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The Importance of the Bretton Woods Institutions for Small Countries
Opening Address

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Ladies and Gentlemen,

It is with great pleasure that I may welcome you to the conference on "60 Years of Bretton Woods – Governance of the International Financial System – Looking Ahead" hosted by the Oesterreichische Nationalbank. I am equally delighted that we managed to attract so many distinguished speakers from around the globe, who are here in Vienna today to discuss various aspects of the governance of the international financial system with us. I would like to express my sincerest gratitude to all these speakers for their contributions in advance. I feel also honored that such a great number of you have accepted our invitation to participate in what promises to be an ideal opportunity to reflect upon the history and future of the Bretton Woods Institutions.

During our conference it is supposed that policymakers, investment bankers and academics will discuss the governance of the international financial system, debate about exchange rate issues and explore ways to improve the current crisis prevention and resolution framework. We believe that these three broad themes are central to the debate on the international financial architecture.

1. A Brief Review of 60 Years of Bretton Woods

The 1930s demonstrated that the pursuit of nationalistic beggar-thy-neighbor policies can have dramatic and devastating effects.

In order to prevent a repetition of this destructive experience, the Bretton Woods system consisting of the International Monetary Fund (IMF) and the World Bank was created in 1944 to govern the post World War II economic system. This regime was expected to perform three important functions:

- a regulatory function by administering the rules governing currency values and convertibility,
- a financial function via the supply of supplementary liquidity to members facing balance of payment pressures and
- a consultative function by providing a forum for cooperation among governments.

I consider the Bretton Woods system very innovative for four reasons: First, with this system international monetary cooperation was for the first time attempted on a permanent and institutional basis. Second, this system respects the principle of national sovereignty while committing members to collective responsibility. Third, it provides a mechanism for inter-governmental consultation. And fourth, even though the principle of national sovereignty is respected, voting rights are allocated in proportion to quotas rather than on a one-state, one-vote basis.

The first major systemic crisis – the breakdown of both the gold exchange standard and the par value system of the original Bretton Woods system in the early 1970s – was weathered surprisingly well. Unlike during the 1930s, monetary relations did not degenerate into total chaos. Instead, a significant degree of cooperation was preserved under the auspices of the IMF.

Later on the international financial system has been exposed to a string of crises since the early 1980s. But the IMF in particular was chastised for its role in the crises of the mid- and late 1990s. A common feature of these crises was that they grew out of weaknesses in domestic economic policy frameworks accentuated by international capital flows and often in combination with unsustainable fixed exchange rate pegs. In most of these cases, Fund surveillance had not ex ante and publicly stressed the weakness of domestic or financial sector frameworks or questioned the inconsistence of economic policies with a fixed peg.

The social impact of crises on countries raised questions about the IMF's approach, its quality of advice and accountability. Academics, policymakers and nongovernmental organizations alike criticized the IMF for advocating rapid capital account liberalization and paying insufficient attention to the foundations for stability and growth; for applying a "one-size-fits-all" model that was insensitive to countries' individual circumstances and needs; for advocating policies that served primarily the interests of creditors and for being insufficiently open to outside views and advice.

While some of this criticism seems justified, I do not wish to ponder the counterfactual: what if the IMF had not existed and thus would not have helped resolve these crises? In addition, the Independent Evaluation Office of the IMF, having reviewed some of the aforementioned criticism, refuted most of it.

In other areas, the Fund reacted to the criticism and has changed some of its policies, for instance with respect to capital account liberalization. To my mind, these are very important developments which show that the Bretton Woods

Institutions are – without any doubt – learning institutions. What is more, these institutions are of significant importance when we look for an orderly solution to economic imbalances or financial crises.

2. Multilateralism and Governance of the International Financial System

The main function of international financial institutions today is to provide the best framework for the governance of globalization so that this process becomes a win-win proposition, in which all economies ultimately benefit through productivity and growth effects.

This means that a level playing field should exist that governs the integration of national economies via trade in goods and services in particular to minimize unfair cross-border competition. A world of global capital markets offers faster rewards for success both for the countries concerned and for the international system; on the other hand, weaknesses are also punished harder and faster than before. Globalization presents all economies with new opportunities.

More substantial trade and investment flows lead to lower prices and greater choice, larger markets and economies of scale and faster adoption of new technologies. Stiffer competition among firms and exposure to the world's best-practice standards as well as free movement of capital generate a more efficient allocation of resources. Thus, globalization can play a major role in enhancing growth and living standards.

