Editorial

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The papers in this OeNB workshop volume were presented at a conference jointly organized by the Austrian Federal Ministry of Finance, the Oesterreichische Nationalbank (OeNB) and the Reinventing Bretton Woods Committee. The conference took place in Vienna on February 27 and 28, 2014, to commemorate the 70th anniversary of Bretton Woods and its institutions, the International Monetary Fund (IMF) and the World Bank, and to look afresh at the future of the international monetary system.

At the conference, speakers delineated the history of the Bretton Woods system and outlined the role of the euro area in the international monetary system in the past decade. Further issues included global adjustment in an increasingly multipolar world, the management of capital flows, reserves and exchange rate volatility, in particular with respect to some emerging economies and the challenge of preventing the middle-income trap. Finally, speakers discussed the lessons learned from the Bretton Woods system and their relevance for the current crisis.

In his welcome remarks, *Ewald Nowotny,* Governor of the Oesterreichische Nationalbank, stressed the achievements of the EU over the past ten years, during which 13 new Member States joined, bringing the total number of Member States to 28. At the same time, the euro area – the very core of the European integration process – grew from 12 members in 2004 to 18 participating countries. Governor Nowotny emphasized that the euro was the second most important international currency after the U.S. dollar, a fully functional and internationally traded currency, shielding its individual Member States from speculative attacks. Throughout the recent crisis years, the unprecedented joint crisis management of the IMF and the EU had proved successful and could serve as a blueprint for future cooperation between the Fund and regional financial arrangements.

In his introductory speech, *Jochen Danninger,* State Secretary in the Austrian Federal Ministry of Finance, acknowledged the particular role of the World Bank Group as the most important, most influential and truly global development institution, which had sharpened its focus on poverty reduction as its overarching goal. He stressed that assistance provided by the World Bank Group was key not only in the poor countries of Africa or South Asia, but also on Austria's doorstep, in Southeast-

ern Europe. In particular, Danninger emphasized that the World Bank recently had created a regional base in Vienna for its activities in Southeastern Europe and lauded the World Bank's Vienna Office as one of the big achievements in the relationship between the World Bank and Austria in recent years.

Marc Uzan, Executive Director of the Reinventing Bretton Woods Committee (RBWC), outlined the challenges of the current international financial architecture at the 70th anniversary of the Bretton Woods system: high exchange rate volatility, persistent large external imbalances, competitive devaluations, significant international reserve accumulation, the fragmentation of financial markets, financial repression and growing difficulties in maintaining a satisfactory international level of cooperation. Uzan pointed to the need to identify global trends, taking into account the rise of new creditor nations, such as China and other major emerging markets. Multilateral initiatives such as the BRICS' announcement of a new development bank and, more recently, a joint currency reserve pool as a protection against "unintended negative spillovers" could be seen as pragmatic steps toward providing alternative multilateral solutions to the international monetary system. Uzan argued in favor of a system based on a basket of both advanced and emerging currencies in the long run in order to avoid over-reliance on a single country's currency and policies.

Session I: Regaining Control at Bretton Woods

The first session of the conference provided a historical overview of the development of the Bretton Woods institutions.

Liaquat Ahamed, author of the book "Lords of Finance: The Bankers Who Broke the World," gave an overview of the negotiations at Bretton Woods, especially between Keynes and White. Both wanted a stable international monetary system, as trade wars were a consequence of currency wars. Both agreed that capital flows were destabilizing and that temporary financing for the balance of payments was necessary. The main differences of opinion between Keynes and White can be traced to the interests of their respective countries – the U.K. was a debtor country with an overvalued exchange rate and a current account deficit, whereas the U.S.A. was a creditor country with a current account surplus. So Keynes proposed a high amount of initial IMF funding (USD 26 billion), whereas White proposed only USD 5 billion and making devaluations difficult. In the short term, White won, as the settlement was USD 8 billion and the requirement that countries wishing to devalue had to get the approval of 75% of the IMF quota. In the long run, however, Keynes won, as the U.K. devalued already three years later. Ahamed concluded that nowadays, after the most recent crisis, IMF funds in real terms were close to what Keynes had proposed.

