Oesterreichische Nationalbank

Eurosystem

Workshops

Proceedings of OeNB Workshops

60 Years of Bretton Woods – The Governance of the International Financial System – Looking Ahead

June 20 to 22, 2004

No. 3

The Bretton Woods Institutions after 60 Years – Some Thoughts on Markets, Governance and the Role of the IMF

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1. The Failures of Two Fundamentalisms

The reference here is not to religious fundamentalism. I am thinking of the fundamentalism one could find and sometimes still continues to find in economic writings. On the other end of the ideological spectrum, market fundamentalists have argued, and some continue to argue, that if markets are to do their job of allocating resources, there should be no interference from government, no public sector type decision making to counter the market. Ludwig von Mises[1], for example, argued that "the market economy …and the socialist economy preclude one another. There is no such thing as a mixture of the two systems". Friedrich von Hayek argued along similar lines: "Both competition and central direction become poor and inefficient if they are incomplete …a mixture of the two will be worse then if either system had been consistently relied upon".[2] Milton Friedman came very close to similar views, arguing, for example, that speculative behavior in foreign currency markets will always be stabilizing. Traces of the same kind of fundamentalism can be found in the views of those who see the Bretton-Woods

* Parts of the material in this article are based on Kemal Derviş in cooperation with Ceren Özer, *A Better Globalization: Perspectives on Legitimacy, Reform and Global Governance*, a longer work-program carried out with the support of the Center for Global Development (CGD) in Washington, DC. The book is expected to be published by the CGD in the fall of 2004.

1 Ludwig von Mises (1949), Human Action: A Treatise on Economics. New Haven: Yale University Press.

2 Hayek, Friedrich A. (1949), The Road to Serfdom. Chicago, IL: University of Chicago Press, 50th anniversary edition.

institutions, particularly the IMF, as colossal sources of moral hazard, undermining the discipline of free international capital markets. They tend to believe that markets, including financial markets, work well, both domestically and globally, across national borders. The role of governments and international treaties should be to enforce property rights and perhaps provide a basic social safety net, and it should stop at that.

On one end of the ideological spectrum there were those believing in the virtues of central planning. They enjoyed their heydays in the late 1940s and 1950s when the Soviet Union appeared to be growing very fast and catching up with the U.S.A. The fact that the first man in space was a Soviet comforted them in their belief. The famous Marxist economist, Oskar Lange, for example, became a total convert to central planning in the late 1940s, despite the fact that he had been one of the architects of a model mixing planning with markets in the 1930s. In the late 1940s, Lange argued that the advent of computers abolished the need for markets, because thanks to computers, all allocation decisions could be made by central planners working with computers.

The history of the last 60 years has proven both types of fundamentalisms wrong. Some communist countries tried to actually practice the fundamentalism of planning (the Soviet Union particularly in the 1960s and 1970s, other Eastern European countries, with the most extreme case being the Albania of Enver Hoxha.) It all ended in unmitigated disaster. Market fundamentalism, on the contrary, was never really implemented anywhere. It was proven wrong in a different way: democratic societies could not or would not implement it, because the political mechanisms at work in a democratic society would not turn the entire allocation and distribution of resources over to the unadulterated market mechanism. Throughout the twentieth century, there has been a lot of debate on the best possible balance between the domain of the market and the domain of government, but markets have always remained "embedded" in public and social institutions.[3] In fact, the share of resources allocated by the state has steadily increased since the early 1900s. The share of government in GDP of what are now the OECD countries has increased from about 10% before World War I, to an average of about 45% in the 1990s.[4] The share has stabilized over the last decade but it has not and is not declining. Even the so-called Reagan-Thatcher revolution in the 1980s did not have a significant impact on the balance between the public

[3] The term "embedded liberalism" was coined by John Ruggie in the early 1980s to describe the social market economy that emerged as the dominant socio-economic model in the western world during the post-world-war II period. Ruggie, John G. (1982). International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order. International Organization. 36 Spring.

