

The demise of the Bretton-Woods system

explains in great part our present problems.

or : “ From one book to another ”

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When I suggested this talk to my friend Jordi Gual, I was about to publish an essay on : “The 10 mistaken consensuses” or “prejudices” that have inspired the mainstream thinking of professional economists over the last 50 years and have thus shaped up “decision makers” policies, policies that have produced the results that we can see today.

It is my view (a view that, I hasten to say, is not shared by the main “consensus”) that the dramatic financial evolutions that have unfolded over the last four decades or so (i.e. : overleveraged economy, excessive reliance on easy money, very low interest rates, exacerbation of financial cycles, ...) have a common origin : the demise of the Bretton Woods system.

I have lived through the breakdown, in 1971-73, of the post-war exchange rate system. This episode is described in my “Memoirs” (“50 years of financial crises”). While reflecting, later, on those events, it became clear to me that the abandonment of the Bretton Woods system was bound to have profound consequences that were not understood at the time and are still largely underestimated today.

Therefore, I thought it might be interesting to refer to those two books in order to try and understand the process that lead to the weakening as well as the oversizing of financial markets.

I will organize my remarks around two headings :

1. What have been the far-reaching consequences of the demise of Bretton Woods system ?
2. How can this explain the dramatic “undercurrents” and growing structural imbalances with which we are saddled today ?

I – The far-reaching consequences of the demise of Bretton Woods

The demise of the Bretton Woods system has entailed deep and far-reaching consequences for our societies.

Indeed, one has to understand that the International Monetary System created in 1944-45 was much more than a set of technical rules on exchange rates.

It was, in fact and foremost, a way of maintaining a common framework for stability and a coordinated economic policy stance among the major players of the international system. If a member country decided to follow a policy at odds with the common understanding (for example by running large fiscal deficits or huge credit expansion in order to try and reach higher growth), the exchange rate of such a country came inevitably under pressure : capital flights and inflation would weaken its balance of payments as well as its exchange rate, which would be pushed against the limit of the 1% authorized fluctuation band.

At the time, the country in question could not easily devalue : it had to request from the IMF the permission to do so. And, under the Fund conditionality, its economic and monetary policies had then to be adjusted in order to regain the common implicit anti-inflationary stance. The system did not allow “free riders” nor the competitive and repetitive devaluations of the 30’s that had contributed to the run up to the Second World War.

It was precisely to avoid that common discipline that the US, on August 15th 1971, decided to put an end to the convertibility of the dollar into gold. They wanted to finance the Vietnam war through deficit spending and recover their freedom of manoeuvre that was severely constrained by the Bretton Woods system - as well as by the limits of their gold reserves. The “ Triffin dilemma ” had to be surmounted.

At the time, the economic profession was very much in favor of getting rid of the exchange rate stability system.

The “consensus” developed the famous theme called the “trilemma”.

According to that view, a country could not pursue at the same time the three following objectives :

- ✓ The autonomy of its economic policy in order to maximize growth,
- ✓ The freedom of capital movements (which was supposed to be a major growth factor) ;
- ✓ And the fixity of the exchange rate.

One element had to give : it was the exchange rate fixity.

It was added that a floating rate system had other virtues :

- ✓ It would help – through exchange rate depreciation – debtor countries to regain their competitiveness ;
- ✓ It would also encourage – through currency appreciation – creditor countries to adjust.

But, in fact, the 1976 Jamaica agreement, result of the international negotiations, was very different from the theoretical pattern. The total freedom for countries to choose their exchange rate regime - principle that was enshrined in the IMF Articles of Agreement - was misused. Creditor countries were afraid to lose their competitiveness if they allowed the market to drive up the appreciation of their exchange rate. Therefore they intervened heavily by buying dollars to prevent such an appreciation.

The result was fourfold :

1. Creditor countries accumulated huge reserves in dollars, thus expanding massively international liquidity (this has been a major source of international liquidity creation) ;

2. The US could easily finance its structural deficits without having to suffer the impoverishment that would have been the inevitable consequence of a true floating system (imported inflation through the dollar exchange rate depreciation was thus avoided) ;
3. The economic policy coordination, at the heart of the Bretton Woods system, had disappeared. The expectations that had been anchored on a stable exchange rate system had been replaced by a “non system” in which each country could intervene as it wished on the exchange rate market ;
4. And most importantly, structural reforms could be postponed since it had become so easy to borrow under the new system. The name of the game, since the early 80's, became : “Borrow as much as you can and wish. You do not have to worry about your exchange rate. The market will take care of that.”

II – The fragilities of our present financial system are largely the result of the demise of Bretton Woods

Many manifestations of overborrowing have been surging since then. A few examples :

- ✓ Official reserves jumped from :
2% of world GDP in 1969 (less than 1 trillion \$)
to 10% in 2011 (5 trillion \$)

i.e. a multiplication by more than 5 in real terms in 40 years.

- ✓ Non-financial private credit more than doubled from 2000 to 2016 ;
from 52 trillion to 105 trillion (outstanding) ;
- ✓ From 2000 to 2007 credit has grown around 5% yearly i.e. twice as much as economic growth rates.

This evolution towards more and more financial products and services was facilitated by deregulation and financial innovation that flourished since the early 80's. This resulted in :

- ✓ Huge leverage in the economy, accompanied by a growing fragility of the financial system (lending institutions as well as borrowers get weaker and more subject to the vagaries of the credit cycles when the amount of debt gets out to control). In that respect, let us not forget that the over extended financial system in 2007 has been the major factor behind the crisis ;
- ✓ A systematic postponement of structural reforms since easy and cheap borrowed money was available after the demise of Bretton Woods.

