The Late 1990s Fatal Hubris

How the Camp David decisions produced policies that failed to recognize capitalism's intertemporal nature.

By Bernard Connolly

The Covid-19 epidemic has been a human tragedy. The Keynesian recession and financial collapse in the world which loomed in March 2020 was averted by unusually prompt and effective fiscal and monetary action.

But the pandemic is now provoking economic, political, and social tragedy by instituting the reign of big government and Davos Man—by importing, in effect, a Chinese model of state/crony capitalism into the West. Yet the problem goes deeper than the pandemic. As economists and financial markets agonize about the threat of a return to destructively inflationary conditions in the world, and the United States in particular, the question arises of whether the fatal hubris of the late 1990s, from which so many problems have flowed, was preordained by the Camp David decisions of 1971.

Economist Rudi Dornbusch once wrote that the problem with the world monetary order is not that there are too many currencies but that there are too many countries. The monetary order is less important than the democratic order, which requires national sovereignty. But Rudi put his finger on what was the true great fault in the classical gold standard.

In the rapidly changing global dynamics of the final third of the nineteenth century and the beginning of the twentieth century, very high rates of return on capital in what a hundred years later would be called "emerging markets"—very importantly initially including the United States and subsequently including Tsarist Russia—put upward pressure on world real interest rates (relative to a baseline). This created severe economic difficulties, with attendant social and political strains, in the more mature economies,

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notably Britain, France, and Belgium, and subsequently imperial Germany. As real interest rates rose in those mature economies, mainly via falling prices, there were pressures there to boost rates of return to match those in emerging markets. The results—cartelization; protectionism; an intensified and competitive search for colonization opportunities; increased conflict between capital and labor; union militancy and the rise of socialist parties—certainly contributed to the slide towards the First World War (and of course in the United States the robber barons had already gained sway by the 1890s).

Given the classical gold standard, the only way to avoid economic strains and divisions leading to conflict would have been the dystopian nightmare of world government (one in fact now being imposed by totalitarian wokeism). One can see the colonies-grab by the United States, Germany, and Japan late in that period, joining the earlier British and European imperial powers, as a prelude to a battle about who was going to impose that nightmare.

The Inadequacy of Inflation Targeting

The demise of the postwar remnants of the gold standard mitigated the international aspect of anchoring a dynamic global economy, and thus did something to reduce international tensions. But its ultimate successor—inflation targeting in its various forms, plain vanilla or exotic—replicated the fatal intertemporal fault of the gold standard within countries. Inflation targeting cannot cope with a dynamic economy in which creative destruction ("destructive creation" would be a more insightful term) has, as it should, free rein.

—B. Connolly

In a sense, the monetary order established in the free world after the Second World War was an attempt to establish a free world monetary authority while avoiding a formal imperium. The Bretton Woods monetary order was, like the security order embodied in NATO, a hegemonic one, but with significant responsibilities placed on the hegemon, the United States. (In Bretton Woods, the commitment was to convert, on demand, other countries' dollar reserves into gold; in NATO, the commitment was to provide most of the forces and treasure.) The satellites had the right to adjust their exchange rate against the dollar in circumstances of "fundamental disequilibrium" (a phrase that should have, but generally did not, prompt a recognition that the exchange rate is an intertemporal variable as well as an international one).

In the early years of postwar reconstruction in Europe and Japan and of "dollar shortage" (supposedly, at least), the economic and financial dominance of the United States was so great that those Bretton Woods responsibilities were not over-burdensome. But reconstruction involved high rates of return. As the reconstructing economies grew rapidly, the United States began to experience some of the problems that Britain had suffered in the previous century. U.S. real rates of return began to get out of kilter with free world-average rates of return and free world-average *ex ante* real interest rates. In addition, the Kennedy/Johnson Vietnam war and the Johnsonian "Great Society" turned what had perhaps been a dollar shortage into what was undoubtedly a dollar glut.

Yet the United States was the only country that could not devalue, and countries such as West Germany stubbornly refused to revalue against the dollar. The travails of the London Gold Pool in the late 1960s were a harbinger of what was to come (and a reminder, in France's mischievousness, of similar Gallic mischievousness at the beginning of the 1930s in the interwar gold-exchange standard). Camp David was the ineluctable outcome.