[4] See Tanzi, Vito, and Ludger Schuknecht. (2000). Public Spending in the 20th Century: A Global Perspective.Cambridge. Cambridge University Press, for a comprehensive study of the share of government in the national expenditures of a large number of countries.

and the private sphere in the advanced western economies. Privatization of parts of the public sector did become more widespread and the share of the public sector in value-added did decline somewhat in several countries, but the share of taxes and public expenditures did not decline.

In a recent book the French economist Jean Paul Fitoussi explains the success of what I call the "social-liberal" synthesis[5] as follows:

> "On the one hand the market is governed by the principle of voting where the appropriation of goods is proportional to the resources owned by each – one euro, one vote. On the other hand democracy is governed by universal suffrage – one woman, one man, one vote. This contradiction had been perceived already at the time of the origins of political theory in ancient Greece. Our system reflects the result of an inherent tension: on the one hand individualism and inequality, on the other hand public space and equality. This forces a permanent search for an in-between, a compromise".[6]

To summarize, the history of the last hundred years has shown that there are two dimensions to the social "embedding" of the market: redistribution and regulation. Democratic societies do not accept the distribution of income which would result from the outcome produced by a particular set of endowments individuals have interacting with purely market based production and exchange. They demand that public policies achieve a certain degree of redistribution and provide a social safety for the most vulnerable. Democratic societies have also learned that markets need effective regulation and constant supervision to function well. Competitive structures cannot be assumed to exist and persist naturally, technology and information economies often require large scale organizations, so that difficult competition and principal-agent problems arise which cannot be ignored by public policy.

What does all this have to do with the 60 years of the Bretton-Woods institutions? A lot, I believe. Over the last few decades the domain of the market has become much more global. Production is increasingly planned and carried out in integrated networks across the world. Financial markets have become even more integrated. All this is being made possible in accelerating fashion by modern communications technology. We are in the midst of a tremendous revolution in the

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5 Derviş, Kemal. (2004). A Better Globalization: Perspectives on Legitimacy, Reform and Global Governance. Center for Global Development unpublished manuscript (forthcoming). Washington, D.C.

6 See Fitoussi, Jean Paul. (2004). La Democratie et le Marché. Paris. Grasset. p 46.

nature and use of knowledge. Everywhere, citizens are affected by economic events and market driven decisions happening far from where they happen to live.

At the same time, in the political domain, liberal democracy has triumphed. Within nation states, a political system giving each citizen equal weight and equal value through free and democratic elections, which are essentially based on a one-citizen one-vote principle agreed on today by a very large part of humanity. The ideological triumph of democracy, which is linked to the triumph of the principle of human equality, is not easily compatible with a global system where human beings are "equal" in the sense of having equal democratic rights *within* national borders, but remain very "unequal" *across* these borders. Pressures are rising for the *global market* to be "embedded" in a *global community* in a manner similar to what happened within individual countries. The global market too must be regulated and the results it leads to must be partly altered by redistributive mechanisms for market driven globalization to be accepted by the majority of those affected by it. Markets may be good for national growth as well as for global growth – but that is not enough for their results to be accepted as legitimate.

We are of course very far from a global community that resembles what exists at the national level. It will take time for the global market to become "embedded" in a manner described by Ruggie in the context of national markets. Responding to a genuine and deeply legitimate demand, the process of building global public institutions has started long time ago, when the founding fathers gathered with great foresight at Bretton-Woods and tried to lay the foundations for a world economic order that would spare their children and grandchildren the horrors of war. It continues with the pursuit of the millennium development goals and with the debate on improving global governance. I believe that it is against this broad background that one should discuss the role and future of the Bretton-Woods institutions six decades after their conception. The notion of embedding the market goes beyond the valid but more narrowly economic notion of public goods. The provision of public goods by governments corrects for market failure, improves economic welfare and is desirable and justified on purely economic grounds. Embedding the market in democratic and public institutions adds legitimacy and acceptance to the socio-economic outcomes created by market mechanisms regulated and altered through democratic processes. It is within this philosophical and historical approach that I want to share my thoughts, briefly, on the role of the International Monetary Fund (IMF) in the coming years in the second part of this paper.

