"60 Years of Bretton Woods"
A Summary of the Bretton Woods Conference

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From June 20 to 22, 2004, the Oesterreichische Nationalbank (OeNB) and the New York-based Reinventing Bretton Woods Committee co-hosted an international conference in Vienna to commemorate the 60th anniversary of the Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank.

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 a 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 resolution processes. With a view to the criticism the IMF, in particular, had to face after the Asian crisis, Mr. Liebscher stated that, whenever justified, criticism had brought about a change in the way the international financial institutions work, as had been the case with capital account liberalization. According to Mr. Liebscher, this example shows that the Bretton Woods institutions do react to constructive suggestions for improvement.

Furthermore, he underlined a number of important functions the IMF and the World Bank fulfill:

– Monitoring member states' economic developments helps increase and maintain their living standard and prevents international financial crises.
– Therefore, economic standards and codes have been established to facilitate member states' integration into the global economy.
– Moreover, *Financial Sector Assessment Programs* (FSAPs) have been implemented to help analyze strengths and vulnerabilities of national financial systems. (Austria has recently conducted such a program with excellent results.)

These and similar measures serve to strengthen member states' economies, enhance their resilience to crises and thus curb the need for international financial assistance in crisis situations.

In case a financial crisis does occur, the private sector is also called upon to assume responsibility for its investment decisions. According to Mr. Liebscher, one important future challenge will be the establishment of a regulatory framework that is to facilitate the resolution of sovereign debt crises.

Mr. Liebscher pointed out that another major task of the Bretton Woods institutions, and of the World Bank in particular, is poverty reduction. Although not a "development" institution in spirit and by design, the IMF, too, plays a significant role in the efforts the international community undertakes to eradicate poverty.

As an impressive example of the strong track record of the Bretton Woods institutions, Mr. Liebscher mentioned their contribution to the successful transition process of former socialist economies, above all in Central and Eastern Europe. Austria has played an important part in this respect as well, and it continues to support the Bretton Woods institutions through technical cooperation projects and as a sponsor of the *Joint Vienna Institute*.

According to Mr. Liebscher, the ongoing discussion about reforming the international financial institutions should be viewed as positive. However, in his opinion such a reform should not result in an expansion of the institutions' functions but rather in a return to their core responsibilities.

As *Marc Uzan*, executive director of the New York-based Reinventing Bretton Woods Committee, pointed out, the international financial system has changed considerably since 1944. Instead of a system of fixed exchange rates among major currencies, there is now a floating rate system, and global financial markets have replaced once pervasive capital controls. From a relatively small group of 35 countries, IMF membership has expanded to include virtually every country in the world. 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. One of the pivotal issues concerning the future development of the international financial system will be the exchange rate regime. Despite recent movements toward more flexible exchange rates, some important emerging economies, such as China, continue to peg their rates to other currencies. Another major issue, according to Mr. Uzan, will be the future role of the IMF. If countries are to deal successfully with future challenges, they will need to reestablish the strong sense of international cooperation originally laid out in the Bretton Woods agreements.

Panel I: The Governance of the International Financial System

Zeti Akthar Aziz, governor of Bank Negara Malaysia, the central bank of Malaysia, also emphasized the importance of international cooperation. Some immediate challenges, in her opinion, are unsustainable current account imbalances and unstable capital flows. She called for adjustments in the international financial system and recommended taking precautionary measures to prevent crises instead of waiting for the next crisis to take effect.

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. Sovereign states remain key players in the system, but given their increasing interdependence, they have to cooperate more closely. According to Mr. Shafer, major challenges comprise adjusting current account imbalances, improving financial sector surveillance and adapting the World Bank's role to match higher liquidity in financial markets. In this respect, 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. Although EU votes nearly outnumber U.S. votes by two to one, the EU has less influence within the IMF than the U.S.A. Furthermore, Mr. Shafer called for the establishment of a G-4 consisting of the U.S.A., the euro area, Japan and China.

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. The sometimes excessive levels of public debt in emerging countries are not sustainable in the long run, especially since capital markets are highly volatile. Mr. Derviş advocated providing IMF financial assistance also on a long-term basis, as World Bank resources alone are insufficient in this context. The problem with IMF conditionality is that its implementation may lead to political problems in the respective countries.

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 a converse 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. While the volatility of capital flows in emerging economies may create problems, one should not only bear in mind the costs, but also the benefits of free capital flows. History has shown that rapidly growing economies often tend to be instable. In many cases IMF conditionality is hardly acceptable from a political point of view. Quoting the situation in Austria in the 1920s as an example, Mr. James stated that the conditionality of the League of Nations had been too strict and had subsequently prompted other countries to refrain from accepting financial assistance by the League of Nations.