Edmund Conway, author of the book "The Summit: Bretton Woods and the Fight to Save the World's Economy" debunked some conventional wisdom about the

negotiations at Bretton Woods. For instance, it had not been the U.S.A. that put the U.S. dollar into the IMF Articles of Agreement, thereby making it the dominant reserve currency, but the U.K. The U.S.A. had remained vague on this issue. Also, it was not true that White was a spy for the Soviet Union. He passed some information to the Soviets but that was rather some sort of private diplomacy than involvement in espionage. After all, he was no fan of the socialist system. Conway noted that the French, meanwhile dominating the IMF, had played a relatively irrelevant role at the negotiations at Bretton Woods. His lesson from history was: Beware of conventional wisdom, and the general public is not always aware of the importance of some events, just like Bretton Woods was not perceived to be a big event by the general public at the time.

Ruogu Li, President of the Export-Import Bank of China, stressed that the collapse of the Bretton Woods system showed that there were inherent flaws in an international monetary system which depended on a single currency. It faced the "Triffin Dilemma" and could hardly remain stable. Li argued that it was impossible to avoid the risk that the core country takes advantage of its special position of having the global currency to manipulate international finance. He stressed that the current international monetary system was unable to address the flaws of the old Bretton Woods system and had created new problems. Therefore Li advocated a new international monetary system that consisted of the major currencies, including the U.S. dollar, the euro and the Chinese renminbi, based on coordinated exchange rates and reasonable flexibility. The internationalization of the Chinese renminbi – the result of the growth of China's economy and its financial market – would contribute to a more diversified monetary system. At the end of day, the market would decide whether the Chinese renminbi becomes a really internationalized currency.

Eric Rauchway, Professor of History, University of California, stressed that focusing on the conflict between White and Keynes was misleading and impoverished our understanding of the fundamental shared ideas underlying Bretton Woods. He explained that there had existed a much deeper consensus, not only between Keynes and White, but also between Keynes and Roosevelt, over how to reform the international monetary system. This consensus had developed at the depth of the depression, at the time of Roosevelt's election. The elements of this consensus included the idea that exchange stability should be a secondary goal, subordinate to the promotion of sustainable economic growth, and that governments should be free to pursue policies to promote economic growth even at the expense of short-term stability. Ultimately, the way to stability lay in growth, an insight that policymakers and their advisors began to develop and express in the Great Depression.

The major features of what would become the Bretton Woods program – the international fund, the proposed international currency (which would, whether bancor or unitas, ultimately vanish, though it provided a basis for initial negotiations), the

managed currencies, and above all, the desirability of international exchange stability and the insistence on the priority of prosperity over internationally stable exchange rates – were all in place in 1933. The main promise of Bretton Woods was that the monetary agreements would make full employment and rising real wages an international priority. The Bretton Woods system was sold to the world's governments and peoples as a flexible mechanism that would permit making prosperity a priority. Rauchway concluded that we could regard the Bretton Woods era a success in so far as these promises had been fulfilled; if we wished to recover it, however, we would do well to attend to these foundational pledges that general welfare should come first and lead to greater stability afterwards.

Session II: Regaining Control in the Euro Area

Michael Bordo, Professor of Economics, Rutgers University, examined analogies made by recent literature between the events in Europe in 2007–2012 and the collapse of the Bretton Woods System in 1968–1971. He found that a clearly more relevant analogy for the euro area's ongoing problems was that between the U.K. and Germany: The U.K. ran persistent current account deficits, was faced with ongoing deflationary pressure and eventually had to devalue in 1967, while Germany ran persistent current account surpluses over the same period, was faced with ongoing inflationary pressure and on two occasions was forced to revalue the Deutsche mark. Finally, Bordo suggested an alternative analogy to the TARGET imbalances in the euro area, namely the breakdown of the payments mechanism in the U.S.A. during the Great Depression. During the Great Contraction from 1929 to 1933 there were massive gold flows between regions, reflecting a substantial drain of gold from the interior southern and western regions hardest hit by the successive banking panics, to the safety of the eastern money centers, especially New York. Unlike in the recent financial crisis in Europe, the Fed did little to accommodate the demands for liquidity. By the fall of 1932, the breakdown of the payments system was so widespread that many of the U.S. states declared banking holidays to prevent depositors from making withdrawals from their bank accounts. Banking holidays spread from state to state as the authorities in neighboring states tried to prevent depositors who could not get cash in one state turn to banks in neighboring states. The contagion culminated with a nationwide banking holiday, which effectively ended the panic. The TARGET experience reflects learning from that experience.

