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

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Editorial

The papers in this volume were presented at a conference co-hosted by the Oesterreichische Nationalbank (OeNB) and the New York-based Reinventing Bretton Woods Committee. The conference took place in Vienna, from June 20 to 22, 2004, to commemorate the 60th anniversary of the Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank and to look ahead into the governance of the international financial system.

At the conference, speakers delineated the evolution of the international financial system, outlined future challenges and formulated possible solutions to crisis situations. Core issues included the governance of the international financial system, the development and future role of exchange rate regimes and the crisis prevention and resolution toolkit.

In his introductory remarks, *Klaus Liebscher*, governor of the OeNB, stressed the fundamental role the Bretton Woods institutions, i.e. the IMF and the World Bank, play in maintaining the stability of the international financial system and in ensuring welfare and the stability of the global economy. As platforms for international cooperation, the Bretton Woods institutions fulfill an important function especially for smaller countries like Austria, which may use these forums to actively participate in international rule-making and crisis prevention and resolution processes.

As *Marc Uzan*, executive director of the Reinventing Bretton Woods Committee, pointed out, the international financial system has changed considerably since 1944 in the fields of exchange rate regimes and the number of actors in the system. Particularly since the financial crises of the 1990s, the debate over how to improve the international financial architecture and how to strengthen the international financial system has intensified. According to Mr. Uzan, integrating the emerging markets into the global economy poses much greater policy challenges than previously anticipated.

Panel 1: The Governance of the International Financial System

The keynote speaker of this panel, *Jeffrey Shafer* (Citigroup), discussed the far-reaching changes the Bretton Woods system has experienced over the last 60 years: fixed exchange rates have been replaced by floating exchange rates, capital controls have been removed to allow free cross-border capital flows and, last but not least, the euro has been introduced. Although requirements for the governance of the international financial system may have changed, the IMF and the World Bank still constitute its core institutions. According to Mr. Shafer, major challenges comprise adjusting current account imbalances, improving financial sector surveillance. For the World Bank he advocated providing grants rather than loans. In addition to that, ways of dealing with countries whose debt levels have become unsustainable must be found. Concerning IMF governance, Mr. Shafer noted that the Executive Board of the IMF is no longer representative of the present geopolitical realities, with the EU, in particular, being overrepresented and Asia being underrepresented.

Kurt Bayer (Austria), executive director of the World Bank, gave an overview of the tasks of the World Bank, whose original mission was to reduce poverty and promote development. In Mr. Bayer's opinion, the World Bank, together with regional development banks and their specialized institutions, still has the potential to contribute immensely to fulfilling this mission. Recently, strengthening the financial systems in developing and emerging economies has become even more important, particularly when bearing in mind that the damage caused by financial crises in these countries during the last few decades equals the amount of official development assistance they received.

Kemal Derviş, former Turkish minister of economic affairs, discussed the two fundamentalisms that characterized the 20th century – central planning and market fundamentalism – pointing to the fact that central planning has been discredited because of the collapse of communism. According to Mr. Derviş, the market, when left on its own, is not able to distribute all resources efficiently, but depends on government support in fulfilling this task. State and market are thus complementary actors. Markets must be embedded in adequate framework conditions. Currently, this embedding exists at the national level, but not at the international level. In Mr. Derviş' opinion the IMF has a key responsibility to correct market failures at the international level and to provide public goods like financial stability. Its two main functions are crisis resolution and the economic surveillance of member states.

Harold James, professor at Princeton University, pointed to the success of the Bretton Woods system, which had originally been based on three pillars: the IMF, the World Bank and an international trade organization, which was effectively established only in 1995, when the World Trade Organization (WTO) was founded. Mr. James explained that there has been an opposite development in the monetary domain and in trade. While the monetary order is moving away from strict rules, i.e. from a fixed exchange rate regime to a system of floating rates, trade is experiencing a shift towards more rules and regulations, as established by the WTO. Historically, exchange rate adjustments served to solve trade problems, as was the case in the U.S.A. in 1971 and 1985. Applying this kind of solution will become increasingly difficult, as half the world, i.e. the U.S.A. and Asia, have entered into an informal Bretton Woods system, in which currencies are pegged to the U.S. dollar.

Panel II: Exchange Rate Regimes

Michael Bordo, professor at Rutgers University, offered a historical account of the evolution of exchange rate regimes. Mr. Bordo emphasized the credibility of economic policy as a key factor when countries choose an exchange rate regime. While countries traditionally pegged their exchange rates to other currencies and used them as nominal anchors, the new consensus increasingly tends toward domestic monetary anchors, mostly through inflation targeting. Emerging economies with fixed exchange rates are prone to encounter difficulties. The historical performance shows that pegs work well for developing countries but not for advanced economies. The more advanced an economy is, the sooner it can switch to floating exchange rates.

