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Sixty Years After Bretton Woods: Developing a Vision for the Future

Rome — 22-23 July 2004

Ministry of Economy and Finance, Italy

Summary of Discussions

by

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Background

Marking the 60th anniversary of the Bretton Woods conference, senior policy-makers, leading financial market executives and some of the world's foremost academic experts, met in Rome for the first in a series of collective deliberations on how international monetary institutions and arrangements should be adapted to meet contemporary challenges.

The Rome Roundtable marked the launch of the International Monetary Convention Project (IMCP), a series of public-private roundtables, supported by directed research and an online knowledge environment, on the international financial architecture.

The objective of IMCP, launched by the World Economic Forum and the Reinventing Bretton Woods Committee, in co-operation with a number of finance ministries and central banks, is to make a substantial contribution to the debate on the arrangements needed to ensure the smooth functioning of the international monetary system in light of the emergence of a wider range of important national actors and the increased role of private capital flows.

Below follows a summary of the discussions in Rome, the focus of which was to identify the main topics on the agenda for forthcoming roundtables.

A Bit of History

To put things in perspective it is necessary to go back to 1944 when 735 delegates from 44 countries locked themselves up for three long weeks in July, at the Mount Washington Hotel in Bretton Woods, New Hampshire, to deal with the issue of how to patch up the international financial system. Efforts to deal with the effects of the depression via currency devaluations and trade barriers had not only been ineffective but had actually contributed to make matters worse in the inter-war period. International trade, in

particular, had collapsed. The conference was dominated by J. M. Keynes, the head of the British delegation, who, at the outset, perhaps slightly pessimistically, wrote to a friend in London that the gathering was “the most monstrous monkey house assembled for many years” and that the only thing one could predict with some reliability about the likely outcome was that “acute alcohol poisoning would probably set in before the end.”

Maybe this somewhat dour assessment reflected slight frustration with the fact that the U.S. Treasury had vetoed some of his more ambitious initiatives for the conference—Robert Mundell noted that the original plan for Bretton Woods was to create a world currency. (Actually, as recounted by John Cassidy, in a very nice piece in *The New Yorker* a few years back, on the off hours, the focus of attention was Keynes’ wife, the Russian ballerina Lydia Lopokova, who used to practice her dance steps everywhere and at all hours.)

Much in fact was accomplished, however, and, by the end, Keynes’ own assessment had turned considerably more positive. “All of us here have the greatest sense of elation. All in all, quite extraordinary harmony has prevailed. As an experiment in international cooperation, the conference has been an outstanding success”, he wrote back to his London friend.

Five Features of the Bretton Woods System

What exactly, in a nut shell, was agreed at Bretton Woods? Volumes have been written on the subject but, to judge from the discussions in Rome, most would agree with Richard Cooper’s five point characterization:

1. Great deal of freedom for national economic policy to pursue national economic objectives (employment, price stability, economic growth) to prevent another 1930s depression.
2. Fixed exchange rates—desirable against the turbulence of the 1930s and the distortionary effects of competitive devaluations.
3. Convertibility of currencies for trade in goods and services; this was wanted because of dissatisfaction with extensive use of exchange controls and wartime restrictions. Governments would no longer interfere with private sector decisions on the allocation of foreign exchange and so on. (John Lipsky thought that this was the most important achievement of the Bretton Woods system).
4. Medium-term lending to cover BOP deficits of a temporary nature; the creation of the IMF was at the centre of this particular initiative. (Hence the discussion below on the role of the IMF—an institution at the very centre of the Bretton Woods system.)
5. And, if deficits turned out not to be temporary, then countries could alter their exchange rates.

The system implied a bargain between the US and the rest of the world: “We (the US) will maintain domestic economic stability; you (the rest of the world) will fix your currencies to the US dollar and will accumulate reserves in dollars which will be gold-convertible.” There seems to be consensus—and nothing that was said at the Rome conference contradicted this—that this system implied enormous implicit gains for the US, which, with unlimited access to the capital markets, could buy goods abroad without

selling an equivalent value of its own goods; an arrangement akin to paying for such goods with checks that are not cashed. Robert Skidelsky noted that the accumulation of US dollar reserves in the EU during the 1960s was part of this contract: protection against Communism financed by an “imperial tax.” He did not think that its modern-day equivalent, the “war on terror,” was taken by most to be an appropriate substitute, however.

The system, perhaps because the historical backdrop was so horrible, proved very successful and led to close to 30 years of growth and stability, with trade expanding by leaps and bounds. It also saw the emergence of the EU as an attempt to build upon this global framework. However, the system had two major flaws which did not become apparent until much later—Cooper has written on this and this analysis draws on his analysis.