Elena Flores, Director Policy Strategy and Coordination, European Commission, gave a comprehensive overview of the European Union's response to address the faults in the architecture of the euro area, which had been revealed by the crisis. She sketched the main features of the EU's improved framework for fiscal surveillance, economic surveillance (in particular of the newly established Macroeconomic Imbalances Procedure), the creation of emergency funds (e.g. EFSF; EFSM, ESM)

as well as the launch of banking union. However, she cautioned that all these building blocks would not be sufficient, unless the euro area moved away from country-specific recommendations to policy measures that were needed for the entire currency union. In this vein, Flores mentioned the Blueprint for a Deep and Genuine EMU. She argued that monetary policy was an effective tool to deal with symmetric shocks in general; adjustment to asymmetric shocks, on the other hand, required deep reforms leading to greater flexibility and should be supported by other adjustment mechanisms. She argued that fiscal integration could be that mechanism and concluded that a genuine EMU involved further transfers of sovereignty to the European level, which must be accompanied by steps ensuring strengthened democratic legitimacy, accountability and scrutiny.

Gertrude Tumpel-Gugerell, former Member of the Board, ECB, took account of the successful reform steps that had been taken in the euro area in order to overcome the crisis. She focused on three areas of change – economic cooperation, convergence and financial sector reform. Economic cooperation had been fundamentally reformed by aiming at balancing the structural budget, reducing debt, addressing macroeconomic imbalances and putting more emphasis on competitiveness and structural reforms, including earlier corrective action. She welcomed the reform steps undertaken in the area of financial sector surveillance and the creation of new institutions in order to improve the resilience of the financial sector. She emphasized that these reform efforts had not been sufficient and that reflections on the future shape of the Union needed to be undertaken. Tumpel-Gugerell sketched two possible avenues of development: first, the creation or enlargement of a central fiscal capacity for the Union, and second, a further mutualization of policy risks and risk sharing, such as joint issuance of debt.

Dinner Speech by Fabrizio Saccomanni

Referring to the conference theme, *Fabrizio Saccomanni*, former Italian Minister of Finance, argued that control over the international monetary system had not been regained yet. Despite tighter global regulation on banking, the volumes intermediated by global financial markets had not been affected. At the same time, the shadow banking system had grown even further, as funds were increasingly shifted from the regulated to the unregulated sector of the international banking system. As a possible approach to solve this problem, Saccomanni suggested to strengthen macroeconomic policy coordination among the main actors on the global scene in order to promote stability in the global financial system. He proposed a form of target zones for the exchange rates of the major currencies. In his view, policy coordination should be moved away from the G-20 and be left entirely to the IMF, which is endowed with the necessary legitimacy.

Session III: Regaining Control: The Global Adjustment Question from Bretton Woods to a Multipolar World

Jean Boivin, Associate Deputy Minister in the Canadian Department of Finance, pointed to the increasing importance of global financial linkages and risk-taking channels. In order to integrate them into macroeconomic policy decisions, a better understanding of the link between macroeconomic policy and financial stability was needed. He concluded that the international monetary system did not need to be redesigned from scratch, but rather needed to be completed. As a concrete suggestion, countries vulnerable to swings in investor sentiment should deepen their domestic financial markets and strengthen their monetary policy frameworks in order to become more resilient to cross-border flows.

Jerome Booth, Chairman, NewSparta, introduced the term “core/periphery disease,” meaning that mainstream analysis typically focused on the effects of the core, i.e. the developed world, on the periphery, i.e. emerging markets. Booth argued that we should actually ask the question the other way round, given that central banks and sovereign wealth funds of emerging markets own a major share of government bonds issued by developed countries. Booth suggested redesigning the international monetary system in a way to move to a multipolar reserve system where emerging market central banks diversify their reserve holdings toward trade-weighted shares, also given the increasing share of south–south trade in global trade (which has already reached 30%). In this context, China could play a leading role, and other emerging markets would follow. At the same time, Booth doubted the necessity of coordination via the G-20.

In his presentation, *Ibrahim H. Çanakci,* Undersecretary of Treasury of the Republic of Turkey, emphasized the growing importance of emerging market countries in the global context over the past two decades. Against this background, he lauded the ability of the G-20 to enhance coordination between advanced and emerging countries. He stressed the need to improve global financial safety nets in order to prevent in particular emerging economies from building up excessive reserves. He also pointed to the current representation gap weakening emerging countries’ ownership toward the IMF and reiterated his call to the international community that the dynamic growth of emerging markets should be duly reflected in the international financial architecture.

