A New Bretton Woods?

Raghuram G. Rajan, Professor of Finance, Chicago Booth Graduate School of Business

The Bretton Woods sisters—the International Bank for Reconstruction and Development (hereafter the World Bank) and the International Monetary Fund (IMF)—were set up in 1944. The original purpose of the former was to help post-World War II reconstruction; the purpose of the latter was to help revive global trade while averting the “beggar-thy-neighbor” exchange rate policies that characterized the interwar years. Over the years, the World Bank has refocused on helping poor countries grow while the IMF broadly attempts to foster country policies that ensure macroeconomic stability and limit adverse spillovers to the rest of the world. While these roles still remain, their nature has changed somewhat. In particular, given the development of financial markets around the world, the primary role of these institutions has moved to shaping, guiding, supplementing, and stabilizing the flow of private finance rather than substituting fully for it. This paper focuses on the new ways multilateral institutions may have to perform old tasks, as well as the ways they could perform new tasks such as slowing climate change. Critical to their transformation will be the attitudes of the countries that play the largest role in their governance, as well as reform of the governance process itself. Hence the call for a new Bretton Woods.

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission’s mandate is to “take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers.”

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission’s Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.
Abstract

The Bretton Woods sisters—the International Bank for Reconstruction and Development (henceforth the World Bank) and the International Monetary Fund (IMF)—were set up in 1944. The original purpose of the former was to help post–World War II reconstruction; the purpose of the latter was to help revive global trade while averting the “beggar-thy-neighbor” exchange rate policies that characterized the interwar years. Over the years, the World Bank has refocused on helping poor countries grow while the IMF broadly attempts to foster country policies that ensure macroeconomic stability and limit adverse spillovers to the rest of the world. While these roles still remain, their nature has changed somewhat. In particular, given the development of financial markets around the world, the primary role of these institutions has moved to shaping, guiding, supplementing, and stabilizing the flow of private finance rather than substituting fully for it. This paper focuses on the new ways multilateral institutions may have to perform old tasks, as well as the ways they could perform new tasks such as slowing climate change. Critical to their transformation will be the attitudes of the countries that play the largest role in their governance, as well as reform of the governance process itself. Hence the call for a new Bretton Woods.
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It still is in the world’s self interest to reduce poverty and economic instability in all countries, not just because their effects spread through trade but also because they can be sources of conflict, of politically difficult immigration, and of environmental degradation. But can multilateral financiers like the World Bank and the IMF help attain these goals?

In the past, they contributed through loans and through economic advice, with the former being the lever through which multilateral institutions forced countries to accept the latter. During the relatively benign 1990s and the early part of this century, the value of lending eroded. Moreover, many developing countries developed their own think tanks and economic institutes (often staffed by former staffers of multilateral institutions or economists who had been educated in the same universities as current staffers), and believed they did not need outside advice. Many felt that the role of multilateral institutions had to be rethought. However, the current economic and financial crisis sweeping the world suggests that the rethinking has to incorporate two additional elements. First, market failures and crises are not history, and may indeed be more global in their impact because of the extent to which the world has become integrated. Second, countries with very sophisticated economic and financial systems made serious policy mistakes, which raises questions about the legitimacy of all economic policy advice. It also suggests more thought be given to the difficult issue of how economic groupthink by multilateral agencies and their

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counterparties in countries, leading to policy advice that creates common vulnerabilities, can be minimized, even while the agencies avoid an “anything goes” approach that leads to systemic incoherence and the ineffectuality of any advice.

The rest of this paper will focus on the new ways multilateral institutions may have to perform old tasks, as well as the ways they could perform new tasks such as slowing climate change. Critical to their transformation will be the attitudes of the countries that play the largest role in their governance. These then are the subject of the rest of the paper.

World Bank Lending

In the past, private capital flows were limited, and the World Bank could bridge the gap between a poor country’s desired investment and domestic savings with its own money. Indeed, finance was the key missing ingredient in the post-war reconstruction of countries since these countries already had the capability to put it to good use.

But recent years have seen an explosion of cross-border private capital flows. To the extent that these flows are long term and committed, such as foreign direct investment (FDI), they serve as a direct substitute for long-term multilateral finance. Even if a project has some benefits for society that do not enhance private returns, the government can offer to monetize these benefits and pay project promoters from its prospective revenues—and if the country is growing, prospective revenues will be higher than today’s. Of course, not every project can, or should, be undertaken by the private sector. It is very hard to entrust certain activities like governance to the private sector because the high-powered monetary incentives that typically accompany private contracting could elicit the wrong kind of behavior. Nevertheless, even if undertaken by the government, projects can be privately financed with stable capital.

