

Bretton Woods and the IMS in a Multipolar World?

Keynote Speech

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I would like to thank the organizers of this conference for having asked so many eminent experts to focus on a subject – the International Monetary System (IMS) – that often nowadays tends to be overlooked.

Much of what I intended to say has been – much better than I could have done – expressed over the last two days.

I will, therefore, be as simple and direct as possible and divide my remarks in three headings:

1. Basically, an IMS is a set of rules that result in the harmonization of monetary policies of different countries participating in the system. Historically, such systems have relied either on a “real” external anchor, like gold, or on a national, dominant, currency;
2. After the demise of the Bretton Woods system, Central Banks have, eventually, resorted to inflation-targeting. But this approach, although generally applied, has not resulted in a de facto IMS, and has failed to bring financial stability to the system;
3. Given the present conditions (the rise of capital movements, the innovations in the financial markets, the emergence of new players, the shaping up of a multipolar world...) how could a true IMS be conceived?

1 An IMS always Tends to Harmonize National Monetary Policies

When different countries – different by their size, productivity, resources etc. – get heavily engaged in cross-border trade, they usually feel the need to dispose of an international currency, in order to facilitate commerce and eliminate permanent uncertainty on exchange rates. Economic agents need a currency to help them settle their transactions and store reserves for future business.

This can be an externally based currency like gold or a – dominant – national currency as was the pound sterling, and later on, the dollar which was chosen to be the anchor of the Bretton Woods system after World War 2.

But in both cases, the existence of a common single yardstick exerted a unifying pressure on national monetary policies. Indeed, if a national central bank was tempted to reduce inordinately its interest rate, or to issue “too much” money (in relation with the policies conducted in the center), it was quickly brought back to a more “common” and compatible monetary stance by the very rules of the IMS. Either nationally held gold would leak out of the more accommodating country, or its currency would be pushed into devaluation, which was strictly monitored and restricted under a fixed exchange rate system à la Bretton Woods.

We know that changes in external imbalances are fundamentally determined by the variations of net domestic assets of a country’s financial balance sheet (i.e. credit extended to the economy and to the State). Therefore, any IMS results in the enforcement of a common monetary policy by national States abiding by the “system”. That policy is influenced itself by the quantity of the stock of monetary gold or by the monetary stance followed by the center.

Of course, many countries did not enforce the rules nor respect the discipline of the IMS. But, in that case, these “outer” players could not benefit from the advantages stemming from the convertibility of their currency and from the inflows of international capital because of the uncertainty of their national exchange rate.

In a way, one could say that the IMS was in fact a cluster of individual monetary policies compatible with the stability inherent to the system.

2 Inflation Targeting Has Failed to Achieve Financial Stability. Since the Demise of the Bretton Woods System, there Has Been no Proper IMS Able to Harmonize Monetary Policies

When the Bretton Woods system collapsed in 1971 (with the unilateral US decision to sever the link between the dollar and gold), central banks had, seemingly, regained freedom in their approach to monetary policy.

Many economists thought, for a time, that through a floating exchange rate system, central banks would achieve more adequately their national goals in terms of monetary stability and growth.

In fact, what happened was that the discipline of the IMS anchor had disappeared while nothing had replaced it.

The end result was more monetary ease, more inflation and more exchange rate volatility.

Of course, national monetary stances were different from one country to another. These differences favored balance of payments imbalances and capital movements.

The inflation of the 1970s cannot be understood without taking into account the breaking down of Bretton Woods.

A world of floating currencies, some being more or less pegged to the dollar, has prevailed since then. After a decade of high volatility and inflation in the 1970s, the period of the “Great Moderation” began in the 1980s when the chair of the Federal Reserve, Paul Volcker, put a crush on inflation. Productivity gains stemming from technological changes and central banks’ independence were also important factors. However, in the 1990s, the Great Moderation became to some extent an illusion. Much of the reduction in inflation was the consequence of low wages contained in emerging market exports. In fact, monetary policy of the advanced countries was too loose with real interest rates hovering around zero¹. The explosion of credit and of leverage – favored by those low interest rates, by deregulation and by persistent external imbalances as well as by an inappropriately exclusive single monetary tool: “inflation targeting” led to a strong expansion of credit and of the money supply in the run up to the 2007-08 crisis. All this did not amount to a system. Indeed, there was no common discipline applied to reduce external imbalances. Each country was free to float or peg its currency to another one; and the dollar, as the primary international currency, gave the Fed a predominant influence on world monetary conditions.

The results of such a situation are volatility, persistent imbalances, disorderly capital movements, currency misalignments, and eventually currency wars and capital controls.

If one reflects on the monetary setting of those last fifteen or twenty years, one cannot just say that it amounted in a “non-system”. It was actually much worse: it amounted to an “anti-system”.

This is to say when countries are free to peg their currency to another one, (or to peg it partially), in order to preserve their competitive advantage, the system is bound to run into problems. The systematic intervention on the exchange rate markets by creditor countries has considerably contributed to increase world liquidity and to lower interest rates, thus helping the massive over-leveraging of the financial system.

So we had no system: Central banks were focusing exclusively on a misleading yardstick (ex- post CPI targeting) while they turned a blind eye to the massive and artificial expansion of credit, to the formation of huge asset price bubbles² and to the new mindset in which liquidity was understood as access to credit. And there was no interest in multilateral surveillance of macroeconomic policies. Imbalances were

¹ Fed Fund rates were negative in real terms from August 2002 to February 2005.