- I. Gold convertibility of the dollar would become gradually doubtful as the volume of dollar liabilities outpaced the growth of the US gold stock. To have halted otherwise the accumulation of foreign-held dollar reserves would have stifled growth of the world economy.
- II. The prospect of devaluation gave way to speculation. Capital controls were allowed under the BW system but with improved communications, electronic money, and so on, capital transfers became much more difficult to control. Indeed, over time, the distinction between a current account transaction (for which the currencies were convertible) and a capital account transaction (for which they were not) became blurred. Most countries in the end gave up, which at times made them vulnerable to swift changes in market sentiment and expectations—new terms, such as “bandwagon effects” and “self-fulfilling prophecies”, found their way into the economics literature. Cooper referred to “expectations feeding on expectations,” perhaps echoing Keynes’ earlier sentiments that: “nothing is more certain that the movement of capital funds must be regulated” for if this didn’t happen money would “shift with the speed of the magic carpet and these movements would have the effect of disorganizing all steady business.” In Rome Klas Eklund noted that only 3% of FX trading these days is linked to current account transactions, adding that FX markets suffer from herd effects, instability, fickleness, with “fundamentals” no longer affecting them as they used to. (He also thought that fickleness and its effects would lead to pressure for more stable arrangements.)

So, the system eventually collapsed in 1973, the dollar was no longer gold convertible and the world moved to a non-system of floating exchange rates characterized by:

- Considerably more variability in exchange rates, including, by now, probably well over 100 episodes of runs on countries’ currencies and with short-run movements in real exchange rates fairly detached from what policymakers have come to recognize as “economic fundamentals.”
- Greater degree of uncertainty for trade and investment. Indeed, the perception that unpredictable movements in real exchange rates can severely complicate macroeconomic management—against a background of increased international integration—was a key factor in pushing the EU to adopt the euro in early 1999.

- Manipulation of exchange rates for national gain—e.g., to fight high inflation, for instance, through monetary tightening and an appreciated currency.

In the meantime, of course, the world has changed dramatically. Manufacture has gone the way of agriculture, real per capita incomes have increased, the world has become electronic and this has led to a much greater degree of financial integration. Capital flows have grown several-fold as well. This means that movements in exchange rates are potentially more disruptive of profits, production, and employment because of the much greater possibilities for substitution of geographic location in all types of production. John Lipsky thought that with the on-going globalization of manufacture, the concept of “country of origin” was becoming fuzzier by the day, as was the meaning of “current account balance” and, hence, the willingness of countries to deal with imbalances when they emerged. He also thought that the Fund’s Articles of Agreement had not kept up with the pace of change in the global economy and were “disjointed from reality more than ever before.”

Salient Issues During the Rome Discussions

The Role of the IMF

Jack Boorman’s dinner speech focused on some of the challenges facing the IMF in the period ahead, particularly in the areas of governance, surveillance, and the Fund’s role in emerging markets. Several other conference participants addressed, over the two-day period, aspects of the issues raised by Boorman.

Governance

There are at least three issues here. One is finding the appropriate balance between the extension of broader jurisdiction to the IMF, to cope with the consequences of growing complexity in the global economy associated with the process of globalization and financial integration, on the one hand, and the application of the principle of subsidiarity, on the other. This is a dynamic process and it is not clear that the appropriate balance has been reached, reflecting the quick pace of change in the global economy during the past decade or so. The second pertains to the use of power by some of the larger countries to force decisions within the Fund and the related problem of the passivity of other members when this is being done, sometimes blatantly.

Yet another aspect of governance has to do with the failure of the distribution of voting power within the Fund “to keep up with changes in the world economy.” Voting power within the Fund no longer reflects the relative sizes of individual economies: the EU is overrepresented, relatively small economies like Belgium’s have twice the quota of countries like Mexico, with a GDP at least three times as large (in PPP terms) and nine times the population; “the seven largest Asian countries (other than Japan) have somewhat lower aggregate quotas than Austria, Belgium, Denmark, Finland, Norway, Sweden and Switzerland, notwithstanding seven times the share in world GDP (in PPP terms), and vastly larger trade.”

These distortions—and there are many others—undermine the Fund’s legitimacy in the public eye. Cooper, however, thought that the legitimacy of the Fund would be reduced if the weight of non-democratic governments were to rise. Related to the question of the

distribution of voting power is the issue of the selection of the Fund's managing director, where the EU has been reluctant to give up its "historical" claim to the job, notwithstanding "new principles and specific procedures for the selection process that were endorsed by Executive Directors in April 2001."