What is strange is that far from being the object of study, criticism or, at least, questions or concerns, the present financial system has been theoreticized and generally approved by the mainstream views of economists ("Washington consensus"). The "Washington consensus", established in the 80's was founded on two dogmatic beliefs : 1) The development and integration of financial markets were supposed to foster economic growth ; 2) Markets are rational and self correct themselves rather quickly in case of deviations from fundamentals. The first belief has never been empirically proved. As for the second one, the 2007/8 crisis has shown abundantly its inanity.

Thus a growing gap has been created between "reality" and the "beliefs" that underpin present paradigms.

My last book gives 10 examples of such mistaken consensuses or "prejudices". The discrepancy between beliefs and objective and factual observation is all the more concerning that policy-makers have been following systematically the new "mantras" without much second thoughts.

Let me give you a few illustrations of what I am saying :

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1. *“Money creation and accommodative monetary policies are good for growth” says the consensus.*

In fact, observation shows that abundance of money eventually distorts and weakens the financial system more than it stimulates growth. It is now widely recognized that the cause of the 2007-2008 crisis was the result of excessive debt.

The “Keynesian” policy of deficit spending can help to revive demand. But, if pursued for long, it can create, with the passage of time, over-extended debt situations and, therefore, financial fragility.

Asset bubbles are an intrinsic consequence of QE¹.

It is interesting to observe that the efficiency of the Keynesian stimulus policy depends very much on the state of public finances (more or less debt) when the stimulus starts operating.

2. *“Low interest rates (even negative) are good for investment”.*

An objective study shows that extremely low interest rates for long periods do not foster investment, but they encourage preference for liquidity (hoarding) which is problematic in terms of investment. Keynes shows that interest rates should not be too low and below what he called “a minimum acceptable rate”.

3. *“High public debt “is not a major problem”.*

Empirical studies show, on the contrary, that beyond certain thresholds (80% of GDP) public debt is accompanied by significantly less growth than in less indebted countries. I could add that the huge amount of deficit spending introduced in many countries after the 2007-2008 crisis has significantly increased their public debt. This is affecting their future economic performance and their fiscal sustainability.

A country like France with a public debt of 100% of GDP is saddled with a high unemployment rate (10%) while others – more frugal budgetary wise – combine full employment and fiscal discipline.

¹ See Tanzi's recent paper : « *The limits of stabilization policies* ». *Acta Economica* Vol 68 – 2018.

4. “ The solution to the “pay as you go” pension problems is the creation of a point system ”.

In fact, because of the ageing of population (1,8 active workers for 1 retiree in 2015 against 5 active workers in 1950), we must increase (to 65-67 years) the age of retirement. The technical advantage provided by the “point system” is not the solution to the demographic fundamental issue.

5. “ The European Monetary Union will facilitate a harmonious development of all members ”.

Contrary to a rather common view, the creation or the existence of a European Monetary Union cannot by itself facilitate the solution of structural problems and foster an increase in productivity.

And I could go on and on ...

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Since the fall of Bretton Woods a profound change has occurred : the international world has entered the era of a “debt driven” economy. Own funds and equity are meticulously “optimized”, regulation wise, or handed over to shareholders through share buybacks and kept at a minimum while liabilities, carrying low interest rates are increased as much as possible.

A graph extracted from CAIXA BANK Research (2017) and that I have reproduced in my book says it all.

It shows that the major destabilization force in the US (and in the world) has been the growing gap between credit expansion and potential growth. That curve – expressing the expansion of credit above potential growth - is strongly ascending while inflation and economic growth trends are stable when they are not declining.

In other words, credit has outpaced potential growth. Before the demise of Bretton Woods, credit expansion and economic growth used to move more or less at the same pace. But since the end of the 70's, credit expansion (more than 5% a year) has reached two times the average rate of economic growth. This has led to the oversizing – and to the predominance – of financial markets (“financiarisation”).

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In conclusion, I am tempted to say that the “libertarian” nature of our financial system has resulted in huge and unstable markets. In contrast with the first 25 post second world war years (1945-1970) when governments were responsible for the external value of their currencies, the game completely changed. Currency value is now determined by the markets as well as by government intervention and markets have become the driving force of economic policies. It is worth noting that all recessions since the 80's have been the result of financial disruptions while in the past they were the manifestations of the unfolding of the real economic cycles.

Could we go back to Bretton Woods ?

I do not think that an identical return to the Bretton Woods system is possible nor desirable : indeed the system was too mechanistic and asymmetrical (since it penalized debtor countries and favored creditors).

This being said, it would be highly desirable to stabilize intelligently the exchange rate system. That is far from being impossible. Mechanisms exist and could be used : a basket of major national currencies should be established and an approved authority would see to it that the relationship between those currencies would be under its close surveillance and that short term disruptive capital flows would be reined in.

But such proposals require political will and leadership.

For the time being, nothing seems to be moving in that direction.

The major players of the world economy (like the US, China, Japan) find the present “non-system” suitable. The Americans can live and grow while borrowing more and more. As for the net exporters, they accumulate dollars while taking advantage of the amount of economic growth stemming from their exports.

In the framework of this fragile balance of national interests, I don't see, for the moment, any will to reform things in a multilateral way.

The element of policy cooperation – and of apparent reduction of national sovereignty that is inherent to the restoration of an exchange rate stability mechanism - does not seem compatible with present nationalistic policies.

In other words, governments believed that by abandoning Bretton Woods they had, at last, recovered their freedom of choosing their policy mix. In fact they have yielded their autonomy to the markets by borrowing massively.

Jacques de Larosière

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