2. Some Thoughts on the Future Role of the IMF

2.1 The Surveillance and Crisis Modes

Considering the role of the IMF within the overall framework of global economic governance one can quickly distinguish two related but distinct activities that are currently ongoing:

- Economic surveillance including the elaboration of globally acceptable and desirable standards and codes accompanied by the pooling of knowledge and experience

- Rescue operations, in the form of work-outs when countries are facing acute balance of payments and related debt rollover problems.

Both functions of the IMF are valuable and fulfill some of the "embedding" role that we referred to above. Market fundamentalists have questioned the usefulness of both functions. Some argue, for example, that private financial markets alone with private rating agencies, financial institutions and consulting firms could carry out activities resulting in "surveillance" and could develop and spread the required knowledge and information. Changes in credit ratings could constitute the kind of endorsement or warning that comes with an Article IV consultation. The "short term alarm clock" models developed by private institutions such as Deutsche Bank, Goldman Sachs or others would alert markets to impending financial "events" and the discipline fear creates would help prevent serious crises. Good policies would be rewarded by greater capital inflows and lower interest rates. The private sector itself can create and disseminate knowledge.

There is truth and merit in these propositions. The side effect of the increased transparency that is being demanded from governments worldwide, has been that the IMF no longer has the same privileged access to timely information that it did have only a decade ago. Central Banks now publish their balance sheets on websites, and government commitments to the Fund contained in "letters of intent" that used to be top-secret documents, can be read by everyone the day after board presentation. It is also true that private institutions able to process and analyze information have developed in many more countries, including in many of the emerging markets. Information is no longer restricted to operators in a few of the richest countries. Nonetheless there remains substantial value in a public international institution complementing market operators and providing a kind of anchor to all these market –driven surveillance, monitoring and analysis. The IMF has the advantage of a huge accumulation of institutional memory and skills spanning a broad set of issues that remains unmatched in the private sector. The very fact that it is not driven by short-term profit concerns allows a special perspective that differentiates the analysis carried out by IMF staff from what is produced elsewhere. Private financial markets are too often driven by herd instinct rather than sufficient analysis of fundamentals. The IMF can provide a longer-term perspective and greater attention to fundamentals. Finally, Article IV consultations and other special IMF missions provide for a formal and accepted framework where governments engage with representatives of the international community as a whole, a process which has acquired a certain degree of legitimacy and continuity.

The best way to look at private sector produced information and monitoring, and IMF monitoring and surveillance, is as *complementary* and *mutually reinforcing* mechanisms that help make information more transparent and improve the overall quality of the analysis that is available. The public nature of the IMF and the absence of the profit motive help to make the IMF into an anchor with a time perspective that helps lessen (although it cannot abolish) the tendency to overreaction and overshooting that so often characterizes private financial markets. A final point here is that it would be very desirable and would increase the legitimacy and effectiveness of the process, if the rich and powerful countries themselves showed stronger interest in and support of the process of consultations with the IMF. The contribution that IMF surveillance and monitoring can make to the quality of information and to global stability is a public good from which every country can benefit in the long-term, even if it sometimes comes with short-term costs. IMF monitoring can also be a form of embedding the global market, provided the governance of the IMF is itself perceived as legitimate and as contributing to greater global democracy. On this, there are, of course, big question marks.

The second ongoing activity of the IMF takes the form of rescue operations or "work-outs" for countries that are facing payments difficulties. For a long time in the past, the word "payments" would officially have had to be preceded by the word "foreign". Over the last decade, however, with a general movement to flexible or floating exchange rate regimes, public debt sustainability and foreign payments problems have become inextricably linked and a "crisis" calling for IMF help is almost always simultaneously a public debt and foreign payments crisis.[7] Causality works in both directions: fears of a public sector "debt event" lead to pressure on foreign payments due to capital outflows and increasing risk premia; sudden large depreciations lead to losses in the banking and corporate sector that may have to be socialized as well as increases in foreign exchange denominated