Surveillance

There is little public understanding of the purpose of surveillance and its effectiveness. The first is very much linked to the responsibilities of Fund members with respect to exchange rate policies under Article IV. One element of this is the advisory role that the Fund can play through the surveillance process in assisting countries to benefit from the vast knowledge and experience accumulated within the Fund over the years on particular policy issues and country experiences. There are questions as to whether the Fund has been as effective as it could be in this area, but the potential is there to be of enormous assistance to country authorities confronting many of the same problems in a broad array of areas.

Boorman was skeptical about proposals aimed at linking access to Fund resources to past "good behavior," particularly when bad policies—as was often the case—were implemented by a government no longer in office. He then noted that the greater commitment to transparency in the Fund had broadened the potential audience for surveillance and enhanced to possibilities for public debate—at least in countries with working democracies—on the policies being followed in individual members and their likely implications. There may be limits to how far the Fund can go, however, with its new policy on openness. At some point officials could cease to see the Fund in the role of confidential advisor (passing on insights on policy issues from its received wisdom) and see it more as a possible source of sensitive information to the markets. It is not clear that the Fund has achieved the right balance between its role as advocate for better policies on the one hand and admonisher or issuer of public warnings, on the other. Indeed, it is not clear that the inherent tensions implicit in this dual role can be satisfactorily resolved.

Boorman hinted that failure to deal with some of the above governance and surveillance issues, coupled with the extraordinary buildup of reserves in the Asian countries may be a key factor behind recent initiatives to create an Asian Monetary Fund, the value of which he thought questionable. Gordon de Brouwer thought that current attempts to create an Asian Monetary Fund reflected fairly broad-based wishes in the region to develop their own crisis management funding mechanisms, as a component of the global financial architecture. The Asian Fund would facilitate policy dialogue (including on exchange rates) and develop crisis management mechanisms which could rely on IMF-style conditionality, while developing independent analysis and advice. The emphasis would be on minimizing bureaucracy and maximizing the speed of response. As least in some fashion, these initiatives reflected dissatisfaction, at some level, with the role the IMF had played in Asia in recent years, which had led many policymakers to feel that "if institutions do not change, they grow irrelevant."

Peter Kenen saw the Fund's surveillance role as involving many elements, including the provision of timely information, the dissemination of analysis—such as that contained in the World Economic Outlook. However, he saw large scope for improvement. Not all staff reports were being published and too many of the PINs (Public Information Notices)

were “anodyne.” He called for the creation of a body akin to a Council of Economic Advisers who would, inter alia, prepare a chapter overview for the WEO, pass judgment on staff reports on key countries and make periodic presentations to the Board on critical issues. It was also high time to significantly increase the Fund’s resources through a quota increase. Jacob Frenkel thought that the Fund had showed some adeptness at adapting to the post-1944 world of globalized markets and ideas and the associated tensions between national sovereignty and global forces, the growing role of private capital, the prevalence of flexible exchange rates, and the rise of democracy. This was evident in the increased attention being given, in the Fund’s work, to financial markets, poverty, and corruption.

The Fund’s Role in Emerging Markets

Boorman identified several central issues in this area: signaling; access policy; and workout mechanisms being perhaps the most important. At its most basic, the Fund sends signals through the decisions it takes in the course of the implementation of its programs. Whether to approve, delay, halt or renegotiate a program—and whether this program is an EFF or a lesser arrangement is part of the package of messages sent to the market and the international community. More ambitious attempts at signaling, through the creation of special facilities, such as the Short-Term Financing Facility (STFF) or the Contingent Credit Lines (CCL)—the latter devised as a mechanism against contagion—suffered early deaths through lack of use. As noted by Boorman “creditors wanted more conditionality and slower disbursements, borrowers less conditionality and more money up front”, many in the Fund saw a potential shift in its role toward that of a rating agency. In the end, the solution may lie in the continued use of existing arrangements and the associated disclosure of more candid staff appraisals. On conditionality, Cooper thought that the Fund should not get into structural conditionality. The IMF and the World Bank “should educate and cajole”, but not impose. To enhance the probability of success, policy initiatives (e.g., bankruptcy procedures) needed to be homegrown.

