Axel A Weber: Sixty years of Bretton Woods - back to the future?

Summarised address by Professor Axel A Weber, President of the Deutsche Bundesbank, Rome, 23 July 2004.

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Sixty years after the signing of the Bretton Woods Agreement the purpose of international monetary cooperation is as relevant today as it was in the 1940s: maintaining stability. The international financial and monetary system has, however, changed tremendously since Harry Dexter White and John Maynard Keynes devised the Bretton Woods system. The then agreed system of fixed exchange rates ended as early as in the 1970s. In the wake of economic and financial globalisation emerging market economies have been integrated into the world economy. Capital account liberalisation and progress in information and communication technology propelled the development of new financial instruments. Large-scale securitisation ultimately entailed a marked increase in international capital flows with a rising share of private capital flows. The ensuing deepening of international financial relations brought about a host of new opportunities in terms of economic development, investment and finance. However, opportunities and risks are two sides of one coin.

The key question, namely how to maintain stability in a financially globalised world, was highlighted by a series of international financial crises during the 1980s and 1990s. Each crisis was characterised by a very specific and complex set of causes. Macroeconomic policy failure, indebtedness, and financial sector weakness belong to the major ingredients of financial crises. An unsustainable policy mix of monetary policy failing to deliver price stability, unsustainable fiscal policy and adherence to an exchange-rate parity that is out of line with the fundamentals will sooner or later put the currency under pressure. Overindebtedness, be it in the public or private sector, especially if denominated in foreign currency and of short-term maturity, fixed exchange rates and financial sector weakness have repeatedly spawned turmoil in the international financial system.

These crises have proven to be costly in terms of output and welfare losses. Consequently, crisis prevention and cost-containment by orderly crisis resolution arise as key policy challenges. The Bundesbank deems a market-based approach suitable for maintaining stability in the international financial system. In this concept, government at both the national and the international level, establishes an institutional framework that sets incentives for pursuing sustainable policies and prudent risk-taking.

The lessons learnt from the recent episodes of financial distress have considerably expanded our knowledge of the origin, development and spread of crises. On the basis of this, benchmarks and best practices have been described by various bodies. The Financial Stability Forum has assembled "12 Key Standards for Sound Financial Systems", and the G-20, an informal amalgamation of the G-7 countries and large emerging market economies, has conducted extensive research on institution building in the financial sector and drawn useful conclusions.

At the risk of oversimplification, the advice given boils down to sound institutions and sound policies as the main tools for preserving stability. Macroeconomic policy must be geared towards stability - price stability and sustainable public finances - and be consistent with the chosen exchange-rate system. Microeconomic policy needs to furnish the economy with a high degree of flexibility. Financial regulation and supervision are to safeguard the strength of national financial systems. The degree of sophistication in financial regulation and supervision determines the prudent degree of capital account openness. The sequencing of capital account liberalisation needs to start with the more stable long-term capital flows, such as FDI. Volatile short-term capital flows are to be deregulated last. A reliable legal system raises confidence while a high degree of transparency allows rational decision-making by international investors. As to international investors, sophisticated risk management is of the essence.

The implementation of the aforementioned institutions, standards and policies falls predominantly into the realm of national governments. They are subject to multilateral surveillance, primarily by the International Monetary Fund (IMF) by means of Article IV consultations. Multilateral surveillance has been devised to identify potential weaknesses early on. The Bundesbank appreciates that the IMF recently strengthened its surveillance activity in terms of quality by expanding vulnerability assessments and by focusing more distinctly on conclusions and recommendations in Reports on the Observance of Standards and Codes and in Financial Sector Stability Assessments. In terms of transparency, the publication of staff reports of Article IV consultations, which is now almost standard procedure, is to be welcomed. In terms of scope, an improvement has been achieved by covering developments in international capital markets more extensively.