[7] The form taken by recent crises in Asia, Russia, Latin America and Turkey always involved massive pressures on the exchange rate and loss of foreign reserves and public debt worries. It is true that public debt levels in Asia were much more manageable than elsewhere but huge and persistent devaluations always threaten the entire financial and corporate sectors of an economy and sooner or later generate pressure on the public sector balance as governments have to socialize at least parts of these losses.

public debt payments that can trigger "debt-event" fears. The second major role of the IMF is to help countries overcome such a crisis. The frequency and severity of crisis increased significantly in the period from the early 1990s to the early 2000s. One of the severest among these crises was the crisis that hit Turkey in the winter of 2001 leading to a halving of the value of the national currency in a few weeks and a close to 8% contraction of GDP during the crisis year.[8]

I cannot here review the whole debate on the role of the IMF in crisis type situations. It involves the arguments about "moral hazard" (availability of rescue finance leads to imprudent behavior by both creditors and debtors), about conditionality (what kind and how intrusive) and the amount of resources that should be deployed (too much resources increases system-wide moral hazard, too little is useless). These arguments are linked and the debate should be conducted linking the moral hazard, conditionality and size of financing dimensions. I want to make some key points drawing lessons from the Turkish crisis which are, I am convinced, of relevance for most crisis situations in which the Bretton-Woods institutions are called to the rescue.

1. One cannot dismiss the moral hazard argument. The availability of rescue finance does encourage risky behavior on the part of both private lenders and policy makers. It is not clear, however, to what extent this moral hazard is directly linked to the existence of the IMF. A severe crisis in an important country imposes political and economic costs on the world community as a whole and it is not unreasonable to think that if there were no IMF some other form of rescue operation would materialize. The IMF provides a more predictable and less politicized mechanism for work-outs that otherwise might occur with G-7 or bilateral type money.

2. A crisis imposes tremendous costs on a country and on the political establishment that is perceived as responsible even when there is a successful work-out. In Turkey real incomes fell by more than 10% in 2001 and none of the political parties that were in power at the time of the beginning of the crisis were able to get into the new parliament elected in 2002. Their combined share of the vote came down from about 53% to about 15%. Given such a huge political cost one should not exaggerate the importance of moral hazard on the behavior of policy makers. The danger may be more serious with regard to creditors.

[8] The author left his position of Vice-President of the World Bank to take over as Minister of Economic Affairs in Turkey on March 13, 2001, three weeks after the February 22 collapse of the currency, and remained in office a year and a half, until mid-August 2002.

3. The IMF (with some support from the World Bank) did provide decisive financial support with net use of IMF resources amounting to close to 10% of crisis year GDP over 2001–2002, and outstanding Fund credit reaching 1685% of quota at the end of 2002. The macroeconomic framework that Turkey agreed on with the IMF in two stages (May 2001 and February 2002) was realistic and contained a margin of safety. It was not "underfinanced".[9]

4. Part of the financing came from a huge domestic fiscal adjustment with a primary surplus of 5.5% of GDP and the promise of continued strong fiscal policy thereafter. The fiscal target of 5.5% was met during the crisis year.

5. The macroeconomic efforts were combined with deep and wide-ranging structural reforms attempting to transform the basic institutional and legal infrastructure of the economy. We did not pursue a macro-equilibrium first structural reform later strategy, but took advantage of the national self-preservation reflex generated by the crisis to start the transformation of the whole socio-economic system of the country towards one that could lead to better economic performance and transparency.

6. Conditionality was comprehensive and reflected the will of the Turkish economic team to seize the opportunity for structural reforms. Conditionality *helped* in speeding up the reforms and encouraged greater coordination within the Turkish government. It *hurt* by giving the program a foreign flavor diminishing the degree of political support, despite the fact that it was driven more by domestic reformers than by IMF advice.

7. Together, very strong fiscal policy with quarterly targets actually met, decisive IMF financial support and ambitious structural reforms, achieved the critical result of restoring confidence and overcoming default fears after just nine months of program implementation. The turnaround in expectations occurred in November 2001 and growth resumed in the Spring of 2002, producing a strong rebound (GDP growth of 7.8% for 2002) which has continued into 2004.

