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Reinventing Bretton Woods?

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Is the notion of Reinventing Bretton Woods conceivable? This simple question brings a multitude of thoughts about the bold objectives of the 45 nations whose representatives gathered at Bretton Woods, New Hampshire in the summer of 1944 to establish a new economic order; about the extent to which these ambitions have been fulfilled; about the many new challenges that have arisen in the world economy since Bretton Woods; and where, in view of these challenges, the international financial system is leading us. It is certainly true that the international monetary system has changed considerably since Bretton Woods – and in ways that were largely unforeseen in 1944. Instead of a system of fixed exchange rates among major currencies, we now have a floating rate system. Where capital controls were once pervasive, we now have global financial markets. From the relatively small group of 35 countries that became the founding members of the International Monetary Fund (IMF), Fund membership has expanded to include virtually every economy in the world. Indeed, all the complexities and uncertainties that the existing international monetary system presents, Bretton Woods seems to evoke a more orderly and cohesive world, raising the question of whether the international community should not strive toward a *new* Bretton Woods.

In order to answer this question, however, one must first consider more fully what Bretton Woods and the IMF, the institution established to oversee the new monetary order, were intended to achieve. Bretton Woods has become almost synonymous with the fixed exchange rate system that prevailed from the time of the IMF's establishment until the abandonment of fixed rates in 1973. However, the visionaries at the Bretton Woods conference had broader objectives in mind. As stated in the IMF's Articles of Agreement[1], they were striving toward a system that would "promote international monetary cooperation," "facilitate the expansion and balanced growth of international trade," and "contribute thereby to the promotion and maintenance of high levels of employment and real income...." They also aimed to "promote exchange stability...maintain orderly exchange arrangements

[1] Adopted at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 22, 1944.

among members and...avoid competitive exchange depreciation." At the same time, they wanted to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." As these goals suggest, the purpose of *Bretton Woods* was above all to establish a more stable and prosperous world economy, and the role of the IMF, to help promote the preconditions for this. The IMF carries out this role by exercising *firm surveillance*.

In considering whether a *new* Bretton Woods is conceivable – or indeed desirable – I would like to evaluate more specifically in my presentation what we learned from the 1990s with the international financial architecture debate.

The last decade has seen a string of crises in emerging markets: Mexico in 1995, Asia in 1997 and 1998, Russia in 1998, Brazil in 1998 and 2002, Argentina in 2001-02, and Turkey in 1999 and 2000-01. The turbulence and its contagion, in financial markets have prompted a wide range of efforts in the 1990s to improve the international financial system, including statements of the G-7 industrial nations. As policymakers, market participants, and academics around the world debated the next steps to address weaknesses in the system, they face a number of critical questions.

The world financial crisis demonstrates that the integration of emerging economies into the global financial system poses much larger policy challenges than had previously been anticipated. The early 1990s will be remembered in the degree of euphoria that had emerged about the benefits of financial liberalization, private capital flows and emerging markets. Now, that the risks and the costs have become more evident, a stronger foundation that would support these benefits with less risk may yet emerge.

Fears that capitalism had run amok and globalization would lead to poverty for most of the world galvanized Western leaders into promising swift reforms of the so-called *international financial architecture*. The Mexican crisis led to the first global debate about the market-led international financial system in which governments are at the mercy of huge flows of private capital that spill across borders, playing havoc with currencies.

The debate took another dimension with the Asian crises, which engulfed Thailand, Indonesia and Korea and then spilled over into Russia, New York financial markets and Brazil – initially centered on who was to blame and what went wrong. Fingers were pointed at unscrupulous speculators, irresponsible bankers and cronyism.

But a plethora of proposals to scrap the existing framework and replace it with a *new* international financial architecture was sidelined by promises of *reform* of the international financial architecture.

The idea was to strengthen rather than tear down and rebuild the skeleton holding together the international financial system, which has no true global authority to enforce rules on sovereign governments. The phrase "reform of the international financial architecture" has been bandied about for years now, topping the agendas of international summits and countless meetings by institutions and policy-making bodies. Two years of debate to explore the possibility of a sovereign debt restructuring mechanism, the international community has decided at this stage to pursue a more market-driven approach through the use of collective action clauses in bond documentation and possibly a code of good conduct clarifying the principles and responsibilities of issuers and creditors in the context of a debt restructuring. Nevertheless, the debate is not over, and the Argentina restructuring is likely to have significant ramifications.

From 1994 to 2004:

In September 1994, when the international financial community met in Madrid to celebrate the 50th anniversary of the Bretton Woods institutions, few observers will have predicted that the period will be followed by a series of financial crises and that the notion of capital flows, moral hazard, bail outs, collective action clauses, debt sustainability, standards and codes, will be the key words of the 1990s.

Today, when we are today celebrating the 60th anniversary of the Bretton Woods conference, I would like to outline some key trends that will affect the role of the IMF.

