THE DEMISE OF THE BRETTON-WOODS SYSTEM EXPLAINS MUCH OF OUR CURRENT FINANCIAL VULNERABILITIES

Speech delivered by Jacques de Larosière during the G7 High Level Conference, Banque de France, July, 16th 2019

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.

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.

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? What could be done to restore a more normal international system ?

1. 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 dilemma" had to be surmounted (at the time, dollars held by foreign Central Bank 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.

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. 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.

2. The fragilities of our present financial system are largely the result of the demise of Bretton Woods

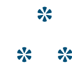
Many manifestations of overborrowing have been surging since then. A few examples:

- Official reserves 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).

This evolution towards more and more financial products and services was facilitated by deregulation that started in the 80's 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);
- A systematic postponement of structural reforms since easy and cheap borrowed money was available after the demise of Bretton Woods.



Just a few words on the – mistaken – consensuses that have flourished since the demise of Bretton-Woods.

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 just state one point:

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, encouraged by Monetary Policy. 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). Zero rates reduce the "risk signaling" element of interest rates.

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.

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;

- 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 can lead to more imports than to increased local output.

Asset bubbles are an intrinsic consequence of QE (see previous paragraph).

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, Netherlands (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".

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. "Free capital movements are good for growth"

As Mr Villeroy de Galhau has just said, capital flows can be disruptive, feed bubbles and destabilize the financial system.

Since the fall of Bretton Woods a profound change has occurred: 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 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).

Could we go back to Bretton Woods ?

I do not think that an identical return to the Bretton Woods system is possible nor even 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.

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:

« 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 is inflating asset bubbles, destabilizing financial markets and hurting business confidence and, thus, entrepreneurship, which is not good for economic growth.

[1] See V. Tanzi « The limits of stabilization policies » - Acta Oeconomica, 2018.
[2] Edmund Phelps, "The fantasy of fiscal stimulus", Wall Street Journal, 29 October 2018.