50th anniversary of the flexible exchange rates 1971-2021

The end of Bretton Woods

The shock : August 15th 1971 – unilateral decision by President Nixon to sever the link between gold and the dollar.

I) Bretton Woods was more than an exchange rate regime:

It was a cooperative and disciplinary mechanism that was supposed to avoid excessive inflation : a country that wanted to inflate its economy was quickly subject to a depreciation of its currency : therefore it had to discuss its devaluation with the IMF.

It worked through the Fund's conditionality.

II) The "triangle of incompatibilities"

The best system was supposed to combine : freedom of economic policies and freedom of capital flows (but no fixed exchange rates).

III) In fact, the system did not work as envisaged :

- no discipline, absolute freedom
- debt became out of control (global debt - IIF figures - has reached 300 Trillion $ = 360% world GDP),
- countries started intervening : creditors to avoid loss of competitiveness, debtors preferred supporting their exchange rate by borrowing rather than adjusting or accepting deep devaluations ;
- External stability of a currency : no more a national problem. The market is now in charge. Each country acted as it wished ;

- emerging economies (EM) paid a high price : as soon as advanced countries lowered interest rates to support their economy, carry trade produced capital inflows in Emerging Markets, which strengthened their exchange rate, creating the dilemma : intervene but face inflation or let the exchange rate go up, and lose competiveness.

IV) The systemic problem ;

- Given the uncontrolled amount of indebtedness, the global economy is now morer and more dependant on the financial conditions initiated by the most important countries ;
- The vulnerability of financial markets is a permanent danger in terms of global instability ;
- The abuse of the "privilege of the dollar" made the system weak. Foreigners accumulated dollars and financed US deficit ;
- The EM are particularly fragile and subject to the vagaries of financial markets ;
- There is no proper "system", but the addition of national objectives and initiatives, which is an invitation to compartmentalization and protectionism (currency wars, loose monetary policy : contagious for exchange rate purposes….).

We need a proper system but:

- no political consensus (the big ones prefer the freedom of the statu quo) :
- and it is tough to get out of the debt trap in a situation of over indebtedness : one needs growth(that has been hurt by the absence of structural measures and by the lack of productive investment, both encouraged by low interest rates) as well as some element of inflation – "but not too much" - which is not happening.

In the future, new economic powers (China) will eventually influence the system. That will probably evolve towards a multipolar frameworks.

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