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I shall divide my remarks in two parts :

1) The consequences of the lack of a proper international system ;
2) How to avoid trade wars ?

I – The absence of a "proper" international monetary system

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 dilemma" had to be surmounted (at the time, dollars held by foreign Central Banks were worth twice 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 of floating rates. 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. And this was permitted.

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, perhaps 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 “.

Since the fall of Bretton Woods a profound change has occured : the international world has entered the era of a “debt driven” economy.

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 has reached two times the average rate of economic growth.

This has led to the oversizing – and to the predominance – of financial markets (“financialization”). 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).

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.

We should draw our attention on the huge increase of net buying of gold by Central Banks since 2018 ;

2) The "non-system" allows, through monetary policy moves, "nationalistic" strategies for the external value of currencies, which is a root cause of trade distorsions and "beggar thy neighbour" policies[1].

<u>II – The lack of a proper international monetary system has triggered "currency wars"</u>

The question is no more :

" Will there be currency wars " ?

Actually, we have already been in such a situation for some years.

After the 2008 crisis and because of the subsequent recession, the Fed lowered its Fed funds rates to almost zero and engaged in three episodes of "quantitative easing" with the aim of lowering short and long-term interest rates.

This easing of US monetary policy led to a weakening of the US dollar, weakening that was welcomed by most US policy makers (because a lower $ increases demand for US products, and helps raise inflation ; it also reduces the value of $ denominated US debt).

However, other countries did not welcome the appreciation of their currencies implied by the $ weakness.

Two types of reactions were observed :

- ✓ China and other creditors bought dollars to keep their competitiveness and the pretext was : building reserves to prepare for future crisis ;

- ✓ Mimicking the monetary policy actions of the Fed (cf ECB, the BoE and the BoJ, followed suit and also engaged in Quantitative Easing) with the pretext to react against the shortfalls of inflation in terms of the target.

[1] *QE started in the US in 2009. It entailed a low dollar relative to the Yen. That led to QE in Japan in 2013 which weakened the Yen. Then, the Euro followed suit in 2014 which depreciated the Euro …*

When the US Quantitative Easing started in 2009, it entailed a lower $ relative to the Yen. That encouraged Japan to introduce QE in 2013 which, in turn, weakened the Yen. Then the Euro followed suit in 2014, which led to a depreciation of the Euro.

The last (September 2019) ECB accommodative turn has led to a fear of a Euro depreciation and to an immediate US complaint about exchange rate manipulation in Europe.

This story shows that it is the US that sets the stage for world monetary policy. The Fed acts nationally but there are overspills and contagion. In fact, no one is bold enough to depart from US monetary ease : the sanction would be an appreciation of the currency of the would-be “conventional” deviating country. This is one of the reasons why the world has embarked on a universal wave of monetary accommodation for the last decade.

We had thought that we were liberated from the Bretton Woods constraint since 1971-73. In fact, the fear of exchange rate appreciations is always there and the exchange rate has re-invited itself in the functioning of the IMS. But in a rather crude way.

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Actually, we have never been, since the end of World War 2, as close as we are today, to the dangers of the currency wars of the 30’s.

Against this background, I believe it is overdue to look not only to trade issues (reform of WTO) but also to the international macroeconomic setting in which we live.

No one wants a repeat of the “beggar thy neighbor” policies of the 30’s. But, in order to avoid such a repeat, we should be working on an adequate action plan that should go further than a “Plaza type” agreement. We would need to address fundamental and concrete questions :

- ✓ Is the provision of world liquidity through the exclusive dollar creation adequate ?

- ✓ How can we introduce some element of discipline in the system along Triffin's inspiration ?

- ✓ How could one organize a "multilateral surveillance" of exchange rates (powers to be given to the IMF) ?

- ✓ How to deal with - and possibly resort to - capital controls ?

- ✓ How to enforce more symmetry in the treatment of balance of payments surpluses and deficits ?

The idea is not to replicate identically Bretton-Woods (which has many drawbacks, in particular its turning a blind eye to structural surplus countries), but to imagine and introduce some elements of discipline in the system.

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. A more ambitious idea would be to anchor exchange rates (with some flexibility) on a benchmark of basic commodities (including gold).

Such an effort is overdue. It would require a modicum of skill and imagination and quite a lot of leadership especially from the US. I believe the US – the country issuing the international currency - , would eventually benefit from a more orderly system, and would be better off than it is now, reacting to each allegation of currency manipulation by tweets and unilateral trade tariffs retaliation.

It is time the largest players in the system start talking to each other – in an informal way at the start – on these fundamental issues.

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