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The process of destructive creation in a dynamic capitalist economy—such as that of the 1990s "New Economy"—should do what it says on the tin: the emergence of firms and projects with high rates of return should put less-dynamic firms out of business. That is a manageable and indeed desirable process within a country, whereas the gold standard equivalent was neither manageable nor desirable among countries. But it can happen only if the real rate of interest in a country goes up when a leap in productivity (essentially, via a burst of investment in products and processes) is in prospect.

Instead, inflation forecast targeting, explicit or implicit, meant, most crucially in the United States, that central banks were very reluctant to allow real interest rates to

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rise as long as forecast inflation was within their "comfort zone." The result, in a process of intertemporal disequilibrium which I have set out in numerous articles in this magazine over the past twenty-odd years, has been a succession of bubbles and Ponzi games which central banks and governments have needed in their attempts to stave off, or respond to, financial crisis and depression, and a very unwelcome concentration of wealth.

The miserable end point of this process must be one in which all private assets have been bought by the government or its agent, the central bank, and the only asset left in the hands of the public is a zero-interest (at best) perpetuity, the government's money. (Inevitably, private cryptocurrencies will be prohibited, but probably only after bubbles in them have produced appallingly large and socially destructive wealth transfers. Central bank digital currencies meanwhile will bear increasingly negative rates and risk putting the allocation of credit entirely in the government's control).

That is bad enough! But a particularly dangerous Ponzi game in government finance is now brewing, most worryingly in the United States. Budget deficits, intended as a substitute for ever-lower real interest rates in providing the boosts to aggregate demand made necessary on a recurring basis by intertemporal disequilibrium, must be ongoing and indeed ever bigger. So too must public debt. Thus to prevent unsustainability, real interest rates must continue to go ever lower.

Real interest rates in the United States are now more negative than before the pandemic caused budget deficits, largely financed by the Fed, to explode upwards. If they had not behaved thus, much more of the famous accumulated saving of the private sector would remain saved because of fears of future tax increases or government default. The problems of an unequal—and inequitable—distribution of wealth and of potential financial instability will remain and worsen.

Even that is not all. While the classical gold standard at least meant, if countries stuck with it, that hyperinflation was not possible, government default—or "going off gold" to avoid it—was far from uncommon. But such events as occurred were typically not the result of aggregate-demand-management decisions. They came in countries in which members and clients of governments of dubious democratic legitimacy and accountability were using public resources to feather their nests, often behind the mask of "correcting" distributional inequity. In the absence of the gold-based constraint, such circumstances (for example in Zimbabwe and Venezuela) do lead to hyper-inflation.

The primary economic harm of Richard Nixon's presidency was not that macro policy was used for nest-feathering purposes. But, freed from a link to gold and supported by a politically compliant Fed, a decade of fiscal incontinence was allowed to produce shockingly and corrosively high inflation.

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Now, with an administration bent on redistribution via massive budget deficits, inflation targeting by a genuinely independent central bank would, whatever havoc it has caused over the past quarter of a century, be a valuable bulwark against a repeat, and worse, of the 1970s. But the Fed has gone woke and is forgetful of its core duties and responsibilities. Its current "make-up" inflation strategy could be dangerous even if its parameters were clearly spelled out. But they are not. And that absence of clarity makes the strategy peculiarly susceptible to being "tweaked" for political purposes, whether the Fed's own wokeism or the administration's redistributional intent.

Could these nightmares have been avoided if macroeconomic thinking had taken a different turn after Camp David? The monetarist doctrines of the 1970s and 1980s at least attempted to provide an anchor for inflation expectations—albeit a shifting anchor given institutional and technological changes in the money supply and demand—while recognizing that a productivity disturbance should lead to a disturbance in the price level (a prescription regarded with horror in the Woodfordian inflation targeting orthodoxy).

But neither monetarist nor inflation-targeting approaches could cope if things ever went wrong. And when the world became more dynamic and more capitalist again in the 1990s—a development that should have been of great and lasting benefit to the world—they did go wrong. They went wrong precisely because monetary policy and macroeconomic thinking failed to recognize the intertemporal essence of capitalism. The clue should have been in the name: the relationship among the anticipated rate of return on investment, the *ex ante* real rate of interest and the rate of household time discount; and the need to accommodate and encourage destructive creation. Some of those elements were implicit in 1802 in Henry Thornton's *Paper Credit* and in 1959 in the Radcliffe Report—which was comprehensively rubbished by monetarists. Those elements have too long been ignored. And the world is now going to have to pay a calamitous price. ◆