

## **The Only Game in Town**

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“Time for a new Bretton Woods Conference. Time for a new Bretton Woods Conference.” The calls grow louder by the day. This is not surprising: in each period of turbulence in international markets, one hears calls to do what the United States, the United Kingdom and 42 other nations did in 1944: convene an international conference to create a new framework for international financial cooperation. Nor is it surprising that the impulse now is exceptionally strong, the current crisis posing, as U.S. President Clinton has aptly put it, “the biggest financial challenge facing the world in half a century.”

This nostalgia is understandable. The 25 years following the negotiation of the Bretton Woods Agreement were a period of unusually rapid growth -- historians now refer to it as a “golden age” -- without parallel in modern economic history. Economic development spread to parts of the Third World where it had been unknown before. By clamping down on capital flows, governments prevented destabilizing financial speculation from wreaking havoc with the exchange-rate system and precipitating banking crises. They channeled credit to the sectors where it could be put to best use. Capital controls gave them leeway to tailor policies to domestic needs and to pursue independent national development plans, something they did with remarkable success. Those were happier times whose lessons we ignore at our peril.

## **No Old Bretton Woods**

But it is important to get the lessons right. And the real lesson of that history is that a new

Bretton Woods agreement is not feasible, either literally or figuratively. Literally, it is not feasible to restore a Bretton-Woods-type system of strictly-controlled financial markets and pegged-but-adjustable exchange rates. Financial markets having malfunctioned famously and being widely blamed for the Great Depression, governments slapped tight controls on their banking system and securities markets. They severely limited the range of transactions in which residents could engage. World War II being a national emergency, governments took direct control of financial markets, subordinating them to the war effort. They used what we would now call “policies of directed credit” to channel resources to essential wartime uses. What was bequeathed by World War II was thus not just controls on international financial transactions but tightly regulated domestic financial markets which made feasible effective enforcement of those control on international financial flows.

The situation has changed more than a bit since the 1940s. The advanced-industrial economies have all liberalized their financial markets. To be sure, the market mechanism is hardly perfect at allocating financial resources. As recent events have served to remind us, investors can bolt like a herd of excited steers when startled by an unexpected event and trample everything in their path. Exuberance which gives way to panic can precipitate very serious macroeconomic and financial problems. Thus, the relaxation of tight regulatory restrictions has allowed the problem of currency and banking crises to resurface.

Despite these problems, however, there is no talk of the advanced industrial countries reimposing policies of financial repression. Decades of hard experience have convinced even the graduates of the French Grandes Ecoles that markets know better than governments. This realization was some time in coming, for the visible hands of bureaucrats could work as well as

the invisible hand of the market so long as the problem for economic growth was to throw more resources at existing sectors and to utilize them in existing ways. In the aftermath of World War II, there was a vast gulf between American and European industrial efficiency; labor productivity in Europe was only 40 per cent that in the United States. European and, even more, Japanese officials could simply take American manufacturing technology and industrial organization as their guide. But the same is not true today, when growth requires innovation, not merely emulation. And this is something best left to the market. Markets allocate resources in an environment of uncertainty by allowing investors to take opposing bets. Some investors go long, some go short. Some invest in old sectors and technologies, others in new ones. The balance of their decisions is then impounded into asset prices which guide the allocation of resources. This is something at which markets are fundamentally better than bureaucrats. Thus, financial liberalization, however nostalgic it leaves us for simpler days past, is unavoidable for advanced- industrial and industrializing countries alike seeking to sustain their economic growth.

Developing countries might seem to be another matter. But the story there is actually quite similar. Asia's tigers could grow rapidly under the guidance of government-led financial systems so long economic development simply involved replicating Japanese industrial structures. But once the easy stage of growth propelled by emulation of that foreign example drew to a close and it became essential to innovate as well, bureaucrats no longer knew better than markets.

And domestic financial liberalization means international financial liberalization. The connection is unavoidable. It is impossible to widen the range of domestic transactions banks and securities-market participants can undertake and at the same time keep a tight lid on their international business. Allow banks to provide trade credits, and they will use invoicing leads and

lags to take positions in foreign currencies, as they did in the 1960s. Allow them to transact in securities and financial derivatives, and they will find ways to use these instruments to take international positions, as they did in the 1980s. Attempt to tightly control their international business when other countries stop doing so and the financial sector will move offshore.

This discussion points to another factor creating irresistible pressure for financial liberalization, namely, powerful changes in information and communications technologies. Computers, the internet, satellite communications and cellular telephones all make it more difficult to close off domestic markets. To be effective, capital controls must become increasingly invasive, as Malaysians are learning to their chagrin. This is another reason why it is impossible to turn back the lock — why the vast majority of governments, notwithstanding their trepidation, see no alternative international financial liberalization.