Based on the European experience, *Josef Christl*, executive director of the OeNB, analyzed whether currency unions might be an option for other regions, such as Latin America or Asia. Concerning the costs and benefits of the European Economic and Monetary Union, he stated that the success and sustainability of a monetary union depend not only on a strong political will and on enforceable fiscal rules. Asia and Latin America may have taken the first steps of a Balassa sequencing by establishing free trade areas and customs unions; however, Mr. Christl said that he was not yet convinced that these regions could currently benefit from a monetary union given their varying degrees of economic development and lack of political will. He considers the adoption of inflation targeting a feasible monetary policy option for achieving macroeconomic stability and economic convergence. In concluding, Mr. Christl said that the EU experience with economic and monetary integration cannot serve as a blueprint for other regions.

Masahiro Kawai, professor at the University of Tokyo, gave a presentation on how East Asia could contribute to a stable currency system. According to Mr. Kawai, the Asian crisis has shown that regional financial architectures are needed to complement the international financial architecture. In Asia, the regional architecture currently essentially involves the Chiang Mai Initiative, the ASEAN+3 dialogue and the Asian Bond Market Initiative. Deepening regional integration and macroeconomic interdependence throughout Asia require financial stability at the regional level. It is this regional financial stability that Asia needs to be able to play a role in international economic relations commensurate with its economic power. However, the fear of losing national sovereignty, the heterogeneity of the Asian economies and the peg to the U.S. dollar render closer cooperation difficult.

Panel III: Crisis Prevention and Resolution

Pedro Malan, former finance minister of Brazil, emphasized how sharply circumstances have changed since the creation of the Bretton Woods system. In Mr. Malan's opinion there is a broad consensus that sustainable macroeconomic policies and stable – rather than fragile – financial systems are needed, while institutional weaknesses have to be eliminated. Addressing economic problems in individual countries is a key priority, but a number of international issues have to be solved as well. One such issue is the asymmetric distribution of information between borrowers and lenders. A surge in debt after the first oil price shock and a rise in interest rates originating in the U.S.A. had triggered the debt crisis of the 1980s, which was not overcome until the Brady Plan was introduced in 1989. In Mr. Malan's opinion, the Sovereign Debt Restructuring Mechanism (SDRM) the IMF proposed is not an adequate means for resolving crises in emerging economies, in particular in his home country Brazil. Instead, he advocated a wider use of Collective Action Clauses (CACs) and stated that close cooperation between the public and private sectors and international institutions is essential.

Gertrude Tumpel-Gugerell, member of the Executive Board of the European Central Bank, analyzed the international crisis prevention toolkit. She particularly underlined the aspect of transparency, pointing out that greater transparency should make it easier for market participants to assess risks. Ms. Tumpel-Gugerell stressed the IMF's increased efforts to promote the provision of data through the Special Data Dissemination Standard. She also emphasized that the Bretton Woods institutions have stepped up their efforts to achieve financial stability, e.g. by establishing an International Capital Markets Department and by drawing up the Financial Sector Assessment Programs (FSAPs). In addition, the IMF's balance sheet approach ensures that countries' balance sheets are monitored more closely in order to detect mismatches that may affect their debt-servicing abilities. Ms. Tumpel-Gugerell continued by saying that views were still evolving on the appropriate balance between transparency and confidentiality. In her opinion, the question whether all the efforts mentioned have actually improved crisis resilience remains an open issue.

Anne O. Krueger, first deputy managing director of the IMF, said that the IMF's mission – to provide a stable international financial system as a sound basis for promoting trade expansion and economic growth – has remained valid since its foundation in 1944, but that the methods used to achieve this mission have changed. Demands on the IMF have also altered, particularly since the capital account crises of the 1990s. Among other issues, Ms. Krueger focused on the pronounced changes in the IMF's surveillance function and on its crisis resolution toolkit. She quoted the enhanced transparency in the dialogue between the IMF, its members and the broader public, the movement away from fixed exchange rates and an expanded definition of macroeconomic stability among the major changes in the Fund's surveillance work. Ms. Krueger underlined the importance of CACs in crisis resolution, even though, in her opinion, it is still much too soon to evaluate to what extent CACs can improve the orderly resolution of sovereign debt crises. By way of conclusion, she said that the IMF, just like the world economy, is constantly evolving and that the Fund should, where possible, try to remain at the cutting edge of global economic developments.

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