On the Fund’s access policy there are also inner tensions. Some have called for tighter access limits, partly to mitigate moral hazard, partly for the benefit of “predictability” and possibly to curtail the ability of management to expand lending limits way beyond established guidelines in the middle of a crisis. Boorman thought that it would not be desirable to tie the hands of the Fund too tightly, to curtail its ability to respond when ample resources were appropriate for a country in trouble. (Note: Whether Turkey in recent years was a good example of the benefits of such flexibility was not clear from his remarks. The broad perception in the financial markets during the period 2000-2002 was that Turkey’s government would never have acceded to such exceptionally high levels of access without US support, much of which, in any event, was predicated on “strategic”—that is, political—considerations.) On a related issue Michael Dooley thought that, independently of access levels, IMF programs, particularly in tricky cases such as Argentina, needed an “exit strategy” in the event that things did not work out as expected. In Argentina the IMF found it difficult to get out because this aspect of the program had been left to “future imagination.”

The debate on SDRM and CACs had been productive; as a minimum it had created an awareness of the underlying issues, it had led to greater acceptance by emerging market countries of the benefits of CACs in bond issues and thus prepared the way for a renewed

examination of “some kind of statutory mechanism”, at some point in the future, possibly in the middle of a particularly complex case. He expressed some concern about a possible misinterpretation of a future agreement between Argentina and its private creditors. One way to read this deal might be to say that, left to their own devices, the markets eventually found a satisfactory negotiated solution. However, in the absence of an appropriate restructuring mechanism, the cost to all parties involved, particularly Argentinean society, had been enormous. Giorgio Gomel thought that the main problem in dealing with sovereign debt workout cases was the lack of predictability, which had resulted in countries like Argentina waiting way too long to address their debt problems head on. Dooley added that in Argentina the IMF faced a conflict of interest between its own exposure and how much of a write off it would accept on its private sector bond debt—regardless of what future elements a SRDM might have, he thought that the Fund would never be able to play the role of unbiased arbiter.

Global Imbalances

Current account imbalances—particularly in the US—figured prominently in the discussions in Rome and spanned a broad spectrum of views. Robert Skidelsky saw a loose fiscal policy in the US as being a primary source of the current account deficit and this was unlikely to be tolerated by others as the US was no longer providing the “security” of the Cold War days. A more cautious fiscal policy in the US could lead to greater exchange rate stability, which would then create the conditions for a more detached consideration of new rules—he thought that a new Bretton Woods would be the best way forward. For his part, John Lipsky thought that the acceleration of potential growth in the US was the primary source of the rise in the current account deficit and that, in any event, it would likely be reduced because the private savings rate in the US would go up, and the public sector deficit would come down in coming years. Thus, he did not think that one needed to appeal to the political arguments put forth by Skidelsky.

Brad de Long did not feel comfortable with this more relaxed view about the US current account. He estimated that the depreciation of the US dollar that would be necessary to bring the deficit from 5% of GDP to 2.5% of GDP would be of the order of 20-30%. He was puzzled that bond markets did not seem to be worried about this. In his view, if services were to witness the expansion seen in merchandise trade in the post-war period, major job creation would be necessary to cope with the consequences of de-industrialization in the United States. Furthermore, the international financial system would have to deal with the likely sharp increase in protectionist sentiment. More generally, he thought that over the next 30 years a growing share of economic activities would come under the pressure of “factor price equalization” and that the world’s financial system would have to learn to deal with this pervasive phenomenon.

Richard Cooper thought it important to clarify that foreigners “do not finance” the current account deficit. The US has a floating currency—countries, for their own mercantilist reasons, willingly invest in the US. He said that the US economy was a dynamo, with a full pipeline of technological innovations. There were US\$5 trillion of savings outside the US in search of an outlet for profitable investment. Was it unreasonable to presume that investors outside the US would want to place 10-15% of their savings in the United States, an economy accounting for some 30% of global GNP? He thus did not think that the current account deficit was unsustainable over a 10-year horizon. In his view, the

main macroeconomic imbalance in the US was fiscal in nature. Robert Mundell agreed with this latter view and thought that the long-term implications of population aging would put enormous pressures on the US public finances (and those of other societies) and force systemic changes. Lipsky thought that business cycles had grown more simultaneous than in the past, largely because of globalization. While these would create challenges for the monetary authorities, they could also facilitate policy coordination in the future at the international level to deal, for instance, with the problem of global imbalances.

Saccomanni, thought that adjustment of the US current account and fiscal imbalances was one of a handful of intractable economic challenges confronting the operation of the market-led international financial system. Nevertheless, he was impressed by the resilience shown by the system in the face of numerous monetary and financial shocks; crises had, no doubt, entailed heavy costs in terms of GDP lost to the countries concerned, but the system itself had survived and “no systemic financial crisis, à la 1929, had occurred.”

