Henrique Meirelles: Bretton Woods II – on its way out?

Speech by Mr Henrique Meirelles, Governor of the Central Bank of Brazil, at the 18th Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2008.

*   *   *

In the last few weeks, much was talked about “Bretton Woods II” and even about “Bretton Woods III”, as we heard here this morning. To many, “Bretton Woods II” represents a new era of cooperation between economic and financial authorities worldwide, aimed at fighting the current global crisis, enhancing cross-border regulation and possibly reform the financial system at some extent. To many others, it is a full redesign of the global financial architecture and of the role of the multilateral institutions. To a few, it implies a sort of arrangement to stabilize major exchange rates – or at least to reduce their fluctuation, not to say a new global exchange rate system, maybe as the one established in the aftermath of the Second World War.

Yet, five quarters after the beginning of the financial turmoil in the US, few people would envisage that we would go that far in terms of international cooperation and proposals, as indicated by the communiqué of the summit of head of states of the G20, held in Washington on Nov 15. The communiqué put forward not only a series of ambitious recommendations, but also a plan of action for the near future that may reshape the global regulatory framework. Even controversial issues that were long blocking international negotiations, as the Doha agenda, received a new momentum in the G20 communiqué.

So far, as you all know, significant progress has been achieved in terms of recognition of the causes of the crises, including development of unsound risk management practices and excessive leverage, in a time regulators in many jurisdictions failed to perceive the build up of unbalances in individual institutions and financial markets in general.

At the same time, each country in one way or another has taken actions to provide liquidity and unfreeze credit markets, and when necessary – particularly in mature economies – to stimulate the economy, strengthen the capital basis of financial institutions and tackle regulatory deficiencies.

That said, authorities in Washington committed to implement reforms that will strengthen financial markets and regulatory regimes. An important novelty is the recognition that financial markets are global in scope, so that enhanced international cooperation among regulators is needed in a globalized world.

Commitment to reform the multilateral institutions to increase their legitimacy and effectiveness has also progressed, granting a larger weight in their decision bodies to emerging economies, as well as expanding the representativeness of the Financial Stability Forum and of the Basel Committee on Banking Supervision. The IMF and the expanded Financial Stability Forum are called to increase efforts in crisis prevention and responses.

The G20 communiqué backed the calls for a broader international cooperation in several fronts, but let me remind you that the international community of central bankers and financial regulators have already developed strong cooperation ties. Institutions as the BIS with its regular meetings or governors and of senior central bank officials and experts or forums like the Basel Committees and the Financial Stability Forum have been providing for years the necessary dialogue, exchange of ideas and information between us. I understand that other forums of economic authorities can replicate our own model of cooperation.

Regarding the IMF, the discussion currently concentrates around its role and legitimacy. Its role should focus on three main topics. The first is surveillance. It is very important that the IMF becomes a key and integral part of the financial early warning system. The IMF is vital not only in terms of forecasting, which is already regularly performed and published, but also in terms of surveillance of each country’s policies and specific warning indicators, aimed at detecting its growing unbalances. One of the points that, in my personal opinion, have complicated efforts to deal with the current financial crisis is that the whole focus of the IMF during decades was to prevent crises in emerging markets. There is a different picture now, and is paramount that the surveillance done by the IMF focus on every relevant economy and really works as an early warning system.

The second topic, evidently, is international cooperation. And international cooperation requires that the IMF and the Financial Stability Forum work together to propose a new set of regulations – some of them were already discussed here today, and particularly regulation and supervision of cross-border transactions, which are not directly restricted to one national supervisory authority. The Basel Committee will most likely continue to be the focal point of conducting the implementation of the process.

The third topic is the IMF role in supporting emerging and developing countries, which have no financial conditions to address the effects of the financial turmoil on their economies. Traditionally, the IMF has focused on crisis generated in one specific economy or group of economies and in proposing policies to restore that country’s soundness. The problem that we are facing today is that some countries might have a sound policy but were affected by the global systemic crisis. How to react to that? If the crisis is “imported” and the country cannot meet its financing needs, the IMF should provide liquidity and contribute to any kind of anti-cyclical adjustment. In that regard, the authorities of leading economies should usefully consider to allow the IMF to issue bonds. In a moment of de-leveraging, when we are talking about re-leveraging, a leveraged IMF would have increased ability to meet its rising challenges.

In regard to the World Bank, it should focus on poor countries, the ones that not only require liquidity or loans, but effectively need financial support. And for both the IMF and the World Bank, a critical question today is legitimacy. And the way emerging market economies are playing a more important role in the global economy – not only they are representing a larger share of world output as compared to before, but also represent at this point a solution for the crisis – it is imperative that these countries have a proportional weight in the governance structure of the two Bretton Woods institutions.

Another fundamental development these days is the increasing role played by the G20, for the very same reason of the growing participation of emerging markets economies in global output. It is clear today that the G7 alone or even the G10 are not able to address all relevant issues that affect the world economy, which are better dealt by a larger group as the G20. Evidently there is always a trade-off, the larger the group, the more difficult its effectiveness. But that is a challenge that we have to face. The first meeting of heads of states of the G20 was an essential step towards making the G20 a more effective decision-making forum.

The next topic is a global supervisory authority. The G20 suggested the creation of a college of supervisors, following a Financial Stability Forum recommendation. President Köhler raised here the idea of having the IMF playing this role. We are in the very preliminary phase of this discussion and many challenges lay ahead in that regard, particularly deciding what should be subject to international supervision and what should be subject to national or regional supervisory entities.

Much of the discussion today evolves around crisis prevention. In terms of crisis resolution, the recommendation is for every country to take all the necessary actions to restore the regular working of its financial system, consumer and investor confidence and the level of economic activity. But every country must act according to its needs and resources. Countries were financial institutions faced severe losses require capital injections, while some countries have to boost domestic demand to compensate for too much dependency on exports. The important point here is to draw a clear difference between fiscal stimulus, liquidity management and monetary policy.

The difference between liquidity management and monetary policy is not clear for many observers nowadays, but it is nonetheless fundamental. In moments of market disfuntionality, for instance, monetary easing sometimes does not work. It is important to mention that in some circumstances liquidity management is the critical issue. Of course, we should not forget the need for price stability in order to have the basis to restore growth.

In this regard and despite recent criticism, inflation targeting continues to be the most appropriate monetary regime to coordinate inflation expectations in both mature and emerging economies, not only providing transparency but also taking due consideration of time lags and uncertainties in the process of monetary policy implementation. In fact, the combination of short-term flexibility with the permanent commitment to price stability embedded in the framework makes it particularly suitable to the current environment.

While disinflation will possibly be fast in mature economies, creating adequate conditions for monetary counter-cyclical actions in different countries, in emerging economies disinflation will probably be slower, particularly where the authorities have not prevented inflation from escalating recently, or where they did not retain a vigilant attitude. In any case, inflation targeting is the most suited framework to coordinate the public’s inflation expectations, particularly in an environment marked by growing uncertainty.