If long-term foreign private financing is not forthcoming, it could mean (i) the project is unviable, (ii) the risk-bearing capacity of the private sector is limited, (iii) the project is deemed too costly given the government support that is on offer, or (iv) the government’s promises (including promises not to expropriate) are not credible. Should the World Bank still finance?

Clearly not under (i)! Turning to (ii), before the current crisis, the risk-bearing capacity of the private sector seemed unlimited. For a while after this crisis is over, it will probably seem too limited. In the long run, though, it is hard to imagine that the risk-bearing capacity of the private sector will, on average, be a limitation on finance. Therefore, while multilateral finance could fill gaps during a serious global downturn, and could be made more flexible so that it can ramp up in volume when the private appetite for risk is small, it should not be seen in general as a substitute for private finance.
Moving to (iii), there may also be projects where government support is inadequate. If so, it is up to the government to see if the country can afford the added support, else the project should be shelved. That leaves (iv)—which means the fundamental missing ingredient in many projects is not capital but government capability and credibility.

The World Bank may be better able to rely on government repayment than the foreign private sector. Both World Bank and IMF loans tend to be the last to be reneged on. This implicit seniority stems from a variety of factors: the multilateral organizations have been careful to not lend when a country is in default to them; they have encouraged the view that their loans will be available when all else is shut off so that they should be seen as a form of insurance that is not lightly dispensed with; they have left unspecified their legal options to enforce payment so that the private sector will be reluctant to lend to a country that is in default to multilateral institutions; and they can rely on the moral suasion of their powerful members to persuade a country to not default.

But even if a multilateral lender has greater power to get repaid, should it lend in the normal course where the private sector will not? The answer is not obvious. Clearly, private sector scrutiny adds valuable information about the value of the project that may not be apparent, or may even be ignored by bureaucrats (both international and domestic) who are eager to do a deal. Moreover, while the Bank may come out whole, the collateral damage resulting from an improperly conceived project negotiated by an untrustworthy government will fall on the country’s taxpayers or its other creditors. By freeing the government from the scrutiny of the private sector or, temporarily, taxpayers, the Bank may do more harm than good.

This is not to say the foreign private sector is angelic in its behavior. But competition exerts powerful discipline on private finance, and where competition is thwarted by corrupt firms and corruptible government officials, there is little the World Bank can do. The World Bank should go in alone only when responsible governments in very poor countries are attempting to undertake social investments that have few immediate payoffs, or where the demonstration effects of a project are substantial. But where possible, the World Bank should only co-invest with private finance. And instead of being a senior claimant on a project’s cash flows with a government guarantee of repayment as is normal practice, the World Bank ought to have its investment at risk if the project does not pan out, so that it has an incentive to do appropriate amounts of due diligence, project structuring, and monitoring, all areas where the World Bank can contribute immense amounts of experience. Indeed, the International Finance Corporation, an arm of the World Bank Group, already takes equity positions, and there is no reason why the model should not be more widely followed.
IMF Lending and Crisis Prevention

Until recently, because of recent years of growth fuelled by external demand, crises had become a distant memory for emerging markets. But as industrial countries have slowed and their demand has collapsed, vulnerabilities have increased amongst exporting developing countries and transition economies. The Fund has shown a capacity once again to help countries in an external debt crisis through its ability to coordinate lenders, to monitor and advise the borrower, and to obtain greater priority in repayment (and thus be more willing to lend). However, the IMF should not just intervene in a panic; it should attempt to prevent a crisis, especially a global crisis, in the first place.

At present, if a country faces financial difficulty and calls on the Fund, the Fund evaluates its needs, negotiates the conditions it will require to ensure the country can regain access to financial markets, and if a “program” is agreed to, initiates lending. Before such negotiations are concluded, though, there is some uncertainty about the quantity of Fund lending a country will have access to and the conditions that will be imposed. Members and financial markets would like more clarity about whether the Fund will lend and, if so, how much.

A second concern potential emerging market borrowers have is that they will be open to all manner of intrusive conditions if they approach the Fund for a loan, including those motivated by the need of powerful members to secure a political or competitive advantage. This was not important when powerful industrial countries could be both borrowers and lenders at different times, for they had the incentive to restrain conditionality. However, as industrial countries stopped borrowing in the 1980s, fears about intrusive conditionality increased, partially vindicated by what was demanded of the Asian countries during the East Asian crisis.

