MOVING TO COMPLEXITY

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As the IMF turns 80, its history holds lessons for future international risk management

The 1944 United Nations Monetary and Financial Conference, held in July of that year at Bretton Woods, New Hampshire, holds out a powerful narrative about how countries may tackle global collective challenges. It stands as the opening of a novel epoch in world history, an age of sustained recovery, widespread prosperity, dynamic growth, crisis-free development, and political stability. Bretton Woods still inspires. Policymakers and academics alike regularly attempt to revive, reinvent, or recast it.

The conference was underpinned, first, by a big political vision of how—as US Treasury Secretary Henry Morgenthau Jr. put it—prosperity and peace are indivisible. Neither could be managed separately from the other. This message came at a time when the whole world was consumed by war: the Second World War was much more genuinely global than the First. The push for a new world order drew lessons from the war: how murderous conflict had been the product of the global economic collapse, the Great Depression; the ensuing political radicalization; and the disintegration of world order into competing blocs.

The United Nations Monetary and Financial Conference, at the Mount Washington Hotel in 1944.

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Second, there was a precise economic mechanism envisaged for managing the world's monetary affairs. Countries were obligated to follow a rule on the exchange rate, and if the rate was threatened they would be assisted by an IMF designed as a credit cooperative, or an insurance mechanism. The intellectual foundation lay in an interpretation of the Great Depression as following from unhindered capital movement, so-called hot money flows. The founding fathers of the Bretton Woods institutions were convinced that such destabilization should not occur again, and the Articles of Agreement provided for continued maintenance of capital controls even during the transition to trade liberalization.

From vision to reality

These underpinnings, political and economic, crumbled, and the broad-brush vision of Bretton Woods was not implemented as its founders intended. It had been envisaged as a genuinely global system, but the Soviet Union—which was powerfully represented at the conference—decided not to ratify the Articles of Agreement. The IMF was excluded from the big US push for European reconstruction, the Marshall Plan. The world was divided by the Iron Curtain. In its first years, the IMF even appeared to be withering away. It really only sprang into life as a result of the mixing of a security and financial crisis in 1956, when the United States was appalled by the intervention of Britain and France in the Suez Crisis and the big European countries faced great financial strain.

Almost immediately a debate developed over whether reserves were adequate and whether there was sufficient liquidity. Economic leaders found stopgap solutions. By the 1960s, as countries struggled over plans to reform the international monetary system, complaints arose that they couldn't see the Bretton Woods for the Bretton trees.

The remaking of Bretton Woods in the 1970s also resulted from the conjunction of a security challenge with an economic and financial problem. The breakdown of the fundamental rule of Bretton Woods, the par value system (which specified an exchange rate), came at the beginning of a push by oil producers to raise prices as well as exert more political leverage. Countries felt vulnerable; democracies were under pressure. The IMF responded with new procedures to use borrowed

resources in support of developing economies hit by higher energy prices—the Oil Facilities.

Capital movement produced new vulnerabilities. In 1982, a debt crisis, most pronounced in Latin America, threatened to bring down the world financial system. At this moment, the IMF started to operate in a new way, as a lender of last resort, as well as a coordinator of rescue packages in which countries would adjust and banks would be bailed in, obliged to put up new money.

Lender of last resort

Fifty years after Bretton Woods, IMF Managing Director Michel Camdessus styled the Mexican peso crisis "the first financial crisis of the 21st century." It followed an unprecedented surge of money into middle-income countries. The crisis of 1994 was quite different from the Latin American shock of 1982, which had also begun with a Mexican problem. There were now very diversified foreign holders of Mexican securities—not a relatively restricted number of banks—who responded quickly to the coalescence of worries about economic overheating and political instability, after a major insurrection and a prominent political assassination in the year of a presidential election. The vast multiplicity of creditors could not be corralled into putting up new money. The obvious answer, a sovereign bankruptcy mechanism, perhaps coordinated and enforced by the IMF, remained elusive. Only a very-second-best approach, putting up large sums of new money, remained—and that persisted as the prevailing philosophy in response to crises produced by volatile capital flows.

The specific crisis was partly resolved by an IMF program, but the IMF on its own did not have enough resources to act simply as the lender of last resort. Mexico also required a large-scale bilateral package from the US, in the form of $20 billion from the Exchange Stabilization Fund, a largely forgotten Depression-era body that conveniently avoided the need for the US administration to get approval from a hostile Congress. The rescue was controversial, and some policymakers argued that it was not proper for the IMF to lend to one country to avoid an adverse effect on another.

The mid-1990s produced a recognition that in the light of the size of capital markets, traditional rescue mechanisms were likely to be inadequate. The lesson was reinforced by the Asian crisis of 1997–98, when all the packages required a mixture of IMF and bilateral funding.

The policy consequences were drawn at the June 1995 Group of Seven heads-of-state meeting in the Canadian city of Halifax, which tried to redefine the tasks of the IMF in light of what would soon be generally called globalization. The summit communiqué called on the IMF to establish benchmarks and procedures for the timely publication of key economic and financial data. The IMF's response was the creation of the Monetary and Capital Markets Department in 2001—designed to "play a central role in the Fund's conceptual work"—together with the publication of the new biannual *Global Financial Stability Report*, born of the merger of the previous publications *Emerging Market Financing* and the *International Capital Markets Report*.