China

China was ever present throughout the Rome meetings. Dooley made the point that a set of fixed exchange rate regime countries—with China being by far the most important—with limited capital mobility and controls had become economically important. They had shown that capital inflows need not translate into higher inflation. The basic problem confronting the authorities in China was how to cope with the rapid incorporation of farmers into the labor force in the cities and the consequent need to create some 20 million jobs per year over the next decade. The “Washington Consensus” would simply not do—the recent disappointing performance in Latin America made this clear. What the countries in Asia had opted for was a combination of foreign capital—China, in particular, does not yet have well-developed capital markets—and an export-oriented growth strategy which, in China, translated into a depreciated exchange rate which kept wages low and was good to attract FDI. Mark Carney characterized China’s exchange rate as “a mechanism to absorb excess labor.” Skidelsky added that fixed rates in China and elsewhere may be preferred for reasons of macroeconomic stability, to facilitate intra-regional trade, and not just for the boost to competitiveness associated with a weak currency. Some concern was expressed about the state of the Chinese banking system and the high level of non-performing loans, with Sarvjeev Sidhu forecasting a “crash sometime during 2006-09.”

Barry Eichengreen argued that, actually, the “Centre” was quite happy, in the short-term, with the state of affairs described by Dooley, bringing, as it did, cheap imports, current account deficits and the ability to live beyond one’s means. But, of course, this model was not sustainable. Central bankers in Asia were already worried about the long-term stability of the US dollar and the potential for huge capital losses. Mitigating this was the perception that a dollar crash would be bad for everyone—so, de facto, there was a cartel in place preventing asset diversification because it would be destabilizing. De Brouwer thought that an additional factor in explaining the rapid accumulation of reserves in Asia was as insurance against future crises, the painful memories of 1997-98 still being fresh in the minds of policymakers. Of course, as reserves piled up, this “insurance” factor had declined in importance. Japan was doing much better—so it did not need to rely quite as

much on a weak yen which meant that purchases of dollars should slow down. In discussing pressures on China to revalue their currency Mundell noted that an appreciation of the exchange rate would destabilize the government, undermine exports, worsen unemployment and the environment for contracts and markets more generally. It would pose institutional challenges to the central bank, which was not yet fully independent from the government. Lorenzo Bini Smaghi was not overly concerned about the “possible collapse of the ruling class in China”, but Mundell cautioned that China “might get a worse government.”

Other Emerging Markets

In an interesting discussion focused on the integration of emerging economies in the international financial system, Jose Viñals divided the world in three regions: Asia, Central and Eastern Europe, and Latin America. He characterized the first two as enjoying fairly predictable frameworks for reform, with Latin America struggling to integrate itself into the global economy—two of the top three debtors to the IMF were from this region.

The Washington Consensus advocating macroeconomic stability, fiscal discipline, the opening of the trade balance and other reforms had not yielded the results expected at the outset. Some progress on the macro stability front had been undermined by the dismal growth performance and the recurrence of financial crises in the region throughout much of the 1990s. There was a broadly-shared perception in the region that a combination of the forces of globalization and some home-grown liberalization had been socially harmful and this in turn had led to a marked weakening in the support for further reforms and the resurrection of old-fashioned populism. Viñals argued that rather than say that the recipe had been wrong, it was fairer to say that it was incomplete. Of course, with the exception of Chile, key elements of the recipe were not applied in many countries. In Argentina a rigid exchange rate regime proved woefully incompatible with loose fiscal policies. The region as a whole had relatively weak financial systems, made worse by poor legislation and regulation. Several countries—again with Chile the noteworthy exception—had been too quick to open the capital account, without equivalent progress on the current account; not surprisingly the market had punished severely such policy inconsistencies.

He described a “deathly trio:” capital flow reversals in closed economies required huge real exchange rate adjustments. But high levels of public debt, much of it denominated in US dollars, created balance sheet headaches of all sorts. This, in turn, explained the resistance to change pegs which tended to worsen the balance of payments. There would appear to be no easy formulas for these countries. Solid fiscal policies were key, as part of an effort to reduce financial vulnerabilities. It was also necessary to reduce the incentives for dollarization—Chile has penalties for mismatches in balance sheets. In particular, higher provisions for companies that have FX debt but peso revenues. More trade openness was necessary to match the capital account opening. And, of course, a more coherent macro framework, needed to be complemented with better governance, property rights and labor market reforms. In discussing the role of the exchange rate Viñals did not think that adoption of the dollar in Latin America was feasible in the near future. But Central American could adopt the dollar, following in the footsteps of Eastern Europe, whose members would introduce the euro. Latin American countries should,

instead, focus more on boosting regional trade integration and with the rest of the world, something that would, in turn, generate much-needed efficiency gains in the region.

Viñals thought that one currency would, in due course, come to the region.