The Fund has worked hard on streamlining conditionality, but it could do more. A greater focus on identifying which countries have adopted sensible policies in normal times could reduce the need for program conditionality, especially conditionality that aims to change the structure of a country’s economy in abnormal times. In a sense, countries earn the trust of the international community through their “ownership” of sensible policies in good times so that the Fund can rely on the country authorities to do what is needed when unexpected adversity hits. This will enable the Fund to move towards more of a system of insurance, where it precommits to help well-managed countries up to a certain prespecified amount, with only light conditionality related to the unanticipated factors that trigger their need.

Such precommitment would reduce uncertainty, thus reducing the need for countries to follow distortionary policies to build reserves. Also, the clear signal of a country’s policies provided by the assessment, and the fear of loss of insurance if the country deviates from good policies, would give countries an incentive to stay on the straight and narrow, thus reducing potential moral
hazard. Finally, the commitments implied in assessments would give the Fund more of an incentive to sharpen those assessments (rather than mask concerns in bureaucratic “Fundspeak”).

Some suggest the Fund would always intervene in times of trouble. Even if this is the case, precommitment would benefit countries with mature policies by helping them avoid trouble and uncertainty. Of course, assessments will also need to be accurate and regular. A steady deterioration in assessments will give a country time and incentive to shape up, while if assessments are “behind the curve,” an overly rapid reassessment may precipitate crisis. Also, the Fund should retain a seldom-used option to refuse loans if a “material adverse” political change occurs in a country to precipitate crisis. The Fund should not lend into revolutions!

A last concern is that the IMF Board, which would be making the final assessments, is still dominated by those who will never borrow. If reform (see later) takes too long, it is worth considering whether a separate facility, advised by the Fund but governed by members (possibly a subset of Fund membership who contribute their own money to the pool), is needed.

**Policy Advice**

Let me now turn to policy advice. Here again there are some differences between the Bank and Fund, and many similarities. The Bank offers poor countries advice on development strategy, and on project conceptualization, evaluation, and implementation. Clearly, project evaluation and monitoring is important and its quality will be enhanced if the Bank accepts its share of the risk in a project. But what about advice on development strategy and on the details of its implementation?

There is a growing view that we economists have little useful to say on workable strategies for growth; see Easterly (2001), for example. Rajan and Subramanian (2007) argue that aid has been ineffective, while Glaeser et al. (2004) suggest that the most recent explanatory variable for underdevelopment, the quality of a country’s political institutions, seems to have had little impact on growth. Grand strategies for catalyzing growth are in disrepute. And increasingly, developing countries have well-trained economists who understand this, and are unwilling to take the prescriptions at face value.

In part, the absence of systematic lessons may be because no matter how well-intentioned policy might be, it is filtered through the lens of governance capacity and of political feasibility. Given the various vested interests in the typically unequal societies in developing countries, the latter is especially hard to correct for. So, for example, even if there is little disagreement that sensible macroeconomic policy (moderate inflation, taxes, budget deficits, tariffs, and current account deficits as well as a competitive exchange rate) and social policy
(a sound education and health care system as well as basic income support for the very poor) help create a reasonable environment for growth, how to implement policy depends very much on the details of the country’s situation. Cross-country experience can be helpful in describing what has worked elsewhere, but those experiences cannot be translated lock stock and barrel. Moreover, any policy that eventually emerges could well founder on the rocks of implementation.

Multilateral institutions should not just advise on what would be good in an ideal world, but offer a second-best solution that recognizes specific political constraints and capacities in the country, and utilizes the knowledge of the political authorities in that country in formulating feasible paths. The true value of World Bank and the IMF advice lies, however, in using their independence from local interests or local euphoria to steer the policies to a better place, thus avoiding the third- and fourth-best solutions that are the natural wont of politicians.

The multilateral institutions have recognized the need for country “ownership” of policies but veer between an overly aggressive interpretation and an excessively timid one. The overly aggressive interpretation is to demand that governments reach out to a variety of domestic organizations, elected and unelected, in formulating a consensual national growth strategy. The result is anodyne country strategy papers formulated so as to offend no one. No country, however democratic, can be governed well this way. The excessively timid approach is to accept whatever the country wants to do, no matter how contrary to economic logic, remonstrating with country authorities only behind closed doors.

An intermediate approach is warranted, where the multilateral institutions encourage strategy formulation by developing country governments and providing support where needed—for example, using their talented economists to offer country-specific analysis that can help advance the public debate over the strategy and even “sell” it. While multilateral institutions should be tolerant of experimentation, if they disagree strongly with elements of the strategy, they should do so publicly and be vociferous about their disagreement. Some may argue that this compromises the role of the multilateral institution as an advisor, and may impair their ability to obtain confidential data from the authorities. At the same time, negotiating strategy behind closed doors compromises the democratic process, breeds public suspicion, and impairs ultimate ownership. A compromise is for the multilateral institution to not reveal confidential data or policies that rely on surprise, but to be completely honest and open about the rest.

