Why a Second Bretton Woods Won't Work

By Bernard Connolly

The world economy's dire situation can't be fixed with an international agreement.

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888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Does the world need a new Bretton Woods meeting, as David Smick suggested in the previous issue of *The International Economy?* Despite the Davos hyper-optimism, the world is in a dire state and certainly needs something. But a new global monetary system run by governments (not that this was what Smick was advocating) or, heaven forbid, NGOs and cabals of businessmen and bankers, might be the last thing it needs.

The "non-system" that has been in place for the past four decades has had a mixed record. The 1970s were pretty awful. But they were awful because of failures of policy, not failures of the "non-system." The ossification of many developed economies via government regulation, control, and intervention, substantial union power, high taxes, capital controls, and a rigid financial and industrial technostructure produced a decline in trend productivity. Preserving employment would have required real wages lower than otherwise. And loose monetary and fiscal policies in the final days of the Bretton Woods system, especially in the United States, sparked a commodity price boom that intensified the downward pressure—if employment were to be preserved—on

Bernard Connolly is CEO of Connolly Insight, LP.

real wages. But unions and governments attempted to resist that downward pressure and many central banks validated that resistance. NAIRUs rose sharply almost everywhere and there was widespread, prolonged, and substantial stagflation. That some countries—notably Germany and Switzerland—performed better than others in this period was largely because they ran monetary policies different from the international consensus. In Germany's case, it was not until the misconceived "coordination" of policies in the Bremen and Bonn summits of 1978 that the country was sucked into the kind of mess already suffered by many others. It is very hard to see, given the intellectual climate of the time and the widespread economic misconceptions and the misdirected political pressure, how some sort of global economic and monetary "system" would not have made things even worse. (At a regional level, the "system" represented by the European "snake" simply could not hold together in those intellectual, economic, and political circumstances).

In the 1980s and 1990s, the "non-system" worked very well. The dramatic changes in economic structure brought about by the tremendous, if not untarnished, efforts of Reagan and Thatcher (not forgetting, of course, the pioneering Roger Douglas in New Zealand) had world-wide demonstration effects. And, just as important, the heroic work of Michael Milken smashed the technostructure, facilitating the productivity revolution of the early 1990s. Globalization and financial liberalization spread capitalism to virtually all parts of the world, lifting hundreds of millions out of poverty. True, there were financial crises in this period, most of them in emerging markets and some of them very serious. But none derailed the march to greater prosperity—except in Japan. That country suffered from its acceptance of international "coordination" in the infamous Louvre Agreement (a certain Jean-Claude Trichet was a crucial player), which not only led very directly to the Wall Street crash of 1987 but also, much more damagingly, gave additional impetus to the final stages of the Japanese bubble. And, of course, the Exchange Rate Mechanism created instability and significant economic damage in Europe.

This was not an ideal world, even aside from the Louvre Agreement and the ERM. But at a global level, it was probably better than anything else the modern world has seen. (What about the final third of the nineteenth century? I'll come back to that.)

Why did things go so badly wrong from the mid-1990s? There were three main problem areas and a unifying intellectual mistake. First, U.S. Federal Reserve Chairman Alan Greenspan totally misread the policy implications of the productivity surge in the United States. Second, the monetary union in Europe magnified the faults of the ERM dramatically, with implications not only for its unfortunate members but also for economies such as Britain's with strong trade links with the union. Third,

How Things Got So Bad

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The thread running through all these episodes was a distortion of the key relationships in a capitalist economy: between the anticipated rate of return on investment, the *ex ante* real long(ish) rate of interest, and the subjective rate of households' time preference. And, as I argued in the Fall 2008 issue of *TIE,* a major source of these distortions was the triumph of a Bundesbank-style model of central banking emphasizing price stability. That triumph produced substantial income inequality (just as Dennis Robertson had worried in the 1920s that the Fed, in "going all out for price stability," as he put it, might be robbing workers). It also made bubbles and Ponzi games inevitable. The mechanism emphasized in the recent International Monetary Fund paper on "Inequality, Leverage and Crises" (Kumhof and Rancière, 2010) describes an effect of these developments rather than a cause. But it is a very dangerous effect, and one pointed to by none other than Karl Marx. (Is China perhaps the country now most at risk of unrest of the kind prophesied by Marx?)

The immediate question now is whether the world can recreate a bubble that will last as long as the 2003–07 bubble. If it can, the world will simply find itself back in the totally unsustainable situation it was in 2007, but probably with a significantly weaker dollar than now and a shift in at least part of the burden of unsustainability away from the United States to someone else to be named later. The financial crisis that will bring this re-created bubble to an end might originate, this time, somewhere other than the United States. But another financial crisis would be an unavoidable result of the process. And accommodating commodity price increases in commodity-importing countries (rather than attempting to offset them through lower nominal wages—an attempt which would bring higher unemployment) would mean an even tighter and longer squeeze on real wages and potentially even greater—perhaps uncontrollable—political strains.

But the alternative is that worry about commodity-price inflation in either emerging markets or in mature economies, or an investment crash in China, aborts the bubble much sooner this time around. Risk asset markets would correct downwards and hopes of a sustained global recovery would be scuppered. Another "Austrian" liquidation crisis would be upon us. The political consequences of that, too, might be uncontrollable.

