeed happen is difficult to determine.

3.2 The IMF

Since Bretton Woods, a lot has happened in the world of currency. First, the gold standard died, meaning that countries are more free to position their currency as the stars dictate. Second, general distrust of the central role the USA played in the system led to the creation of SDRs (special drawing rights), an imaginary currency which the IMF loans to central banks instead of US dollars.

SDRs are paid in annually in proportion to a country's wealth. The number of votes a country has in the operation of the IMF is proportional to the amount of SDRs it pays in. The USA has about

17% of the vote and SDR burden, though many claim that its decision power is disproportionately larger. [Percentage from the IMF member directory, 5 November 2002].

But getting back to the goal of things, currency stability is good. Governments and businesses all want stability. However, currency speculators make their money on volatility. The conflict is clear, and is played out every day in the forex exchanges.

I was once told an anecdote of a trader who was mad at Australia, and so, with a trillion Australian dollars (AUD) or so in circulation, he sold a trillion AUD—the whole currency. The trader was fired and order quickly restored, but more serious speculators (like George Soros, benefactor of MoveOn.org) could readily destroy a currency, and, if properly planned, make millions of dollars in the process. If I got to choose what people picket and riot over, it'd be currency speculators.

A currency's value is also tied to a dozen other factors I haven't yet mentioned, most notably the government's debt. If the government prints more money, the value of the money currently in circulation clearly goes down. Similarly, if the government writes too many IOUs, the value of the currency in circulation also goes down. As discussed above, a weaker currency is not necessarily a bad thing in terms of international trade. But it is a destabilizing factor which makes it harder to defend the currency if necessary.

In the fight between speculators and governments, the IMF is on the side of the governments and the people they represent. It is the lender of last resort, meaning that when the government doesn't have the money to defend its currency, it can look to the IMF for help, which is where the SDRs come in. The government under attack may draw out Special Drawing Rights from the International Monetary Fund and use those rights to buy back its currency. Depending on the situation, it repays the SDRs in more stable times.

3.2.1 Structural Adjustment Programs

Funding from the IMF is not 100% unconditional: if a country is screwing up its own currency, by erratic government and massive budget deficits, then the IMF may insist on policy changes, so as to ensure that it isn't just throwing SDRs down the drain.

Structural Adjustment Programs (SAPs) generally consist of Chicago school economics: cut budget deficits, thereby shrinking the size of government, and drop trade barriers. As discussed above, dropping trade barriers can be a good thing, but may not be under some real-world conditions. Shrinking government can also be a good thing, but in poorer countries, government's roles tend to be rather important and useful, such as providing health and education, building infrastructure, and keeping especially corrupt and useless individuals off the streets by giving them paying jobs in bureaucratic offices. I am unclear on the extent to which an SAP consists of demands to shrink government in general and the the extent to which it consists of demands to cut social services, but the cut in social services often happens just the same.

I will discuss this further in the context of some history, below.

3.3 The World Bank

The World Bank funds development projects. For example, it is the largest single source of education funding for poor countries, having spent an average of $1.9 billion per year from 1991-1999 [source: whirledbank.org, a site critical of the WB, which somehow argued that this was a bad thing.]

Almost all of this is in loans. I am sure that if somebody were to offer to hand over $1.9 billion per annum, the World Bank would happily disperse it without lien, but such donations are not forthcoming. Instead, the Bank puts out bonds and takes relatively small contributions from the wealthier governments of the world.

Its role in the financial process is to remove risk. Loaning to a government which could be overthrown next week is a risk. Loaning money for development projects like the modernization of an electric power plant in the middle of nowhere is also rife with risks. Money for a development project like education or health initiatives will eventually show a return in terms of increased productivity, but nothing a bank can collect on. In other words, Guatemala will never be able to walk into a Citibank branch and expect to get much of a loan.

The World Bank acts as the intermediary. It studies proposed projects and chooses those most likely to succeed, is willing to absorb the loss if the loan is defaulted on, and talks Citibank into making concessions on the interest rate.

3.3.1 Discussion

First, let us consider its role as an intermediary. Unlike commercial banks, it has no profit motive. However, it deals directly with the capitalists of the world who are looking for a return on their investment and have little or no interest in charity. The WB has to somehow pay back those bonds, or else the entire system fails: nobody will put money in to the system so future development projects won't happen, Citibank goes bankrupt because it doesn't get the payments it was relying on, and so thousands of Citibank ex-employees and millions of people whose pensions derive from Citibank stock can't buy food. Citibank's executives will also be bankrupted, but they'll still be able to buy food.