The virtue of going public is that it allows for honest debate and genuine differences in opinion to emerge, which not only could change the consensus in the country but also the thinking of the multilateral agencies. Given that so many in the governments and the agencies have been educated at the same places, this
could allow a necessary countervailing force against the groupthink that would otherwise pervade all policy advice.

**Spillovers**

The IMF was set up to prevent spillovers from competitive exchange rate depreciations that plagued the interwar years. Clearly, concerns about spillovers from exchange rate policy are still with us; witness the current controversy over the renminbi-dollar dirty peg. But cross-border capital flows introduce a whole new set of spillovers that the IMF did not have to deal with in the past.

For one, flows can transmit monetary policy across countries. That a large country can export its inflationary policies to countries that peg their exchange rate to it has been a staple concern. But changes in interest rates in industrial countries have also been associated with “sudden stops” of capital inflows to emerging markets. And lax prudential supervision by the authorities in one country and overly credulous (or poorly incentivized) investors from another can spread financial sector losses across borders.

The point is that the rapid increase in trade and cross-border capital flows in recent years has tied countries more closely together. This is not a bad thing for it allows a more stable growth path for the world. Over the last decade, productive, fast-growing industrial countries provided the aggregate demand to lift crisis-hit emerging markets out of trouble, and the latter financed the deficits of the former. But integration means more spillovers from each country’s domestic policies. As industrial countries have recently plunged into crisis, they have taken many emerging markets down with them.

Greater economic integration will necessitate greater policy dialogue so as to improve a country’s policies that have large adverse spillovers for the rest of the world. The objective of a new global economic architecture should be to (i) reduce the barriers to trade, and as a country’s capacity to handle them increases, capital flows; (ii) ensure that a country’s policies or regulations do not, through the route of trade or capital flows, give them an unfair competitive advantage or destabilize other countries; and (iii) have a system to discuss policies and coordinate some of them in case of crisis. In addition, dialogue will be useful in attempts to create global public goods such as reducing the pace of climate change, eliminating safe havens for the corrupt, and easing economic tensions between countries. The multilateral institutions would be ideal locales for such dialogue to take place, with their staff providing the necessary impartial analysis, identifying problems and solutions. There are impediments, however.

First, some of the largest industrial countries see themselves as more sovereign than others, and their politicians brook no interference in their own domestic policies, while being fully prepared to use multilateral agencies to intervene in the domestic policies of others. When emerging markets had the
need for loans, industrial countries could, and sometimes did, use multilateral agencies, and not always for the greater good of the international community. But as emerging markets have built their own reserve hoards, the only countries that have to listen are poor developing countries, and even they have options.

If indeed we are to manage cross-border spillovers or global public goods better, all countries will have to subject their policies to greater scrutiny. For large industrial countries, this will mean a change in mindset for both politicians and the people—from a growing fear of globalization and an atavistic resort to the crudest nationalism, to embracing its benefits and accepting the need for more collective management of its consequences. Emerging markets too will need a change in mindset; they have to believe that undertaking actions for the global good does not mean a sacrifice of the economic independence they have so recently gained. And while carrots should be preferred over sticks, the international community has to obtain some sticks other than the threat of withholding lending.

But a second problem is that the multilateral financial institutions are viewed with suspicion by the nonindustrial countries. In part the suspicion is of the current governance structures, a vestige of deliberations held over 60 years ago. In part, the suspicion is also of the prevailing economic ideas that often find developing countries are in need of great institutional and policy reform while industrial countries get milder rebukes. Given that the origins of the current crisis lie in substantial part in failed industrial country regulatory policies and in poorly governed private industrial country firms, developing countries will be even less willing to accept advice from a narrow orthodoxy in the future.

We need an effective, high-level, inclusive, and even-handed mechanism through which unstable situations are identified, a dialogue initiated with relevant countries, and countries persuaded to alter the policies that lead to adverse spillovers for the world. The current system is neither sufficiently high-level when it is inclusive, nor perceived as even-handed enough or open enough to ideas outside the prevailing orthodoxy, to be effective.