Among the topics of the ensuing discussion was the issue of moral hazard. Participants stated that, while moral hazard may play an important role in the political discussion, no empirical proof of its existence has been found so far. Exchange rate manipulation – i.e. creating export advantages by deliberately keeping exchange rates low – has so far only been an issue with Korea and Sweden, namely in the 1980s. It could, however, become a problem in China. With respect to the question of governance, some discussants advocated strengthening the IMF and World Bank boards of directors rather than letting informal groups take care of this issue, arguing that the number of "G-x"s was too large already. The main problem with financial crises is that, in general, they have a particularly severe impact on the poorest members of the population in developing and emerging countries.

Panel II: Exchange Rate Regimes

In his introductory statement on exchange rate regimes, *Guillermo Ortiz,* governor of the Banco de México, gave an account of Mexico's experience with exchange rate regimes since the mid-1990s. Mexico was the first emerging market economy to implement a flexible exchange rate regime, introducing floating rates in 1994 after a sharp drop in foreign reserves following interventions during the Mexican crisis. Mr. Ortiz drew a positive picture of Mexico's experience with floating exchange rates.

Michael Bordo, professor at Rutgers University, offered a historical account of the evolution of exchange rate regimes. At the beginning of the 20th century, there had been a clear tendency to join the gold standard, if possible. Now, at the beginning of the 21st century, the consensus is shifting toward floating exchange rates. However, in the period between World War I and World War II, some countries had negative experiences with flexible exchange rates because of speculations and beggar-thy-neighbor devaluations. Not until Milton Friedman argued for floating exchange rates did flexible rates become a real economic policy option again. Mr. Bordo emphasized the credibility of economic policy as a key factor; 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, in particular if they lack a lender of last resort and if their capital markets are not well developed, as external debt in foreign currency is likely to cause currency mismatches and thus creates financing problems. According to Bordo, in cases like these, devaluations often have no effect on the real economy. When speaking of exchange rate regimes, one has to distinguish between de jure and de facto regimes. The de jure regime applied by the IMF appears to hollow out intermediary regimes – which de facto exist in much larger numbers – in favor of either fixed or floating exchange rate systems. 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. In his remarks on optimum currency area criteria, Mr. Christl pointed out that for countries like Argentina these criteria remain important and that their endogeneity must not be presupposed. 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, but also on 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, pointing to countries like Mexico and Chile, which have attained relative stability by applying this strategy. 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 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. To Mr. Kawai, key prerequisites for promoting closer cooperation on the basis of the IMF framework are, among others, stronger regional economic surveillance and an enhanced exchange rate policy coordination based on a G-3 (U.S. dollar, euro and Japanese yen) "currency snake" similar to the European currency snake of the 1970s.

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.

He quoted Hobsbawm, according to whom more changes have occurred since the end of World War II than in any other period of world history. It is important to remember the lessons we can learn from history and to bear in mind the interplay between past, present and future. We must expect financial crises to occur in the future and be prepared to overcome them in the best possible way. Exchange rate regimes and fiscal rules have to be adapted to changing circumstances; naturally, there can be no ideal regime that is valid for all countries at all times. Mr. Malan particularly stressed the importance of growth strategies for developing and emerging economies and emphasized the role institutions play in this context, using the wordplay, "It's institutions, stupid!".

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. As a case in point, he described Brazil's experience with a debt rollover: Brazil had negotiated with the private sector, but the meetings had taken place at the respective central banks in the presence of an IMF representative. This cooperation had been key to the initiative's success.

Richard Portes, professor at the London Business School and President of the Centre for Economic Policy Research (CEPR), summarized the status quo in crisis resolution, pointing out that while bailouts are not the path to success, disorderly sovereign debt workouts are very costly. Solving the IMF's time inconsistency problem requires a clear regulatory framework on presumptive limits. The market itself cannot provide a clear institutional framework for the orderly resolution of government bankruptcies. The SDRM debate may not have produced an international framework for debt workouts; nevertheless, it has spurred the debate and the search for alternatives, which comprise applying CACs, reintroducing bondholders' committees by establishing a New York Club, and creating a mediation agency independent of the IMF to coordinate the Paris, London and New York Clubs. This agency could also carry out other functions, such as monitoring the compliance with a code of conduct. Mr. Portes also presented a new proposal, suggesting that the IMF could act as a lender of first resort and offer a facility similar to a contingent credit line, which a country might use to fulfill its international obligations in the event of a liquidity crisis.

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. She noted that although there has been some contagion, risk differentiation among individual emerging economies has increased.

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.