However, there are risks associated with globalization and liberalization that need to be properly managed by policymakers. Globalization entails not only new opportunities but possibly also new inequalities that need to be anticipated and addressed both in developed and developing countries. As a case in point, the recent financial instability demonstrates the risks associated with volatile global capital markets. Fully opening up to liberalization too early and too quickly, without the necessary preparations, is dangerous. Countries must first put in place appropriate policies and institutional frameworks. The IMF's surveillance mandate is just the instrument to achieve this aim.

3. Surveillance and Crisis Prevention

Self-surveillance is the most effective form of surveillance since self-interest should motivate countries to pursue stronger policies. The ultimate reward for countries with improved policies will be higher economic growth and a higher standard of living for their citizens.

The effectiveness of external surveillance – like the IMF's surveillance mandate – is very much dependent on the credibility of the review process. International organizations can add weight to local voices: national think tanks or academics might have said something many times over and, yet, it helps to have a credible body such as the IMF says it, too.

Therefore, international organizations must ensure that the analysis and advice presented to countries is not perceived either to be tainted by special interests or weakened by the use of flawed analytical methods.

As to its surveillance mandate, the IMF faces critical limitations. In seeking to provide good advice, the IMF is constrained for example by a country's economic progress and authorities' willingness to follow up on advice. However, based on experience across many countries, a consensus has emerged about the broad guidelines for policies that serve the goal of sustained growth and thus should help in preventing crisis. These policies include, among other factors, the need to support an appropriate macroeconomic and microeconomic environment, the need for a market-oriented system with a high level of competition, openness to international trade and investment, price stability and exchange rates that broadly reflect international competitiveness.

All of this has led to a shift in the crisis prevention strategy employed by the IMF. The IMF now concentrates on identifying vulnerabilities, such as excessive sovereign debt or balance sheet mismatches. Also, its stance on capital account liberalization has changed. Today, the IMF advocates that member countries should first have the institutional capacity and a relatively strong financial sector with a sound supervision regime before taking this major step. In fact, before fully liberalizing all capital movements in 1991, Austria had followed this policy. Back then, Austria was criticized for this policy which has now become conventional IMF wisdom.

One important initiative in the sphere of crisis prevention is the Financial Sector Assessment Programs (FSAP), which are conducted together with the World Bank. An FSAP is designed to establish a profile of the strengths and weaknesses of the financial sector of a given country. This initiative is not only geared towards emerging market countries (EMCs) or developing countries, but also towards industrial countries. Austria, for example, just conducted an FSAP with excellent results.

Another important area constitutes economic and financial standards and codes, which are formulated in collaboration with public and private sector institutions. Their aim is to promote meaningful comparable statistics, transparency rules for fiscal and monetary policies and supervisory standards for the banking, securities and insurance sectors. This is meant to facilitate the integration of countries into the global economy.

Will all of these initiatives prevent financial crises altogether? Overshooting and correction will always be part of financial markets. This means that in an open and dynamic market economy there are limits to our capacity to anticipate and prevent crises.

However, with skillful and prudent economic, monetary and financial policies, crises should occur less often and they should be less severe.

4. Crisis Management and Resolution

Over the last 20 years, the Bretton Woods Institutions had to deal with a continuous series of financial incidents. These crises encompassed economic misalignments and systemic vulnerabilities, such as evinced in the Mexican or East Asian financial crises and financial disruptions due to contagion across countries and markets, as for example during the Russian debt default of 1998.

The success of the Bretton Woods Institutions should be reflected in a declining trend of the overall number of Fund-supported programs over time. There are legitimate cases which require access to Fund resources. However, the Fund's financing role should and can only be catalytic, given its limited resources. While policies, such as the exceptional access framework, are in place to safeguard Fund resources, they are often not adhered to.

I am also concerned about the prolonged use of Fund resources which is out of line with its mandate. Countries that run IMF-supported programs over many years or decades are probably not a demonstration of success. Thus, the IMF should strive to prevent that countries become dependent on IMF financing.

During the debt crises of the early 1980s, the IMF acted more as a crisis manager or the official agent in charge of concerted bank lending. This role has shifted over the years, with the Fund now practically resolving countries' financial crises on its own. An important initiative to reposition the Fund once again as a crisis manager came to be known as the private sector involvement (PSI) initiative. PSI encapsulates the official sector's attempt to engage the private sector in crisis resolution more effectively. The private sector has to assume responsibility for its investment decisions. This is grounded in my firm conviction that a collectivization of private sector losses would distort the allocative efficiency of capital markets and would lead to moral hazard via increased risk-taking.