History suggests that, despite all these efforts in crisis prevention, the international financial system will experience rough patches from time to time. A pre-agreed framework for the orderly resolution of financial crises is therefore required. Providing ex-ante clarity on the procedure of debt restructuring is not the least important part of the crisis prevention exercise. The Bundesbank has long been favouring the involvement of the private sector in crisis resolution. Arrangements where the private sector reaps the large profits of risky business while being bailed out in the event of a risky investment turning sour invite imprudent risk-taking, thereby putting the stability of the international financial system itself at risk. Three approaches to private sector involvement compete in the international debate although they are not mutually exclusive but may be combined: Collective Action Clauses, a code of good conduct and a Sovereign Debt Restructuring Mechanism. The Sovereign Debt Restructuring Mechanism was put forward by the IMF but, despite certain modifications, did not appeal to the international community.

Collective Action Clauses (CACs) in international bond issues ensure that an agreement on the restructuring of sovereign debt cannot be undermined by litigating minority investors. This market-based solution is now almost standard in new international bond issues after Mexico went ahead in February 2003. However, CACs can be only part of a solution as they, by their very nature, cannot solve the issue of coordinating a multitude of bond issues by one single debtor, as, for example, in the present case of Argentina. To take account of this problem, it may be advisable to go back to certain elements of the proposed SDRM such as the aggregation of liabilities. We must be aware that the transitional period up to the time when all bonds outstanding contain CACs will span almost three decades.

As a third proposal that was originally forwarded by the Banque de France one and a half years ago, a code of conduct is currently being negotiated between the private sector and governments of some G-7 and G-20 countries. The purpose of such a code would be to facilitate the introduction of certain procedures and a number of recognised principles for governing the very complex debtor-creditor relationship in the event of increasing market tension or acute crises. The code could serve both to keep crises from coming to a head and to make unavoidable debt restructuring run more smoothly. The code, which would not be legally binding, would spell out basic principles about both crisis resolution and crisis prevention. The Bundesbank backs the development of such a code and hopes that consensus can be found soon, maybe as early as this autumn.

If these efforts are to involve the private sector in the process of crisis resolution with a view to delivering the desired result of greater stability of the international financial system, the international financial institutions need to break with their generous lending habits of the recent past. Large-scale lending beyond regular access limits, long-term recourse to Fund resources, and the provision of precautionary lending create moral hazard and counteract the original purpose of advancing financial stability. Furthermore, they have already left the Fund with a very high risk concentration. As liabilities to the international financial institutions now account for a large share of some debtors' foreign borrowing, conflicts of interest between the borrowers, IMF shareholders and private creditors could put the IMF financing mechanism at risk. Ultimately, the entire concept of IMF lending may end up in danger of being undermined.

The Bundesbank therefore welcomes a return to a lending policy more in line with the catalytic role of IMF financing, a policy which the IMF generally endorsed last year. Establishing credible ex-ante clarity about financial assistance is crucial in this respect. The single most important element in a revised lending strategy would be a restrictive exceptional access policy stringently conditioned on acute needs and debt sustainability. Exceptional access must be reserved for only a few true emergency cases. Lending criteria need to be applied without exception. Care must also be taken to ensure that prolonged use of Fund resources does not intrude upon the World Bank's territory of catering to longer-term financing needs for development purposes.

Over the years the IMF has repeatedly expanded its policy of lending to debtors that are in arrears to the private sector (LIA policy). The Bundesbank advocates the establishment and application of transparent and operational LIA criteria and recommends that the regular access limits be respected.

Considerations to install a new precautionary lending facility after the expiration of the Contingent Credit Line should not be pursued any further. Uncapped precautionary lending without acute needs would push the IMF towards the role of a general risk insurer. This would distort creditors' risk assessment, ie invite moral hazard and undermine debtors’ incentives to build strong institutions and to implement sound policies.

The international financial architecture will have to be constantly evolved through formal and informal international cooperation, with a special view to building strong institutions and to creating incentives that propagate stability.