**Do We Need a New Bretton Woods?**

**Talking Points for Cato Institute Monetary Conference Panel Discussion**

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- The worst of the global financial crisis is over and most **crisis countries are in a recovery phase**.

- Nevertheless, there is a clear **consensus that we must improve the functioning of the international system**, because international capital flows to emerging markets have been too volatile, subjecting recipient countries to shocks and crises that are excessively frequent and excessively large, and because there has been too much contagion in the system.

- What should be involved in improving the international system? **Some of the IMF's fiercest critics argue that a new Bretton Woods would be better off without an IMF**. Why? Because of: 1) the inherent conflict between the Fund's role as both a "credit-rating" agency and an agency that works to prevent crises prevents effective surveillance, and 2) the rampant moral hazard the Fund creates through its lending, which together postpone reforms and recovery in debtor countries and therefore increase instability in the system.

- **The view that abolishing the IMF would solve matters is wrong.**

  1. There need not be an inherent conflict that prevents effective surveillance. Indeed strong and transparent surveillance by the Fund can be a crucial tool in encouraging early corrective action.

  2. On the question of moral hazard, the Fund could of course just stop lending. But this solution would ignore the fact that private markets sometimes overreact. As noted above, in recent years, international capital flows have been volatile and we have witnessed the problem of contagion from one emerging country or region to the next. While in Russia moral hazard was an issue, in Asia for example it is difficult to argue that moral hazard was what led to the large capital inflows to the crisis countries in previous years. Thus, it is entirely appropriate for the Fund to exist as a cooperative agency that assists countries deal with shocks and crises "without undue destruction to national or international prosperity" as stated in our Articles of Agreement.

  3. And it should be noted here that the oft-said notion that the purpose of Fund loans is to "bail out" foreign creditors is very misleading. It ignores the fact that in all

recent cases, investors have suffered huge losses in the context of foreign exchange crises.

- **The basic framework remains relevant**--the original purposes for which the IMF was established remain valid and we need an institution to carry them out. That said, as with any 50-year plus entity, we must adapt to the times, particularly to the globalization of capital flows that has taken place. And specifically in response to the recent international financial crisis, we have begun to make significant progress in reforming the international system and the Fund itself.

  And indeed two critical areas for change have been the strengthening of surveillance and how to deal with the question of moral hazard, which notwithstanding the comments above is an important concern.

- **Strengthening the process of Fund surveillance can contribute to reducing the risk and costs of financial crises**. It can do so by facilitating the diagnosis of vulnerabilities to potential crises and the prescription of suitable corrective policy actions. It can also facilitate the assessment of country risk (and thereby help reduce financial volatility) by monitoring the adoption of the various international standards and codes of conduct and helping enforce adherence to them. To this end, efforts have been made to strengthen surveillance in two key respects

  1. First, there have been **efforts to improve the surveillance and monitoring of capital account issues and financial sector vulnerabilities**. In part through joint work with the World Bank, there is much greater emphasis on these issues in our surveillance activities. And there is a greater focus on debt and reserve management practices. The Fund, together with other international financial institutions have taken a number of measures to gather better, more comprehensive, and more frequent data on short- and longer-term capital flows, debt, and official reserve positions. Finally, we have improved our monitoring of international capital markets with more frequent contacts with private market participants.

  2. Second, we are putting a lot of emphasis on **increasing the transparency** of our work and policy advice to countries. This will help ensure greater transparency in the conduct of, and also strengthen scrutiny of, policies in individual countries. And it will also help ensure the quality of Fund analyses by subjecting them to external appraisal. Thus, there has been a tremendous momentum in the last year toward the **publication of Fund documents and staff reports**. This started with the release of public information notices following Article IV consultations, and has been extended to Article IV staff reports, summaries of Executive Board discussions of individual country and general policy matters, key policy papers, and letters of intents and policy memoranda that detail the authorities' policy commitments under Fund programs.

Further significant progress in increasing transparency can be expected in the period ahead.

- No issue has received as much attention in the last year perhaps as how to deal with moral hazard by **involving the private sector in crisis management**. Involving the private sector is also critical in certain cases because of the need to ensure adequate financing of a country's adjustment program. This is a very difficult and sensitive area. There are no set answers or simple framework that can be generalized.

  ▸ The **difficulties arise because of the conflict between providing adequate financing and ensuring burden-sharing** and the avoidance of moral hazard. And in addition, while private sector involvement requires a credible threat of default, one needs to worry about contagion in the event of default.

  ▸ We are at the early stages of an evolving policy, and a variety of approaches have been followed. **So far there is general agreement that**:

  i) **Ex-ante measures would be helpful**, such as the introduction of collective action clauses in new bond contracts. Private contingent financing arrangements should be encouraged as well, although in certain cases these have proved problematic (e.g. Mexico).

  ii) Contracts should be honored whenever possible, and that efforts should be made to reach, to the extent possible, **voluntary restructuring agreements** on the basis of cooperation between debtors and creditors. Defaults and disorderly solutions should be avoided.

  iii) **The role of the Fund in creditor-debtor negotiations should be limited** to analysis of the overall financing needs of the adjustment program and assessment of the consistency of financing packages with medium-term sustainability, with the negotiation of specific agreements left to the debtors and creditors themselves.

  iv) **The Fund should lend in cases where there are arrears to private creditors.** But such lending should be on a case-by-case basis where early support is judged necessary and only if it is judged that the country is making good faith efforts with creditors.

- A lot more is being done in working to adapt the international system:

  ▸ the introduction by the Fund of a new lending facility, the Contingent Credit Line, as a precautionary credit line for member countries meeting certain high standards in a wide range of areas.

- analysis of exchange rate issues, where it seems increasingly clear that traditional pegged exchange rates will be difficult to sustain in emerging market countries with open capital accounts, leading to the increasing adoption of either flexible regimes or very hard arrangements such as currency boards.

- in the area of capital account liberalization, there is widespread acknowledgment that globalization is here to stay. But liberalization needs to be accompanied by adequate strengthening of the domestic financial system and its regulation and supervision. While controls on outflows are generally seen as likely to have long lasting negative effects, price-based measures to discourage inflows may be useful.

- **In sum, the world does still need an IMF**. Not only to deal with international monetary and financial problems in a cooperative setting, and to provide useful technical assistance to member countries, but also to provide effective crisis prevention and resolution through surveillance and lending activities. Our practices will continue to adapt to evolving circumstances to ensure maximum effectiveness.