Beginning in the 1990s, there was no longer a clear and simple rule, and no longer one institution at the center of the management of international risks. Both surveillance and crisis management took place in multiple institutions, with overlapping responsibilities and multiple sources of new money. In its financial sector surveillance, the IMF applied the methodologies evolved by the Basel Committee of Banking Supervisors, a group initially representing only industrial countries. In Asia, the Association of Southeast Asian Nations evolved a parallel complementary surveillance mechanism. Bilateral currency swaps under the Chiang Mai Initiative of 2000 were intended to complement IMF operations.

More and more coordination was needed. The response to the Asian crisis was the establishment of the Financial Stability Forum (FSF); in 2009 this group was strengthened and renamed the Financial Stability Board (FSB). The rescue apparatus became the Global Financial Stability Net, with various providers working through regional financing arrangements. The 2009 Group of Twenty London summit repeated a crucial move of Bretton Woods, transferring authority from the central banks that had run the FSF to control by a wider group of governments in the new FSB.

Lessons for risk management

There are several lessons from this complexification of global financial risk management.

First, the threat to stability can come from anywhere. After Mexico in 1994–95 and the Asian financial crisis of 1997, which then spread to Brazil and Russia in 1998, there was a widespread assumption that the shocks would emanate from emerging markets opening up to capital flows. There were no IMF Financial Sector Assessment Programs for the US and the UK, two countries that proved to be at the epicenter of the financial crisis when it erupted after 2007. The IMF was good at seeing threats to a country from the periphery. At the end of 2006, for instance, its staff had prepared a simulation of potential capital market crises in central and eastern Europe. The simulation seems in retrospect to be an

uncannily accurate version of the speculative attack that in 2008 briefly made Hungary look like the epicenter of a new global contagion. The anticipation helps explain the speed and very substantial size of the program agreed with Hungary in 2008. But the Fund's prescience was limited: the IMF missed the much bigger shock that started with the US mortgage market and financial system.

Second, the extent of the threat depends on linkages, which may be difficult to determine in advance with any precision. The aftermath of the 2008 global financial crisis produced devastating critiques, including from the IMF Independent Evaluation Office, that the Fund had "fallen short" on its key objective because of a "high degree of groupthink; intellectual capture; and a general mindset that a major financial crisis in large advanced economies was unlikely." The response was to move, with the 2012 Integrated Surveillance Decision, to joining up previous practices of bilateral and multilateral surveillance. In particular, spillover reports focused initially on the impact of developments in the major economies and then moved to thinking of systemic linkages.

"Security or political issues need to be solved hand in hand with economic and financial challenges."

Third, the precise character of the linkages is often opaque. Managing complexity in a system in which multiple institutions work is not easy. Who looks at the wood, and who measures the trees? The linkage between the microprudential and the macroprudential remained a key source of weakness. What exactly is in banks' balance sheets during waves of financial globalization? What are the links to off-balance-sheet institutions? These are issues individual bank supervisors could analyze but that were not—and could not be—regularly passed on to an international institution such as the IMF. (The Articles of Agreement in fact absolve governments from the responsibility to provide data about specific corporations.)

Consequently, there was a continual strain. The supervisors meeting in the Basel Committee on Banking Supervision in a sense knew more: they could see the individual trees very clearly. The broad-level global approach saw the woods but could not really investigate the trees.

Fourth, long-term challenges may bring immediate threats to stability and thus must be addressed. Climate change—or more generally perhaps the damage done by the Anthropocene—is a major and increasingly difficult challenge, requiring prompt action. It would also be reasonable to be disappointed by efforts so far, and the recent COP28 was widely seen as weak. An insufficiently noted lesson of history is relevant here. Phenomena will remain in the sphere of abstract discussion, nervousness, or concern, unless they can be accurately measured. Providing data about costs is essential to building a consensus about finding solutions.

At the time of Bretton Woods, the World Bank and the IMF could think differently about development because of a framework of national income accounting that had been developed largely in the industrial countries to meet the challenge of mobilizing resources for war. Today, when newspapers report on the twice-yearly IMF–World Bank meetings, they focus on the assessments of GDP development. They think that GDP matters because the IMF still puts that metric at the center. But when it comes to thinking about the biosphere, GDP is a drain rather than an asset; it erodes rather than enhances the long-term wealth of nations.

Fifth, security challenges can also lead to financial destabilization. Today, we are living in a world where security concerns—often loosely described as "changing geopolitics"—dominate economic news: whether the debate at the western end of the Eurasian landmass about Russia's gas provision and pricing or rising tensions around Taiwan Province of China and in the South China Sea on the eastern side. One underrecognized feature of the Bretton Woods settlement is the parallelism between the IMF and the World Bank on one side and the wider United Nations Organization on the other. The largest five members by quota of the Bretton Woods institutions were identical with the five permanent members of the Security Council: the United States, the Soviet Union, China, the United Kingdom, and France. The symmetry was broken when the Soviet Union did not join.

The extended war that followed Russia's 2022 attack on Ukraine produced a new kind of IMF program: an agreement with a country at war. The financing assurance program needed to be changed to take into account the peculiarities of countries facing "exceptionally high uncertainty." The program also required safeguards in the form of assurances from bilateral creditors that they would provide debt relief once the exceptional uncertainty was resolved. Ukraine's suffering sheds new light on the lessons of 1944—that security or political and military issues need to be solved hand in hand with economic and financial challenges. With the Russia-Ukraine war now fought all over the world, most spectacularly in Sudan, conflict and not prosperity is globalized. Finding adequate answers to uncertainties created by conflict is a key step in casting off the zero-sum thinking that in the past led the world to catastrophe. F&D

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