I believe general lessons can be drawn from the Turkish experience with validity for the role of the IMF in emerging market crisis. There is little doubt that without rapid support from the IMF, Turkey would have had to restructure

[9] Note that in Turkey's case the financing came exclusively from the IMF and the World Bank. There was no parallel G-7 financing or pledges as was the case in several other countries. The amounts should be evaluated keeping that in mind.

domestic and foreign debt involving at least a partial default. While we cannot conduct a counterfactual experiment, there is little doubt in my mind that the income losses due to the much greater disruption this would have caused, would have exceeded what was experienced in 2001 by a large amount. The additional disruption would have hurt the poor disproportionately by creating even more unemployment. The crisis did lead to radical political change, but the change proceeded democratically and peacefully. Forcible restructuring and default to domestic creditors with inevitable restructuring of bank deposits, could have led to social conflict and a total breakdown of the political system. For these reasons, the intervention of the IMF in support of a strong domestic adjustment program helped prevent much greater damage.[10] It was essential that the amount of financing was consistent not with wishful thinking, but with cautious macroeconomic projections. Had it been, say, only two thirds of what it was, I have little doubt that the program would have failed. Comprehensive program conditionality and benchmarks were important in projecting decisiveness and commitment to financial markets and useful, given the IMF's financial leverage, in accelerating structural reform. What was a negative factor was the continued perception of the IMF as a G-7 or even G-1 dominated institution, a perception which caused the reform process to face very difficult moments, and which always increases the danger of policy reversals. Reforms in the governance of the IFIs that would increase their legitimacy among the broad public would greatly contribute to the effectiveness of IFI supported programs. This perceived lack of legitimacy is an obstacle to better "imbedding" of the type referred to above.

A final point is in order about the IMF in a work-out mode. Turkey's situation was such that it turned out to be possible to overcome the crisis without default and I believe this was the preferable solution. It may not be always possible, however, to avoid debt restructuring. The immediate growth potential may be too weak and/or the fiscal-political capacity may not be sufficient in relation to the size of the accumulated debt burden. In such cases, the availability of an agreed sovereign debt restructuring mechanism (SDRM) along the lines proposed by Anne Krueger and others[11]would help reduce the costs of an otherwise chaotic crisis. An SDRM should be considered as an additional tool, complementing stand-bys and work-out finance in the tool-kit available to the international community and to countries in crisis. The generalization of collective action clauses in sovereign debt instruments can take us towards the same objective if it is rapid and comprehensive enough.

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[10] Note that I am here referring to the 2001 and 2002 programs. The earlier 2000 program had failed and it did not have many of the characteristics of the later program. Structural reforms were weak and gradual, the financing had been modest and the fiscal effort had been insufficient.

[11] See Krueger, Anne O. (2002). A New Approach to Sovereign Debt Restructuring. Washington, DC: International Monetary Fund. http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf

3. Beyond Surveillance and Crisis Work-Outs: A Third Function for the IMF

It is fair to say that, for middle income countries at least, the IMF's role is restricted to either, monitoring and surveillance, or to fighting an acute crisis or the threat of an acute crisis. Many emerging market countries fortunately, are not in an acute crisis or pre-crisis situation. This does not mean, however, that they do not face very difficult economic and social problems. As the fall 2003 issue of the World Economic Outlook explains in some detail[12], there is a whole group of middle income countries that have accumulated a level of public debt that appears difficult to sustain. Until the 1970s most developing country debt was foreign debt to official institutions or to commercial banks. With the development of capital markets, governments started issuing bonds in international capital markets as well as at home. Total public debt levels in the group of emerging market countries focused on in the World Economic Outlook (WEO) rose from about 30% of GDP at the end of the 1960s to about 60% at the end of the 1980s and to about 70% at the end of the 1990s.[13]The authors of the WEO define a benchmark level of public debt as a debt level that would equate the present value of expected future primary surpluses to the benchmark level of debt. The WEO than finds that the median value of such a "warranted" debt ratio would be only 25% compared to the 70% actual ratio in the group of countries under consideration. Even if one finds this methodology a bit too constraining, the fact is that there is a whole group of countries which have accumulated an uncomfortable level of public debt over the last two or three decades. These high levels of debt combine with the volatility and herd behavior characterizing international financial markets to make these countries "structurally vulnerable". These countries with debt ratios well over 50% and where the debt has relatively short maturities, also have a history of crisis or near crisis situations the memory of which contributes to maintaining very high real interest rates. This combination of factors leads to a situation of perpetual vulnerability with the underlying fear that an external or internal shock could lead to a "debt event". A confidence crisis could also be triggered by contagion from a debt event in a different country.