Developing countries have their own credit rating, in a sense. For example, Russia defaulted on its loans a few years ago, and has had problems ever since. Similarly, if we just threw away all the existing developing world debt and dismantled the WB, the credit rating of the developing world would collectively fall in the gutter, and no further development loans would be forthcoming for a long, long time. The question is not 'should development loans be forgiven?' but 'how can development loans be forgiven while maintaining stability and the possibility of future aid loans?'

On the other side of the WB's intermediation are the governments of the poor countries. These are frequently incompetent and corrupt. After project funding is procured, it is often difficult for the Bank to ensure that the money goes to the project instead of the leaders.

Each country has a World Bank bureau, whose goal is to get loans of the largest magnitude possible. This creates a systematic bias toward megaprojects, like dams.

In the choice of project role, many claim that the World Bank doesn't do very well. Some projects just don't work, some are environmentally destructive, and some are sociologically destructive. And as discussed in the introduction, it is hard to imagine a project which does not in some way affect the environment and the society.

For example, one of the easiest ways to create jobs is to exploit natural resources, such as mining or logging. For Americans to claim that mining and logging should not happen is hypocritical, since we depend on wood and bauxite for our day-to-day existence. Blocking such projects means miners and lumberjacks won't be able to eat. But allowing such projects to run at full tilt until the forests are empty and the earth a lifeless hole is also indefensible.

In summary, development is not cheap—in terms of dollars, environmental costs, and social upheaval. But to say that as a result it shouldn't happen is to avoid the truly difficult question of where the balance should be. If we believe that development is a good thing, then the question is where the money will come from. Ideally, it would come from contributions from donors, but the businessmen don't care and the Congress is clearly more interested in buying sleeker bombers than building roads. Instead, we have a decidedly imperfect system of loans, with the WB at the center.

3.4 The WB and the IMF as bickering siblings

The best guarantee of economic stability and repayment of a World Bank loan is, of course, support from the IMF. This brings us back to the structural adjustment programs: if a country seems economically unstable (and they all do...), the World Bank may not be willing to entrust them with a loan until the country can get IMF backing, which it can't do unless it accepts the IMF's SAPs.

The culture of the World Bank is much more liberal than that of the IMF, since the day-to-day questions are about education, health, and roads instead of currencies and bonds. The liberal types attracted by development issues typically do not support Chicago School economic ideas. To claim that the World Bank wholeheartedly supports structural adjustment programs, as many, many people do, is to simultaneously misunderstand what the WB does, and to assume that its actions somehow represent the feelings of its employees—or even its head. Joseph Stiglitz, Nobel Prize winner in economics, was chief economist of the World Bank from 1996-2000, and had this to say about the economics embodied in the SAPs:

> When the IMF decides to assist a country, it dispatches a "mission" of economists. These economists frequently lack extensive experience in the country; they are more likely to have firsthand knowledge of its five-star hotels than of the villages that dot its countryside.
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> [...]
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> The mathematical models the IMF uses are frequently flawed or out-of-date. Critics accuse the institution of taking a cookie-cutter approach to economics, and they're right. Country 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.
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> –"What I learned at the world economic crisis", The New Republic, 17 April 2000

4 A few histories

The intent of this section is to give the sort of context in which the IMF and the World Bank deal.

4.1 Latin America

Latin American societies have historically been very unequal. This is due to a Spanish/indigenous hierarchy, uneven distribution of resources, and any of a number of other factors. Meanwhile, thanks to pressure from the people and from the United States, almost all of Latin America has been a democracy for the last few decades. The leaders who do best in an economically lopsided democracy are those who know how to keep the poor masses happy, and the democratic leaders of Latin America have typically been very populist, even socialist. Take this in contrast with the dictator Pinochet, who imposed the free markets suggested by the Chicago Boys.

Populist tactics tend to erode the economy in the long run, since they are typically consumption subsidies, which somehow need to be paid for. Since the wealthy—who may not have much of a vote but still wield power—won't allow their taxes to be raised, this means budget deficits, and as discussed above, budget deficits destabilize the currency. This is not academic: Latin American history in the last few decades is rife with currency failures, which led to riots and depressions.

