Jacques de Larosière

LONDON SCHOOL OF ECONOMICS

CONFERENCE ON FINANCIAL RESILIENCE

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The demise of the Bretton-Woods system

Explains Much of Our Current Financial Vulnerabilities"

or : " From one book to another "

When I accepted your kind invitation, I had just published 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 global 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 intersesting to refer to those two books in order to try and understand the process that lead to the weakening as well as to 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 monetary 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 so that the country could regain the common implicit anti-inflationary stance. The system did not allow “free riders” nor the competitive and repetitive devaluations of the 30’s which 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 manoeuver that was severely constrained by the Bretton Woods system -

as well as by the limits of their gold reserves. The "Triffin trilemma" had to be surmounted (at the time, dollars held by foreign Central Bank were worthier in the value of US gold reserves. So the convertibility of the $ in gold had become impossible).

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 new IMF Articles of Agreement - was misused. Creditor countries were afraid to loose 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.’’

This “non-system”, I should say “this anti-system”, is having far reaching consequences on our so called multilateral system.

1) It is eroding confidence in money at large and in the dollar. The more accumulation of indebtedness, the more uncertainty and less confidence. Mrs Judy Shelton is right to draw our attention on the huge increase in 2018 of net buying of gold by Central Banks (………………..).

2) The “non-system” allows “nationalistic” strategies from the external value of currencies, which is a root cause of trade distorsions and “bigger thy neighbour” policies.

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

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

- ✓ Official reserves in US $ 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 that started in the 80s and financial innovation. 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 of 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, perhaps 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.*

I will not delve into a comprehensive analysis of the advantages and the drawbacks of an accommodative monetary policy. It would need too much time.

But let me state a few following points :

a) The easy monetary policy of the past years has encouraged credit expansion (US Fed Fund rates have been negative in real terms during 12 years from 2000 to 2017). A huge credit expansion has been the main cause of asset bubbles and of the crisis.

b) Pursued for too long, an easy monetary policy acts as a drug : the longer the bonanza, the more difficult it is to reverse gears and to normalize.

c) A systematic inflation target of 2% in terms of the consumer price index, as the one that has been followed over the last 20 years or so is at odds with some fundamental trends that have lowered the inflation environment of the world (ageing populations, trade open to low wage imports from China ...). If the target had been set in a more credible way (lets say at around 1%) monetary policy would have been significantly less accommodative and more pertinent.

d) Monetary policy has been asymetric : immediately relaxed at the first sign of economic slowdown, but tightened with much less haste.

e) In fact, with QE, Central banks have been the major buyers of Treasury securities. Thus they have acted – de facto - as the fiscal arm of Governments and have taken a large part of fiscal responsibility, which has blurred their independence.

f) Observation shows that abundance of money eventually distorts and weakens the financial system more than it simulates growth. It is now widely recognized that the cause of the 2007-2008 crisis was the result of excessive debt. Asset bubbles are an unavoidable consequence of QE.

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 are basically in line with marginal return on capital and should not be too low and below what he called "a minimum acceptable rate".
In spite of very accommodative monetary policies, investment growth in the EU has been lagging over the years : 1% on average from 2010 to 2017 (3% in the US).

3. *" High public debt " is not a major problem ".*

Empirical studies show, on the contrary, that beyond certain thresholds (around 80% of GDP) public debt is accompanied by significantly less growth than in less indebted economies or in countries that have decided to reduce their public debt. 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 as well as 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.

For sure the "Keynesian" policies focusing on the need to simulate domestic demand in cases of recession have been a major breakthrough in policy making.

But one must understand that structural factors can – and do – reduce the efficiency of the multiplier effect.

I will cite just a few :

- ✓ The effectiveness of the stimulus depends very much on the state of public finance (more or less public debt) when the stimulus starts.

Since Keynes times, public debt has enormously increased and it is clear that an over-indebted country has less margin to use budgetary deficit spending and that negative externalities stemming from larger deficits will reduce the impact of stimulus.

- ✓ Labour rigidity and too little job mobility can also jeopardize fiscal stimulus policies[1].

A stimulative policy in an open economy that has lost its competitiveness will lead to more imports than to increased local output.

The issue is more complex than " Do we want fiscal stimulus or not ? ".

In order to pursue the effectiveness of stimulus we need to remove the obstacles that distort the appropriate ecological environment for growth.

There are countries where productive capacities have been stifled by excessive taxation or social contributions, for example. Such enterprises are sometimes unable to take advantage of a given stimulation.

Asset bubbles are an intrinsic consequence of QE (see note 2).

In a recent article[2] the Nobel laureate Edmund Phelps shows that the speed of economic recovery after the crisis was faster in Germany, Switzerland, Nederland (who used relatively little fiscal stimulus) while in Italy, France, Portugal, high stimulus was accompanied by low growth :

"Big deficits did not speed up recovery".

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[1] *See Vito Tanzi's article " The limits of Stabilization Policies " - Acta Oeconomica 2018.*

[2] *Wall Street Journal (October 29, 2018) Tanzi's recent paper : « The limits of stabilization policies » - Acta Oeconomica 2018.*

One of the reasons of this relative inefficiency of fiscal stimulus is lack of business confidence and of dynamic investment which are not determined by fiscal deficits.

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 and the increase in life expectancy (1,8 active workers for 1 retiree in 2015 against 5 active workers in 1950), a country like France 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 their rather common view, the creation - or the existence - of a European Monetary Union cannot by itself facilitate the solution of structural problems and foster increase productivity. The Euro is not, in itself, an agent of integration, but, rather, it shows up a manifestation of divergencies.

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” or handed over to shareholders through share buybacks, and kept at a minimum compatible with regulation while other liabilities, carrying low interest rates, are increased as much as possible. In banking balance sheets, non deposit resources have become predominant over the last four decades.

A graph extracted from CAIXA BANK Research (2017) 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. The curve

that is expressing the expansion of credit above potential growth - is strongly ascending while inflation and economic growth trends are stable or declining.

In other words, credit expansion has outpaced potential growth. Before the demise of Bretton Woods, credit 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 lead to the oversizing – and to the predominance – of financial markets ("financiarisation"). The share of the US financial industry has doubled in real terms since the end of the 70's. (from 4% to more than 8% of US GDP).

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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 world war years (1945-1970) when governments were responsible for the external value of their currencies, the game has 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.

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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. The authority should also see to it that short term disruptive capital flows should be reined in.

In a more ambitious perspective, one could think of reviving Keynes's and Triffin's ideas and move towards a truly multilateral monetary system. In such a system, the IMF would control and adjust the global supply of reserves (including private credit) and issue, for external transactions, an international currency in line with world trade needs and with low inflation. Gradually, this would bring an end to the present drawbacks of national currencies playing the exclusive role of the international reserve of the world system that has shown abundantly its drawbacks.

But such proposals require political vision, 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. And, of course, financial operators are perfectly happy.

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.

In the words of Edmund Phelps[3] :

[3] *Misused theories behind Trump's economic policies.*

« The fundamental problem of our time is the "Great Western Slowdown for the last 50 years ».

The symptoms are :

- ✓ Weak investment,
- ✓ Falling rates of return to investment,
- ✓ Poor productivity gains,
- ✓ Declining job satisfaction,
- ✓ Disappearance of "exhilarating growth".

It is clear that these issues cannot be resolved by monetary or fiscal stimulus.

The huge rise in government debt will require greatly increased taxes in the future.

The enormous rise in money creation and liquidity are inflating asset bubbles, destabilizing financial markets and hurting business confidence and, thus, entrepreneurship, which is not good for economic growth.

Jacques de Larosière

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