To forestall crisis this type of emerging market economy has to run a fiscal policy with large primary surpluses and continuously pay a high risk premium on outstanding and new debt. Emerging market countries with a history of crisis and with public debt to GDP ratios in the 50% to 80% range need primary surpluses in the 3% to 7% range and pay real interest rates on domestic currency denominated

[12] See IMF. 2003. World Economic Outlook. September 2003.
[13] The group contains the countries that are in the Emerging Market Bond Index (EMBI) in early 2002 and a few others.

debt in the 10% to 20% range.[14] Both the large primary surpluses and the high real interest rates exert downward pressure on the growth of GDP, which, in turn, makes it more difficult to reduce the debt to GDP ratio. In this group of countries, fiscal policy tends to be pro-cyclical rather than anti-cyclical as it is in the mature industrial countries. When there is a recession in an economy that does not have to worry about a "debt event", fiscal policy can be expansionary and attempt to stimulate domestic demand. In industrial countries government expenditures increase by more than national income in a downturn – as should be the case to counteract cyclical recession and they increase by less than national income in an upturn. The same does not take place in our "typical" emerging market economy, because the income decline in a downturn tends to worsen the debt to GDP ratio creating "debt event" fears that tend to lead to a tightening rather than a temporary relaxation of fiscal policy. On the contrary, in an upturn, debt fears diminish and governments tend to want to "catch up" on their postponed expenditures. This makes fiscal policy pro-cyclical rather than anti-cyclical. While this is unfortunate it is really not possible to avoid it in countries where public debt to GDP ratios are high, because relaxing fiscal policy at a time of crisis is likely to lead to panic and deepen the crisis. When a crisis occurs, default accompanied by capital controls seems to be the only other option for such high debt countries with costs that usually would outweigh the costs of pro-cyclical fiscal policies!

This chronic fear of crisis not only reduces growth, but also has a very negative influence on income distribution and poverty reduction. High real interest rates redistribute income to the holders of liquid wealth. Social programs are difficult to fund and taxation is more regressive than it otherwise would be for fear of scaring capital and causing outflows.

While average income in the countries that share the features described above is higher than income in the least developed countries, there are large numbers of very poor people living in these countries. The success of the worldwide fight against poverty depends also on rapid poverty reduction in these high debt middle income economies.

The Bretton-Woods institutions find it difficult to help these countries. The World Bank is active and does provide long-term loans and advice dealing with many of the key structural problems. World Bank resources are very limited, however, and cannot by themselves alter the chronic vulnerability deriving from high indebtedness. The IMF, on the other hand, has had great difficulty in defining its role. The countries are not in an acute crisis and the short-term "work-out" mode is not appropriate for them. Surveillance and monitoring alone cannot achieve very much.

[14] Statistics are available in IMF staff reports for a good number of emerging market countries.

The IMF facilities that have been under discussion in the context of these not-in-crisis-but-vulnerable countries have been precautionary arrangements and the Contingent Credit Line (CCL). The latter launched with great hopes a few years ago was discontinued for lack of demand in November 2003. Work on a possible successor is continuing. Precautionary arrangements have and are being used but more in the context of exit from stand-by-programs than as an approach in itself. The reason for the failure of the CCL was that it ended up neither a "lender of last resort facility" that could quickly be drawn on at time of crisis, nor a "protection facility" that would ensure a country against the risk of crisis. Countries, which viewed themselves at low risk of crisis, did not find it desirable to go through the required prequalification process. Moreover, for these countries the CCL did not offer financial terms that were significantly more favorable that what they could obtain from financial markets. Countries at higher risk had, or would have had, trouble meeting the prequalification criteria. Some countries also feared the possibility that the potential loss of "qualifying status" due to a disagreement with the IMF on policy, or a temporary slippage in policy implementation, would send a very negative message to markets that would make things much worse. On the other hand, making access to such a facility almost automatic for a large number of countries could lead to irresponsible macro-policies as politicians would have a virtual bailout guarantee and would cause serious moral hazard problems. Keeping countries qualified to access the facility even if policies deteriorate would lead to the same kinds of problems and would make the IMF co-responsible for the development of a crisis. On the other hand, withdrawing qualification could trigger the crisis itself. These "entry" and "exit" problems could not be overcome and the CCL was discontinued with instructions to IMF staff to come up with a "reformed" proposal that could work.