Jose Antonio Ocampo, Professor of Economics, Columbia University, discussed two alternative ways to reform the international monetary system. The first option would be to enhance the multicurrency character of the current system, which could be accomplished by increasing, e.g., the use of the euro as a global reserve asset or, alternatively, to internationalize the renminbi. The second and most desirable option according to Ocampo would require moving to a fully SDR-based IMF with a clear counter-cyclical focus. This would include counter-cyclical alloca-

tions of SDRs and counter-cyclical IMF financing made entirely in SDR. Ocampo suggested using SDRs to finance IMF programs and, at the same time, introducing a substitution account where central banks could exchange their reserves in currencies they did not want to hold for SDRs. Thus, the SDR could be made complementary to a multicurrency system.

Session IV: Managing Global Finance, Preventing the Middle-Income Trap and Evaluating the IMF

Andy Haldane, Chief Economist, Bank of England, started by tracking back the evolution of global financial integration over the past century and pointed to the fact that particularly over the past thirty years global finance had changed spectacularly into a well-connected network, a genuine system. In order to improve the resilience of the international financial system, Haldane depicted four areas to move forward. First, global financial surveillance could be developed away from country-specific surveillance toward a tracking of the global flow of funds aiming at revealing financial risks in a timely manner. Second, Haldane put forward suggestions of how to improve country debt structures, including GDP-linked bonds or contingent convertible bonds. Third, he advocated enhancing macroprudential and capital flow management. Fourth, Haldane argued in favor of improving international liquidity assistance. In this context, he stressed the importance of the U.S.A. having ratified the 14th quota review. While regional financial arrangements had played a useful role in recent years, the financial system was a global, not a regional one and therefore needed global solutions, Haldane emphasized.

Hans-Helmut Kotz, SAFE Policy Center, Goethe University, Frankfurt and Center for European Studies, Harvard University, stressed that EMU was characterized by a rather distinct set-up: Monetary policy was supra-nationalized, financial markets were almost completely open, with strong capital flows from the center to the periphery – but banking politics remained largely nationalized. Most of the intra-European capital flows had been intermediated by banks. Those banks were largely funded in wholesale interbank markets – particularly vulnerable to herding and sudden directional changes of flows. Beginning with the Great Financial Crisis, jurisdictional (and supervisory) borders became important again. European financial markets fragmented. Completing Europe's monetary and financial union by creating a banking union should lead to the europeanization of banking policies. While the first pillar of banking union, the Single Supervisory Mechanism, is well advanced, the two other two pillars, dealing with troubled banks and underwriting retail deposits, still need some work to be done. But the restructuring and resolution regime now in place already compares very favorably with the ad hoc attempts at handling challenged banks with a cross-border dimension. Kotz also stressed that

from a European perspective, macroprudential policy has a regional capital flow management dimension and will be very important.

Ousmène Mandeng, Managing Director, Pramerica Investment Management, linked the middle-income trap to the EU convergence methodology and discussed immediate and intermediate consequences of the middle-income trap for portfolio investments in emerging markets. He found that real convergence from middle- to high-income status remained rare. Mandeng concluded that the EU emerging markets, as compared to other emerging markets, had been particularly successful in raising income in absolute terms. As regards portfolio investments in emerging markets, he argued that, although they still remained small in relative terms, concerns about the middle-income trap could dampen potential portfolio investment flows. This could possibly fuel self-fulfilling expectations, which themselves contribute to the middle income trap. Looking at convergence patterns over a given time span, he concluded that low-income countries found it relatively easy to become middle income, while absolute income differences between middle- and high-income countries had remained large even within the EU. Post-unification Germany may serve as an example to understand actual limitations to convergence.

Ruben Lamdany, Deputy Director of the IMF's Independent Evaluation Office, examined the main factors that prevented the IMF from being able to detect and warn about the vulnerabilities in the years before the crisis. He identified three main reasons: First, cognitive biases, such as groupthink within the IMF macroeconomists, possibly contributed to "blind" the IMF. Second, Lamdany found governance and organizational impediments within the IMF, as its internal organization along vertical units constituted an obstacle to integrating the findings from multilateral and bilateral surveillance activities or to linking macroeconomic and financial developments. Third, he found analytical weaknesses, inter alia stemming from the IMF's insular culture of rarely referring to work by external analysts. He concluded that the IMF as an organization had already responded to these weaknesses and undertaken many reforms in this respect. As a consequence, the IMF's performance during recent crisis years was widely perceived as improving, in particular as regards its role in coordinated global action, raising its resources in a timely manner to ensure adequate funding of IMF programs or the creation of precautionary facilities.