The Executive Board of the IMF is representative of countries around the world but is probably too large and staffed at too low a level to take important decisions. This deficiency in turn spawns parallel bodies like the G-20, which slows decision making. Two changes could transform this board into a World Economic Committee that is effective, high-level, inclusive, and importantly, includes politicians, some of whom will challenge the orthodoxy espoused by bureaucrats and central bankers. First, the size could be shrunk, in particular by reducing the number of representatives from Europe. Second, the permanent board could be disbanded (which would also free up Fund resources that are engaged in making routine reports), and replaced by a regular quarterly meeting at the ministerial level (with meetings at the deputy level for more routine tasks, and meetings twice a year at the head of state level). Instead of discussing every country’s Article IV, or every application to borrow, the Economic Committee
would focus on issues of policy spillovers that have collective macroeconomic impact, and involve large allocations of Fund resources.

The International Monetary Fund would both be governed by, and serve as the secretariat for, the Economic Committee. Its own functioning will be key to making the Economic Committee appear even-handed. Among the necessary reforms are (i) making the choice of IMF management transparent, not contingent on nationality, and broadly representative of the membership; (ii) making the Fund self-financing so that it does not have to keep going back to key shareholders; (iii) eliminating any country’s official veto power over major decisions; and (iv) allowing the Fund’s agenda to be set by the Economic Committee rather than outside bodies.

The important developmental role of the Economic Committee would be to identify and reduce structural impediments to cross-border investment, consistent with countries’ ability to absorb flows. Its role in ensuring stability would be to identify and remedy situations where large countries run sustained large deficits or surpluses that can make the system more fragile, cause the volume of damaging political rhetoric to increase, as well as impose the burden of adjustment on others. It should also play a role through the Financial Stability Forum and the IMF in monitoring financial sector regulation and coordination amongst regulators. Finally, in times of global stress, crisis management (including the disbursement of resources and the flagging, as well as reversal, of protectionist actions) would be coordinated by the deputies, who have built relationships with one another in normal times.

What if a country, following policies that are not in the collective interest, refuses to be persuaded? Before any discussion of penalties, it is important that the above reforms to make the system even-handed are undertaken so that assessments identifying problem countries can be seen as unbiased. Even so, macroeconomics is not an exact science, so any attempt to prove beyond reasonable doubt that a country’s policies violate international norms is fraught with difficulty. For instance, countries at different levels of income and with different demographics would naturally have different levels of imbalances, though the correspondence is not exact. Judicial processes along the lines of those followed by the WTO are unlikely to be effective.

One alternative might be to continue to rely on peer pressure and the threat of bilateral political action. This has not worked thus far, though international dialogue has rarely progressed to the point that sustained peer pressure can be exerted. A second alternative might be to devise transparent rules like the deficit rules in the Euro Zone; for instance, a rule on the maximum size of the imbalance a large country at a certain level of development and demographics is allowed to run for a sustained period. Countries would be given time to get their imbalances in order, and if problems persisted after this period, increasing trade or monetary penalties would kick in. A third alternative (I thank Eswar Prasad for this suggestion) is to tie a country’s voting power in the Economic Committee to its
being in good standing in terms of policies. Countries whose policies are not compliant or weakly compliant with the suggestions of the Economic Committee would lose voting power.

If indeed global economic governance is to have more teeth, we also have to make sure its remit is appropriately constrained to a focus on the spillover effects of a country’s policies and not on all policies. The lines will be hard to draw, but countries will accept an outside body with more powers only when they are confident of where the lines are. For instance, a country’s policies on the size of its safety nets may be relevant to its savings behavior, and hence its current account surplus, but the international community may have a legitimate interest only in the size of the surplus, and not in how it is achieved. Similarly, there is great enthusiasm for common financial regulation, but it was common regulation of capital norms for AAA mortgage-backed securities that was partly responsible for the worldwide growth in exposure to these securities. Again, limiting multilateral discussion to spillovers could allow for the necessary diversity in regulations that could minimize contagion. It would also be more palatable.

I have suggested these reforms to governance for the International Monetary Fund. Similar reforms could be contemplated for the World Bank, though there is less need for frequent high-level meetings. But given the broad changes that are contemplated to management and structure of the institutions, as well as their ability to impose penalties, a Grand Bargain will need to be thrashed out. Even though it has become a cliché, we do need a new Bretton Woods.

**Conclusion**

The importance of multilateral financial institutions has not diminished, but their role has changed. Instead of being taskmasters who force change by threat of withdrawal of lending, they are better seen as partners to willing and responsible governments, who can provide valuable advice and supplement their advice with risk financing or insurance. They could also undertake impartial analysis to catalyze domestic debate and to set the agenda for international dialogue on issues like cross-border investment and climate change. But to do so effectively, they have to be seen as honest brokers, and thus the need of the hour is governance reform.
References


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