The underlying problem that must be resolved is that short of an up-front negotiated debt reduction for which there is no support at all in a no-crisis situation, the problem these countries face is structural and requires a *long-term* approach. It is not primarily a "contagion" issue as had been assumed in the context of the CCL, but a problem of excessive indebtedness of a whole group of countries in the context of international capital markets that are highly volatile and function in the form of "surges and droughts", increasing the vulnerability of these countries.[15] The World Bank alone, given its current resource base, cannot address the problem. The IMF has more resources but is not supposed to be an institution dealing with long-term structural problems.

To correct the problem we need a long-term work-out approach in the form of support for long-term growth and debt reduction programs which would have the

[15] The term is due to French-Davis, Ricardo, and Stephany Griffith-Jones. (2003). From Capital Surges to Drought: Seeking Stability for Emerging Economies. New York, NY: Palgrave Macmillan.

objective to gradually but surely reduce the debt indicators and thereby vulnerability and high real interest rates. The best way to develop such an approach would be for the World Bank and the IMF to work closely together. Significant long-term and relatively low cost resources would have to be made available so that countries borrowing these resources could use them to substitute more costly short-term debt and thereby achieve debt-reduction in a gradual fashion, which would not be disruptive. There would have to be substantial conditionality to avoid moral hazard problems and to ensure that overall policies are strongly supportive of rapid growth, the other key determinant of positive debt dynamics. In some ways such an approach would complement the Poverty Reduction Strategy Papers/Poverty Reduction and Growth Facility (PRSP/PRGF) approach that has been developed for the poorer countries with appropriate difference reflecting the circumstances of the highly indebted middle-income countries. The details in terms of funding, cost, coverage and specifics about IMF-World Bank cooperation would have to be worked out. What is critical is to recognize that the issue is not just the danger of contagion but the fact that the accumulated burdens of the past and the nature of financial markets have left a number of countries with a structural, chronic problem.

This problem creates systemic risk for the international economy and its resolution is therefore a global public good deserving the allocation of some common resources. The persistence of chronic vulnerability is also a key obstacle for global poverty reduction and therefore satisfies the second criterion for public policy: a solution would also lead to a more desirable distribution of income.

4. Conclusion

Sixty years after their conception the need for active and successful Bretton-Woods institutions has not diminished. With globalization, it has, if anything, increased. Their activities must "embed" the global market by helping to correct market failures (the public good providing function of public policy) and by helping to make the results of market allocations more equitable (the redistribution and poverty reduction function of public policy). It would be desirable to think about the future of these institutions explicitly in these terms and be ready to adapt their operations accordingly. We should free ourselves from the unjustified ideological pressure that developed in the 1980s and that tried to argue that the working of near "perfect" global markets made these institutions redundant. They should try to provide global public goods and aim at a better income distribution in a cost effective way and with approaches appropriate to the problems, as they exist or arise. If this requires radical change, so be it. It may be, for example, that much greater integration between the IMF and the World Bank is the appropriate response to the need for a longer term perspective combined with greater resources to reduce chronic vulnerability. The changes should include changes in the functioning of governance, which reflect the need for greater global democracy, participation and legitimacy. Regulation and redistribution can only be successful if the institutions that implement these policies are perceived as both efficient and legitimate. The international community owns these institutions. It is therefore up to all of us to help them face the new challenges of a new century.