1. Exchange Rate System

The Asian and Argentine crises as well as the Dubai G-7 communiqué have strengthened a movement within the international financial community to emphasize flexibility in exchange rate systems. Yet, many important countries continue to effectively peg their rates. What is an appropriate path toward flexibility for emerging market economies? How can the system as a whole improve its contribution to the adjustment of major, sustained balance of payment imbalances? Now that the euro has become more established and Japan's economy may finally be returning to health, are we likely to see countries diversify their reserves away from dollar assets? What would be the implications of a world of multiple reserve currencies?

Today, there is little doubt that China's exchange rate policy has emerged as a major global topic. China is perceived as a threat because it has been enjoying export growth of 35% during recent months. As a result of booming foreign direct investment and the return of flight capital, China also has foreign exchange reserves of USD 355 billion or the second highest in the world after Japan. The U.S.A. is now able to finance its large fiscal deficits and current account deficits because of currency intervention by Asian central banks, especially Japan and China. The central banks of China and Hong Kong have purchased nearly USD 100 billion of U.S. government securities during the past eighteen months. The

East Asian central banks now have 70% of the world's foreign exchange reserves compared to only 30% in 1990 and 21% in 1970. They keep their USD 1.7 trillion of reserves 80-90% invested in U.S. government securities.

On the eve of the 60th anniversary of the creation of the Bretton Woods system, some observers have argued that we may be re-entering *the old paradigm*. Professor Michael Dooley and his colleagues argue in a recent paper that the system was never actually destroyed just put into hibernation. Just as Europe and Japan benefited from fixed exchange rates in the 1950s and 1960s, the reasoning goes, so Asia is now profiting from the same. The success of China and India in exporting goods and services respectively is certainly built in part on undervalued currencies. Some Asian currencies are fixed, some have a managed float, but all of them are accumulating vast amounts of official reserves in U.S. dollars. The insight of Dooley's team is that this is an explicit contract, like Bretton Woods, not the operation of a free market. China has the potential to be a source of strength as well as vulnerability in reinforcing the precarious stability that has now returned to the international financial system, and in forwarding the recently interrupted move toward a genuinely global system of open finance. How it manages its multiple transformations will be of enormous importance for the international monetary system.

2. The Future Role of the International Monetary Fund

Many of the discussions on a new international financial architecture that were spawned by the Mexican crisis and continued through the Argentinean crisis raised questions about the future role of the IMF. Four major areas merit attention: 1) the scope of Fund activities, 2) surveillance, 3) lending, and 4) governance. The IMF is still needed to help countries resolve payments problems in an internationally responsible way, to address liquidity crises, and to act as a crisis manager or convenor. Does this mean that crisis prevention should be at the core of the IMF's work? Should it deepen its efforts to collect and disseminate information to investors and markets, further covering indicators of financial vulnerability as well as macroeconomic fundamentals? To what extent should its resources be expanded to enable it to provide liquidity, and under what circumstances should the Fund provide backstop financing for countries?

According to observers, the large financing packages of recent years have increased the fund's financial risks.

Credit outstanding the largest three borrowers have reached an unprecedented share of total fund credit. This increased concentration in Fund exposure has been associated with a prolonged use of Fund resources by middle income countries with access to international capital markets. The current level of concentration has some precedent. But the importance difference is that previous episodes of high concentration reflected current account deficits of few large members which were offset by the current account surpluses of other members. What do these trends mean for the IMF and for the shareholders? And in relation, what is the likely future evolution of the demand for Fund resources? For example, the financial support provided by the IMF program with Mexico amounted to 18 billion U.S. dollars. This sum represented 6.3% of Mexico's GDP. If China achieves levels of per capita income similar to Mexico and becomes vulnerable to capital account crises, the potential for demand for fund resources relative to future GDP could become very large That suggests that the cost of mitigating an emerging market style crisis in a country like China or India could well be of an order of magnitude that would dwarf present day level of fund resources. But other economic developments may temper this tendency as developing countries have increased their international reserves for self insurance and we are seeing a shift towards more flexible exchange rate regime that might temper the need of future demand for Fund resources.

Indeed, the environment in which the Fund operates has changed but the instruments at the Funds disposal have not. Can the IMF perform within its current governance structure or does it require a change in the governance reform? Does the Fund have the internal governance and risk control mechanism to deal with capital account crises?(If the preferred credit status should be reexamined in this new evolution, if we deal with fiscal policies difficulties and not balance of payment problems.)

How can disparities in economic weight and financial contributions be reconciled with the need for more inclusive decision-making in international institutions and arrangements (for example, in IMF voting)? Should the G-7 be expanded, perhaps through the inclusion of China? More broadly, how can emerging economies be best represented in the international financial architecture, recognizing that improving their development prospects is a principal aim of global financial governance? Will the G-20 serve as a basis, perhaps in combination with regional forms of governance? With the advent of the euro, should we now consider one EU single seat at the IMF?

These reflections bring me back to the question of *Reinventing Bretton Woods*. Despite the considerable changes that have occurred in the international economy since the Bretton Woods conference, I believe that the Bretton Woods goals are as valid today as they were half a century ago. In this respect, to the extent that a *new* Bretton Woods is needed, it would be necessary to re-establish the strong sense of purpose and determination that motivated the founders of the Bretton Woods system, based on a machinery of international cooperation.

If we decide to meet again in ten years, we will be facing an international financial architecture very different from the one that we have today.