² Real house prices rose by more than 70% in the years 1996–2006. Income and population growth in this period would not have warranted any extraordinary increase in demand (Dean Baker “International Economy” fall 2013).

huge and structural, but they were financed more and more smoothly with innovative products. So why bother? This eventually led to the 2007-2008 crisis that is threatening the very fabric of our societies.

3 Given the Present Situation in the World (Free Capital Flows, Absence of Monetary Policy Coordination, Rise of Emerging Countries...) What Could Be a Solution for the Future?

Does the present world offer the conditions for a proper functioning of the international monetary system? By present world, I mean a state of play where there is no envisageable return to a form of global standard or to a stable exchange rates mechanism; where freedom of capital movements and the importance of liquidity in financial markets (essentially in the USA) are a key determinant for the success of international currencies. This is a world composed of states determined to preserve their own interests (or what they believe are their interests) without having to accept external constraints. In sum: a world of national objectives.

If we want to imagine a true international monetary system, then this final factor, at least, must change. Indeed, the word “system” implies the acceptance of an element of externally agreed consistency. The juxtaposition of national positions cannot, by definition, amount to a system. Nations should therefore accept that they must coordinate their economic and financial policies in order to achieve a sustainable global macroeconomic balance, under the surveillance of an international institution disposing of adequate powers and sanctions. If the International Monetary Fund (IMF) was chosen to fulfil such a role, it would have to better reflect the real world and particularly the growing importance of emerging countries.

This, in theory, should be an attainable objective so long as states are ready to convince themselves that the common discipline which they would have to abide by is not only desirable internationally, but also in their own interest. Indeed, in a financially globalized world, exchange rate volatility, currency misalignments and structural deficits are in the interest of no-one. But, in the present circumstances, the probability of common macroeconomic governance with some form of constraints on member countries policies seems to be very remote.

Sociological empirical studies have demonstrated that the rise of risks tends to weaken cooperative arrangements: some players are tempted to join more limited groups or follow individual strategies. Less international cooperation and more competition are usually the result of greater turmoil and uncertainty.

Yet several technical adjustments could be envisaged to the present anti-system. Some proposals concern an increase in financing facilities provided by the IMF. The G20 countries have already considerably reinforced the Fund’s resources and made their use more flexible. But some argue that this is not enough and that the

IMF should be allowed to provide last resort funding to countries affected by a liquidity crisis (not by solvency problems that are usually linked to inadequate economic policies). To that effect, they propose that the IMF should be allowed to borrow on the markets and to substitute or complement central banks swap lines, the provision of which are often uncertain and therefore not adequate to prevent looming crises.

Other ideas touch on the extension of the role of the special drawing right (SDR). But it is highly improbable that the SDR could become a substitute for the dollar. Besides, it should not be used as a form of multilateral guarantee for countries having accumulated excess reserves. At any rate, in relation to the size of financial markets, the potential offered by the SDR seems weak.

Given the fundamental flaws of the present system = i.e. the existence of unilateral monetary policies enforced by the largest financial centers without any concern about their international consequences (as we can see with the present “tapering off” of the US Fed’s policies of quantitative easing), and the absence of any macroeconomic coordination, it seems to me that such possible technical adjustments to the Fund’s present procedures do not address the real problems.

Given the low probability of a “grand” reform of the international monetary system, I believe the world will evolve slowly over the years towards a more multi-polar system. The emergence of countries such as China, India and Brazil is a powerful factor of change. Monetary power will eventually match economic influence as has always been observed in history. We are already seeing the harbingers of such a transition: domestic currencies of emerging markets are being used more and more in local and regional transactions, non-residents are beginning to have access to emerging currency pools, emerging financial markets are gradually expanding and issues of bonds denominated in emerging currencies are developing on international markets. These changes will take time before they translate into universal convertibility. But the direction is clear: more currencies will count and participate in international finance.

But such a transition will not solve all problems. It is the excess of credit expansion that fuelled the financial crisis. Too much bank leverage contributed to the explosion of the money supply – and monetary policy limited to inflation targeting (but not concerned with over-leveraging and asset price bubbles) was powerless.

In order to avoid the repetition of such crises in a world where currencies look likely to continue to be free to misalign, another approach seems essential: macro-economic oversight. Central banks and regulators from around the globe must work together to remain on guard to both identify and counter financial imbalances. If, for example, real estate borrowing becomes excessive in a particular country, regulators should react by setting limits on loan-to-value (LTV) ratios. Or, if credit bubbles threaten, then monetary policy should respond by increasing interest rates or by other measures like raising reserve requirements or introducing counter-

cyclical provisioning. If the present network of mushrooming systemic boards could work together to foster this fine-tuning of monetary and regulatory measures – to be applied not uniformly across the board but according to the problems of each country – then we would live in a more stable environment. The absence of an international monetary system would, to a certain extent, be mitigated by a serious macroeconomic oversight system.

One could rightly object that governments might not be willing to apply countercyclical policies, which so often are unpopular in “good times”. But central banks and regulators may perhaps have more leeway and independence to act in such a diversified manner than governments to abide by multilateral surveillance.

A final note: capital requirements are not the only way of fostering the resilience of the financial system. And increasing global headline ratios can be very costly in terms of reducing normal credit availability. Sectoral and cyclical capital requirements and lending limits would be much more effective and less expensive than a “one size fits all” capital ratio approach. Systemic risk attention seems to be the persistent missing link of our mindsets.