The frustration of the IMF should be apparent now: its Neoclassisicist managers had an obligation to support these currencies, and at the same time felt that further failure was inevitable due to the structure of the populist governments. This was the genesis of the SAP conditions.

Are the imposition of SAPs overriding the decisions of the governments they are imposed upon? The first point to note in answering this question is that 'imposition' is not a literal term. A choice was presented to the elected leaders: either the IMF will leave you alone and the people will throw you out for ineptly managing your economy, or you'll have to implement the SAP in which case the people will be miffed but might let you hold office for another term. In some cases where the economy was especially trashed, and hyperinflation made day-to-day transactions impossible, there was even popular support for the SAPs, even though they cut programs that the people depended on.

Were the Neoclassical SAP recommendations the right ones to make? Who knows. In the context of Latin American populism, they were a sensible counterpart to the sort of excesses that the governments were committing. But non-Chicago School people would no doubt come up with other conditions, perhaps insisting that the budget be balanced by raising taxes on the upper echelons and barring cuts in services.

4.2 East Asia

Asia suffered a speculative crisis (mostly in real estate) in 1997. By then, the IMF had established its pattern of SAPs, and presented them to the ailing governments of Asia. But somehow, East Asia doesn't have the populist history that Latin America has. Government isn't all that big, and inflation isn't a problem. Typically, the economy is weak due to governmental decisions and then speculators take advantage of this and cause the currency collapse. But in this case, it was all about the speculators.

Yet the IMF imposed the same "cookie-cutter" SAPs that it had in Latin America. Many claim that this was a misapplication which exacerbated instability and made what could have been a manageable situation much worse. But the IMF economists didn't see this, because their faith in the market and distaste for government was so strong.

5 Conclusion

By now, my agenda should be clear: I am a fanatic moderate, and do not believe that extreme answers are ever the correct ones. On the critical side, "The IMF should just be dissolved" or "No large development projects are good" are too extreme to be reasonable. On the establishment side, the WTO's official answer to every question is that trade barriers should be removed, and the IMF's recommendation for every problem is that interference by government needs to be eliminated. This is equally myopic.

The World Bank's job is to push for development—meaning destruction of the status quo. Critics often paint a picture of the status quo consisting of noble savages who eschew technology that would make them more comfortable, live longer, and work more efficiently, who only accept such things due to brainwashing by McDonald's or the use of force by the World Bank's nonexistent army.

The WTO exists to press for trade which is as free as possible. Tariffs can often be used destructively (thus terms like 'retaliatory tariffs'), and are almost by definition supporting an industry which works more efficiently elsewhere. Therefore, the WTO is a necessary organization for checking domestic political pressure to help certain industries make more money than they would in a free-trade world. However, in trade between the developed and undeveloped world, the developed country has more resources at its disposal to subsidize its industries and engage in antisocial behavior such as dumping. How can trade barriers be dropped in a manner that ensures that the magic of comparative advantage works?

The IMF exists to maintain monetary stability. Most folks here in the USA don't realize the incredible importance of this because the US dollar is so stable that we don't think about such things. But the planning of new businesses and the survival of old businesses depends on the stability of the currency, which the IMF defends. But what should the IMF do when stability is threatened? How often is the Neoclassical approach the correct recommendation to make? What other fixes could they recommend to an economy which is desperate enough to resort to the lender of last resort?

The World Bank supports development projects by acting as an intermediary between wealthy capitalists and third-world rulers. Both of these groups are famous for not being very nice people; how can the WB best bring them together to facilitate the development programs that people need and want, while at the same time keeping each side's desire to shaft the other at bay? How can the WB implement development projects in countries where the government can be expected to steal half the funds? If we feel that old debts should be forgiven, how much can be forgiven without destabilizing the US and European economies and destroying the debtor countries' credit?

Almost by definition, development destroys the current order, socially and environmentally. What sort of projects accommodate the fact that people in poor countries want electric lights, easy transportation, the tools they need to work efficiently, and the ability to trade goods with the rest of the world; while preserving the diversity and other desirable features of the status quo? Any bureaucracy's goal is to maximize its budget, so how can we ensure that all of the projects proposed and approved, especially the megaprojects, are warranted?

Even though most of them have no answer, those are the questions I think we should be asking.