The fact that international capital mobility is an unavoidable reality, in contrast to the exceptional interlude after World War II, knocks the props out from under the other leg of the Bretton Woods Agreement, namely, the creation of a system of pegged but adjustable exchange rates. Pegging the exchange rate was politically palatable only because capital controls loosened the link between domestic and foreign economic policies. In their absence, countries would have been forced to follow U.S. monetary and fiscal policies in lockstep and had no capacity to tailor policy to their domestic economic development strategies. The markets, in turn, would have realized that political support for policies dictated by anonymous American officials thousands of miles away would have been less than complete. Speculators would then have tested the willingness of policymakers in other countries to subordinate all other objectives to the imperative of exchange-rate stability and brought those currency pegs tumbling down.

Nor would periodic adjustments of Bretton Woods pegs have been feasible in the absence of capital controls. The merest hint that policy makers were contemplating a change in the exchange rate would have unleashed a massive outflow of funds and precipitated a full-blown crisis. This was already a problem before 1971 when capital controls, while extensive, were less than watertight. Even then, governments were reluctant to contemplate adjusting their exchange-rate pegs for fear of precipitating a crisis. And as exchange rates grew increasingly rigid, they grew increasingly fragile. The disintegration of the Bretton Wood System of adjustable pegs in 1971-73 was a predictable consequence of the inevitable postwar recovery of capital mobility.

These are lessons that Europeans in particular took to heart. They learned, or so their actions suggest, that rising capital mobility leaves only two options for the exchange rate: let it float, a la the UK, or fix it once and for all by establishing a monetary union or its equivalent for the individual economy: a currency board.

From this perspective, it is peculiar that the new German government should call for target zones or that the French should urge other parts of the world to emulate Europe's example by negotiating common basket pegs and creating a regional currency bloc. Short of going all the way to monetary union, which is patently impossible for regions that lack Europe's integrationist tradition and where there is no equivalent of its half-century-long effort to build regional political institutions, none of these schemes is feasible. They are all recipes for disaster.

### **No New Bretton Woods**

What about an agreement that invokes Bretton Woods for inspiration but develops along very different lines? Tony Blair's blueprint for a "new Bretton Woods for the next millennium"

envisages a World Financial Authority, effectively merging the International Monetary Fund, the World Bank and the Bank for International Settlements to create a single super-regulator of financial markets. Some European governments see the need to endow the International Monetary Fund with additional resources so that it can act as a true international lender of last resort. Others, preoccupied by the moral hazard created by international rescues, evince more than a little sympathy for academic critics who suggest that the IMF should instead be closed down, or at least that greater reliance should be placed on alternatives to every-bigger bailouts. The Canadian government proposes incorporating into loan contracts provisions providing for an IMF-sanctioned “pause” or payments standstill to be invoked in the event of financial difficulties. George Soros proposes a new international debt insurance corporation, Henry Kaufman a new international credit-rating agency, Jeffrey Garten a new global central bank, Jeffrey Sachs an international bankruptcy court.

It is hard to overlook the inconsistent and mutually-incompatible nature of these proposals, no matter how much proponents of a new Bretton Woods Agreement might try. While some see a need for greater exchange rate stability, others insist on the need to restore “fixed” exchange rates. While some suggest the reimposition of capital controls, others dismiss as anachronistic. While some would create a super-regulator of financial institutions and markets, others would abolish the IMF and ore generally minimize international meddling in domestic financial markets in order to eliminate the moral hazard problem.

This situation is very different from 1944. Notwithstanding differences among national delegations, then there existed a consensus on the broad contours of desirable reform. Policy makers agreed on the need for exchange rate stability. They agreed on the need to tightly regulate

domestic financial markets and restrict international capital flows. They agreed on the need to create a super-national body, the IMF, to oversee, approve and, if necessary, veto beggar-thy-neighbor changes in exchange-rate and monetary policies.

This exceptional consensus existed only because countries had shared the searing experience of the Great Depression and drawn the same lessons from it. Perhaps future historians will look back at the 1997-8 crisis as another pivotal event that created an exceptional consensus and an opportunity for radical reform. Realistically, this seems unlikely. However serious the financial difficulties of 1997-8, they show few signs of plunging the world into a global depression akin to that which began in 1929. They show few signs of leading to the tariff wars and wholesale debt defaults that culminated in the collapse of the world trading system and the disintegration of international capital markets in the 1930s. Different countries continue to be affected very differently by the current turbulence, leading them to different conclusions. Policy makers have learned valuable lessons about how to create a financial safety net for their domestic banking systems and of the need to keep monetary and fiscal policies on an even keel, which is good for economic stability but bad for encouraging a fundamental rethink of prevailing institutional arrangements. With luck, there will be no extraordinary disaster to create an extraordinary policy consensus.