Another important initiative, which the IMF started to discuss in late 2001, proposed to establish an international bankruptcy procedure for unsustainable sovereign debt (SDRM). I believe that this mechanism would have made the PSI initiative more operational. However, the time may not have been ripe yet for such a comprehensive framework for the restructuring of sovereign debt. Nevertheless, public and academic awareness has been raised.

The debate has helped in that many EMCs have introduced collective action clauses (CACs) in their sovereign bond contracts and major EMCs and the private sector are discussing a Code of Conduct. This notwithstanding, I am firmly convinced that we need an international arrangement which would facilitate the orderly resolution of sovereign debt crises.

Such an arrangement would also help shift the function of the IMF from its current role as crisis solver to crisis manager.

5. Economies in Transition, Developing Countries and Poverty Reduction

In addition to finding more effective mechanisms for crisis prevention and management, the international community faces another major challenge, the eradication of poverty.

One of our prerogatives should be to integrate developing and transition economies in such a way that they can maximize the benefits of globalization, while minimizing the costs.

This implies, specifically, helping these countries attract sufficient sustained private capital flows, while strengthening measures for crisis prevention and better crisis management, supporting policies and structural reforms that facilitate development, and helping secure sufficient external funding to sustain their growth and poverty reduction.

While not being a "development" institution in spirit and by design, the Fund's role in the developing countries has nevertheless become an essential and integral part of the efforts of the whole international community to advance development.

Especially by launching the HIPC (Highly Indebted Poor Countries), the PRSP (Poverty Reduction and Strategy Papers) and the PRGF (Poverty Reduction and Growth Facility) initiatives, the Fund substantially reframed its role in low-income countries, making poverty reduction and growth the key objectives and modalities for programs supported by the Fund. While the PRGF relates strictly to the Fund's role, the HIPC and the PRSP initiatives guide the cooperation with developing countries, the Fund, and also the World Bank.

I see the Fund's role in developing countries and especially its financing role as catalytic rather than substantial. The Fund should allocate only a limited amount of financial aid to developing countries in support of their progress towards macroeconomic stability and financial soundness.

Turning to transition economies, I believe that we often overlook the strong track record both the IMF and the World Bank have established in these countries.

While the Bretton Woods Institutions were caught as much by surprise by the collapse of Communism as everybody else, their involvement in these countries was instrumental to their integration into the world economy. At the beginning of the 1990s, the majority of transition economies had some form of IMF involvement via a fully-fledged IMF program or technical assistance. The IMF together with the World Bank worked hard to stabilize the economies of these countries, devise economic policies and build modern institutions, thus transforming many of these economies into today's very successful market economies.

Owing to a common history and its geographic location, Austria has a particular interest in the stability and economic progress of the transition economies.

Austria had already started in the late 1980s to develop extensive economic ties with the transition economies, which have increased substantially over time.

Strong trade linkages, very high levels of foreign direct investment and support for their integration into either the EU or other international institutions have been mainstays of Austria's policies towards the transition economies. In addition, in 1992, Austria decided to participate in setting up the Joint Vienna Institute together with the IMF and other international organizations to respond to the strong demand from economies in transition to train officials in market economics and the free enterprise system.

6. Conclusion

Ladies and Gentlemen!

Austria joined the World Bank/IBRD in 1948 and the IMF in 1952 and has been an active and supportive member of the Bretton Woods Institutions (BWI) ever since. Especially for a small open economy like Austria, the BWI were and still are important windows to the rest of the world. Therefore, both the Oesterreichische Nationalbank as well as the Ministry of Finance have always kept close and good working relationships with the management and staff of the IFIs.

I am a firm believer in the value of the Bretton Woods Institutions for the global economy as a whole as well as for small countries and the positive contribution they have made to the world economy. The 60th anniversary, this conference or the strategic review of International Financial Institutions which is presently conducted by the G 7 mark an opportunity to look afresh at these institutions, assess whether they have fulfilled their respective mandates and reflect upon their future roles. However, I expect that we will not attempt to overhaul the system which can be improved upon but ultimately has worked to the benefit of all.

I sincerely hope and advocate that we go back to the roots of these institutions with the World Bank as the primary institution for structural policies and development and the IMF as the institution for short-term macroeconomic surveillance, crisis prevention and crisis management rather than attempt to redefine their respective roles. In addition, what sometimes is forgotten in many reform debates: these institutions fulfill functions for all their members and cannot or should not be narrowed.

In concluding, I am looking forward to fruitful and challenging discussions during our conference and I wish all of you an interesting stay here in Vienna.