International monetary reform: a regulatory fix

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The prime cause of the crisis is a global monetary order in which currencies are free to misalign. So the obvious idea is to build a system that deals with currency misalignments. Yet there are alternatives. In this chapter, I shall propose one such alternative: a form of macroeconomic oversight which calls on central banks and regulators to join forces and together watch for signs of nascent systemic risks and act to prevent disruptions.

The chapter is structured around three themes. First, what have been, historically, the conditions for the proper functioning of a true international monetary system? Second, is it possible to recreate such conditions? And third, absent a positive answer to this last question, what can be done?

So, what have been the key elements of the functioning of the gold standard and, later, of the dollar exchange standard under Bretton Woods? The gold standard that stabilised exchange rates in the second half of the 19th century and up to the first world war, and played an important role in fostering economic growth, was built on three pillars. First, the adoption by states of the gold standard was voluntary. However, larger countries, which were at the time relatively balanced in terms of geopolitical power, chose to make their currencies convertible, which was a key element for their trade and financial influence worldwide. Second, the system was self-disciplinary: protracted balance of payments deficits were sanctioned by gold losses and were corrected by adequate policy adjustments. Third, the system could not be negotiated or tinkered with. It was a binary one: either the currency was convertible into gold or it was not. In the latter case, it could not become a reserve currency or an instrument for international payments.

Flaws

This system was far from perfect. It relied on the production of gold for providing liquidity to the world, although the pace of gold extraction could not be an adequate determinant of sustainable growth. It was also asymmetric (the countries in surplus could accumulate gold without facing sanctions, while the deficit countries were the only ones who had to adjust).

The gold standard that formed an essential element of the first globalisation broke down with the 1914 war. Efforts to rebuild it were made in the 1920s and 1930s, but to no avail: nationalism, beggar thy neighbour policies, capital controls and competitive devaluations prevailed – with all the dramatic consequences that we know too well.

With Bretton Woods, an indirect form of the gold standard was established after the second world war. The dollar was the centre of the system: all par values were determined by a fixed but adjustable link to the dollar. The *quid pro quo* was that the dollar was convertible into gold (at a fixed price).

This system survived as long as the United States followed a stable and non-inflationary economic and monetary policy. But in the 1960s, the Vietnam war and the financing of the welfare state created large deficits and, in turn, a loss of confidence in the dollar. The pressure on the US gold reserves eventually led the administration to break the link between the dollar and gold in August 1971.

A great moderation?

A world of floating currencies, some being more or less pegged to the dollar, has prevailed since then. After a decade of high volatility and inflation in the 1970s, the period of the Great Moderation began in the 1980s when the chair of the Federal Reserve, Paul Volcker, put a crush on inflation. Productivity gains stemming from technological changes and central banks' independence were also important factors. However, in the 1990s, the Great Moderation became to some extent an illusion. Much of the reduction in inflation was the consequence of low wages contained in emerging market exports. In fact, monetary policy of the advanced countries was too loose with real interest rates hovering around zero. The explosion of credit and of leverage – favoured by those low interest rates, deregulation and external imbalances – led to a strong expansion of the money supply in the run up to the 2007–08 crisis. All this did not amount to a system. Indeed,