Nor has there been a global economic and financial disaster to discredit existing institutions. While the IMF drawn withering fire, it is still there. Indeed, it has just received \$18 billion of additional funding from the U.S. Congress. The Basle Committee of Banking Supervisors is still there despite the criticism that has been levied at the particulars of the capital standards it lays down for international banks. There is no institutional vacuum into which new

institutions can step. Effective reform will have to take place within the existing institutional framework.

### **What is to Be Done?**

What would be entailed by “effective reform within the existing institutional framework?” Working within the Basle framework would mean reforming the Basle Capital Standards so that they discourage banks not just from undertaking excessively risky investments, as at present, but also from financing their activities in excessively risky ways (notably by borrowing abroad). It would mean reforming the Basle Standards so that countries that choosing to peg their exchange rates would hold their banks to higher prudential standards, since such governments will be in no position to provide the services of a domestic lender of last resort.

Working within the existing framework would mean negotiating international standards in areas relevant to financial stability. The prerequisites for financial stability extend to the use of internationally-recognized auditing and accounting practices so that lenders can accurately assess the financial condition of the banks and corporations to which they lend. They extend to effective corporate governance, so that claimants can monitor and control the economic and financial decisions of managers. They extend to investor-protection laws to prevent insider trading, market cornering and other anti-competitive practices that prevent securities markets from developing. They extend to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. While these are problems for individual countries to address as they see fit, whether they arrive at an adequate solution is also of concern to the international policy community, given the scope for financial problems to spill contagiously



across borders. The inability of countries to reach *national* solutions, in other words, can threaten the stability of the *international* financial system.

Unfortunately, neither the IMF nor any other international organization has the resources to provide each and every emerging market with advice on every item on this list. The IMF in particular needs to acknowledge its limited administrative capacity. Instead of trying to solve all problems by itself, it is essential that it encourage the promulgation of international standards of acceptable practice by private-sector bodies with expertise in these areas (the International Accounting Standards Committee, the International Corporate Governance Network, and the like). National arrangements may differ, but countries participating in international financial markets all must meet minimally acceptable standards. The role of the IMF should be to collaborate with these other bodies, to bestow official status to the standards they promulgate, to monitor countries' compliance, to encourage information on that compliance to be disseminated to the markets, and to condition its lending on steps to comply.

Working within the IMF framework would also mean that the IMF has to become an advocate of prudent regulation of the capital account. The IMF needs to make clear that amending the Articles of Agreement does not mean eliminating Article VI, Section 3 of its Articles of Agreement, which gives members the right to apply controls on international financial transactions. The Fund should make clear that such controls may be needed to buttress the stability of the financial system in countries that are small relative to global capital markets, whose domestic financial markets are shallow, and whose regulators have limited capacity to prevent excessive risk-taking by domestic intermediaries. It should encourage the use of Chilean style taxes on capital inflows by virtually all developing countries.

The Fund will also have to make clear its insistence that countries give up the international monetary equivalent of tightrope walking without a net -- of attempting to peg their exchange rates within crawling bands, target zones, and reference ranges. Unexpectedly large changes in the exchange rate can cause serious financial distress among banks and corporations with unhedged foreign exposures, as the Asian crisis has illustrated. There are only two ways of avoiding this. One is letting the exchange rate float continuously, so banks and corporates learn to hedge their exposure by buying insurance in currency forward and futures markets. The other is to fix it once and for all by creating a currency board, so that unexpected largely exchange rate changes — for that matter, any and all exchange rate changes — cannot occur. Given the ability of crises to spill contagiously across borders, the Fund will have to insist that its members abandon the pursuit of destabilizing bands, zones and crawls. None of this requires an amendment to the IMF Articles of Agreement, of course, which in the present context is the point.

Finally, avoiding both routine rescues and devastating defaults will require creating a more orderly and efficient way of restructuring problem debts. Under present circumstances, restructuring is too difficult and protracted. To solve this problem, majority voting and sharing clauses need to be added to loan contracts to prevent isolated creditors from resorting to lawsuits and other means of obstructing settlements that enhance the welfare of the debtor and the vast majority of creditors alike. Clauses making provision for a trustee to represent and coordinate the creditors and providing that a minimum percentage of bondholders must agree for legal action to be taken would similarly help to create an environment conducive to restructuring negotiations. This approach is infinitely more realistic than imagining the creation of a super-national

bankruptcy court. Reassuringly, G7 finance ministers and central bank governors, in a declaration issued at the end of October, finally embraced these ideas and stated their willingness to “consider” the use of such clauses in their own government bond issues.

None of these recommendations will win the prize for originality. They will not sell magazines. Nor do they justify calls for a new Bretton Woods conference. But if we are serious about making the world a safer financial place, they are the only game in town.