The world thus remains in a dire state. But it is hard to see how any feasible agreement among governments about an international "system" could really help improve things. Certainly, a return to any kind of commodity standard would be fraught with danger. The final third of the nineteenth century, the heyday of the "classical" gold standard, is often held as a paragon of systemic virtue. But that period saw a very rapid retreat from free trade everywhere except Britain and its colonies. That retreat, along with colonialist exploitation by all the major powers, reflected a desire to maintain rates of return in the more mature economies at levels elevated enough for high global real rates of interest, induced by high rates of return in the "emerging markets" of the day, not to destroy employment. Income-distribution struggles became virulent and incipiently violent. One does not have to be a Marxist to see the strains created by a rigid global monetary system in the face of dynamically changing geographical patterns of comparative advantage and rates of return as being a major contributory factor in the slide into the First World War. Similar rigidities today would probably destroy not only capitalism but peace.

One can see these dangers all too clearly in the economic, financial, social, and political disaster that is European monetary union. In the world more broadly, the lesson of the experience both of "systems" and of the "non-system" is that in a globalized, dynamic economy, macroeconomic policies in individual countries must be tailored to suit their individual circumstances. The alternative must involve either devastating boom-busts or "coordination," not just of monetary policy and macroeconomic policy, but coordination of all policies in all areas that might impact the rate of return: industrial policy, trade, educational, labor market and incomes, social, demographic, cultural, religious—everything you can think of. "Coordination" is an excuse for proto-Marxists, or at least statists, corporatists, and market-phobes, to impose a centrally planned economy and an anti-democratic polity. This nightmare is now very visibly playing out in Europe, coordinated by the two arch market-phobes, the French and German governments. This has been a very predictable development (indeed I predicted it fifteen years ago in my book, *The Rotten Heart of Europe*) but it is no less alarming for that.

But even total central "coordination," horrendous as it would be, could not solve the existing problems created not by the "non-system" or even just by EMU, but by a failure of monetary policy understanding, most crucially in the second half of the 1990s, which has made the world as a whole an enormous Ponzi game. The academic macroeconomics industry must bear a heavy burden of shared responsibility for this *trahison des clercs.* or treason of the intellectuals. At all events, the world now faces a dilemma. One route involves abandoning loose monetary policies and triggering a collapse and goodness knows what else. The other involves continuing those policies and having, sooner or later—and probably sooner, even in rich countries—to face the political and social consequences of further shifts in the distribution of wealth. Inequality will increase between financial market booms on one side and, on the other, real wages reduced by commodity price booms together with real returns to savings reduced by a secular downward trend in real rates of return, real interest rates, and—delusion of delusions—risk premiums.

Again, "coordination" can do nothing to resolve this dilemma, which, for want of a better term, one can perhaps christen "Austro-Robertsonian." A counter-example arguably can be found: the G-20 late in 2008 may have helped steer many countries towards providing fiscal support in conditions of a global collapse both in "animal spirits" and in the availability of private-sector finance. But it is only in extremely rare globally Keynesian conditions—as prevailed for six months or so after the Lehman bankruptcy—that coordination can potentially be helpful. In all other conditions, "coordination" means, in practice, doing something which is damaging in the aggregate in one country but helpful for a particular interest group in another country if that other country agrees in return to do something equally damaging for it in the aggregate but helpful to an interest group in the first country.

Of course, genuine international imbalances exist. The most immediately damaging is that between Germany and the peripheral countries of EMU. It is beyond doubt that the best way—though, given the unfortunate present existence of EMU, still highly disruptive—to resolve that imbalance would be through a return to a "non-system" of exchange rates in Europe. The bilateral issue between the United States and China has similarities. If China is not going to accept a need to make huge unrequited transfers to the United States every year, it must choose between much more flexibility in the renminbi and eventual massive U.S. default.

But while a resolution of some bilateral problems could help the world at the margin, there can be little optimism that international meetings, "coordination," or the erection of new international monetary systems could help. And the bigger problem is that the "non-system" required, for its benefits to be reaped, that monetary policy in all the major economies must be pursued appropriately. In fact, it has been pursued inappropriately, ever since the second half of the 1990s, in the United States, the euro area, and China (as I noted above, it was pursued highly inappropriately in Japan in the late 1980s precisely because of the attempt of the Louvre Agreement to establish elements of a "system")—and, in consequence, virtually everywhere else. No set of macroeconomic policies going forward can avoid the dreadful dilemma between potential collapse and certain income-distribution calamities. Anything that might be implemented at the international level would simply be, in large measure, shuffling problems around between countries, at undoubtedly enormous cost in terms of the establishment of new international bureaucratic, unaccountable, and anti-democratic institutional structures—a global *nomenklatura,* in fact.

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What is instead needed is some way of allowing real interest rates to rise, bringing them into closer alignment with subjective rates of time preference, without producing a terrifying "liquidationist" collapse. The only way to do that is to create a worldwide rise in the rate of return, such that future income and (non-bubble) demand prospects validate *ex post,* so to speak, the volume of real fixed assets, at present reflecting expectations of future bubble conditions demand currently in place. That requires competition—in cutting tax rates, in reducing government interference and control, in stimulating initiative, in fostering globalization, and in restoring the spirit of free enterprise. In other words, it requires everything that current moves in Europe are designed to avoid or at least to distort. A capitalist system cannot work without capitalism. And attempts to create a global monetary and economic "system" are the enemy of capitalism—and of democracy, freedom, and political stability. ◆