Session V: Bretton Woods and the IMS in a Multipolar World?

In his keynote speech, *Jacques de Larosière,* former Managing Director of the IMF, stressed that an effective international monetary system (IMS) resulted in the enforcement of a common monetary policy by national states abiding by the "sys-

tem." Historically, such systems had relied either on a "real" external anchor, like gold, or on a national, dominant currency.

After the demise of the Bretton Woods system, central banks had resorted to inflation targeting, which did not result in an IMS able to harmonize monetary policies. Inflation targeting had failed to achieve financial stability.

De Larosière saw a low probability of a "grand" reform of the IMS and believed that the world would evolve slowly over the years toward a more multipolar system. To avoid the repetition of crises in a world where currencies were free to misalign, he recommended a macroeconomic oversight system. He emphasized that central banks and regulators from around the globe must work together to identify and counter financial imbalances.

De Larosière warned against global capital requirements, which could be very costly in terms of reducing normal credit availability. In his view, sectoral and cyclical capital requirements and lending limits would be much more effective and less expensive than a "one size fits all" capital ratio approach. He saw systemic risk attention as the persistent missing link of our mindsets.

Richard Cooper, Professor of International Economics, Harvard University, pointed out that we had always lived in a multipolar world. Negotiations on trade and international monetary issues always involved several players. Recently, China, Brazil and India had become more important, but the world had not recently become multipolar because of the addition of those countries. Even the international use of currencies had never been unipolar. While the U.S. dollar has played the predominant role since the 1940s, the British pound was important into the 1970s; later the Deutsche mark grew in importance and was subsequently replaced by the euro, which has been playing an even greater role. Maybe the Chinese renminbi will be added to this list in the future, but this would take a long time.

Cooper expects the U.S. dollar to remain the dominant international currency for a long time because of the size of the U.S. economy and especially the size and the liquidity of U.S. financial markets, along with an independent and impartial judicial system for settling commercial disputes. Equally important were extensive network externalities that had been established through the historical use of the U.S. dollar, comparable to the use of English as a common means of communication, Cooper said.

In his view there was no effective alternative to the U.S. dollar. The euro, as the obvious competitor, had recently suffered a setback by economic troubles in Europe. In the longer run, Europe was in relative economic decline, much more so than the United States.

Jacob A. Frenkel, Chairman of the Board of Trustees, G30, stated that the original Bretton Woods conference was a success because it was the outcome of very detailed technical analysis. While there had been ambiguities in the initial drafting,

no unintentional ambiguities were left in the Fund Agreement; they were a skillful way to bridge, maybe to cover, disagreements.

He recalled the practical preparations for the G-7 Louvre Agreement of 1987, which focused on internationally coordinated macroeconomic policies, thus going much beyond the Plaza Agreement of 1985, which had aimed at international exchange rate adjustments. On a more general note, policy cooperation could be instrumental in facilitating outcomes that internalize some of the externalities that prevail in the complex interdependent world and should create win-win outcomes rather than just a zero-sum game.

Finally, Frenkel briefly sketched the major challenges for the international financial system, such as the prevention of future financial crises, macroeconomic imbalances both within economic blocks as well as between them and the dramatic shift of economic power away from advanced industrial countries toward emerging markets.

Siddharth Tiwari, Director of the IMF's Strategy, Policy and Review Department, recalled that the IMF was formed in 1945 in response to global crises and the recognition that the international monetary system (IMS) would benefit from rules-based global financial cooperation. The IMF as an institution had been far from static and had adapted to a changing world economy. Global trends such as the dramatic increase in economic and financial interconnectedness, with more intense spillovers, the ongoing transition to a more multipolar global economy and the evolving multilayered global financial safety net were some of the challenges to which the IMF was still responding today in order to remain a relevant player in the future.

Tiwari emphasized that the global financial safety net had become a multilayered system. Besides IMF financing, central bank swap lines or regional financial arrangements (RFAs) provided additional layers. They helped increase the size of available resources and brought regional expertise and greater program ownership. They could, however, only offer limited risk pooling and so the stability of the IMS still necessitates a strong IMF at the center.