From Bretton Woods to the Euro:
How Policy Maker Overreach Fosters Repeated Economic Crises

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Introduction

• In spite of the appeal of BW arrangements with pegged ER, there seems to be little desire to return to these.

• The ‘straightjacket’ of pegged style ER systems is made more unpopular still given the ongoing travails of the euro zone.
  – BUT...more limited ER flexibility, combined with ‘macro-prudential’ type limits on capital mobility and improved ‘micro-prudential’ regulations continues to have great appeal.
Introduction

• Could Canada, paragon of the floating ER system, also be a convert to a less ‘pure’ ER system?
  – Contrast Murray’s (2011) comment: “...flexible exchange rates, which have a great deal to recommend them, have failed to live up to their initial optimistic billing. (Canada’s positive experience with a flexible exchange rate through the 1950s and early 1960s might have contributed to this overly sanguine assessment.) Their stabilizing properties were shown to be more limited...” with Murray, Schembri and St. Amant (2003), “…flexible exchange rates facilitate adjustment to shocks in the underlying fundamentals.”
Introduction

• Why then do we remain fascinated by BW-type ER systems?
  – It only lasted a dozen years
  – It seemed to be doomed right from the start (Triffin’s paradox)
  – It may not have tied members’ hands sufficiently tightly
  – BUT...it appeals to our innate desire to foster cooperative economic arrangements
Policy Frameworks: What Lasts?

• BW gave a (false?) sense of stability, sustained economic growth & rising international trade
• Remember the ‘Great Moderation’? It too seems to be an era mourned for the apparent stability & growth it created, or did it?
Economic Performance During BW

Consumer Price Inflation

Real GDP Growth
Policy Frameworks: What Lasts?

- BW gave a (false?) sense of stability, sustained economic growth & rising international trade
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Economic Performance – The GM & Beyond

**Consumer Price Inflation**

- **Canada**: Slight inflation throughout the period.
- **China**: No significant change in inflation.
- **Japan**: Minimal inflation.

**Real GDP Growth**

- **Canada**: Steady growth.
- **China**: Significant growth.
- **Japan**: Moderate growth.

*Source: Balsillie School of International Affairs*
## Summary Statistics: Real GDP Growth

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<tr>
<td>Canada</td>
<td>5.18% (1.80%)</td>
<td>2.37% (2.17%)</td>
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<tr>
<td>Germany</td>
<td>4.21% (2.42%)</td>
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<tr>
<td>Japan</td>
<td></td>
<td>0.63 (1.80%)</td>
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<td>China</td>
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<td>8.90% (2.63%)</td>
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Bottom Line # 1

• The ‘success’ of a regime should not only be judged by performance during its life but also by the aftermath & ability of institutions to deal with crises as well as governance.
Illustrations I: Current Account Imbalances

Industrial Economies

Note: The Oil exporters comprises OPEC members and Russia.
Source: International Monetary Fund World Economic Outlook
Illustrations II
Implications

• Accords of the BW kind work when countries accept that there are net benefits to externally imposed constraints
• Transparency is vital to keep everyone ‘honest’ and build ‘trust’
• ‘stakeholders’ must acknowledge that there exists a trade-off between national sovereignty and the effects of globalization
A Look Back at BW

• The theory: cooperative solutions are possible even if individual countries independently follow their own policies (Obstfeld and Rogoff 2002)
  – Of course the prediction is based on an idealized model
  – It does NOT consider what happens if the transmission of economic shocks change over time
    • The ‘coupling’ vs ‘decoupling’ idea
Coupling vs Decoupling: Real Economy

Plot of conditional correlations

USA, ASEAN
USA, CEE
USA, CHN
USA, EU
USA, JAP
USA, LA
USA, ME
USA, NIC
Coupling vs Decoupling: Financial Markets

The graph shows dynamic correlations over time with different lines representing various DCC models, such as DCC(R_SH,R_SP), DCC(R_SH,R_PC), etc. The x-axis represents dates from 6/1/1995 to 10/12/2009, while the y-axis indicates dynamic correlations ranging from -0.1 to 0.4.
Bottom Line # 2

• Globalization need not mean more ‘coupling’
  – Corollary: exchange rates can’t always protect you from external shocks
Bottom Line # 3

• If you are going after a BW system then you need to spell out how the system is going to work
  – Architects of BW “…never spelled out how the system was supposed to work.”
  – Architects of EMU never spelled out how “surveillance” would be implemented – a failure of governance –
  – Decisions/voting mechanisms assumed that US’s (& Europe’s) economic prominence would be permanent + gave little room for ‘outsiders’ to have real influence
Historical Experiences

Bretton Woods
- Uni-polar world
- “[T]he architects never spelled out how the system was supposed to work.”
- Build-up of imbalances
- Limited exchange rate flexibility + moral suasion
- CB independence not meaningful
- Supplemented by supra-national institutions

EMU
- Bi-polar world
- [Maastricht] Treaty: Meaningful CB Independence + numerical objectives
- Focus on price stability with zero exchange rate flexibility + (nearly) total fiscal autonomy
- Supplemented by supra-national institutions
Lessons? Can We Do Better?

- BW failed
- EMU may be on the brink
- Cooperative solution needs to be credible + ensure that reputation is built
  - G20 is a start + encourage the development of a multi-polar world...but challenges remain as it is too loose, surrounded by too many other Gs, and then there is the US Congress
  - Rely on existing ‘suite’ of supra-national institutions for ‘normal’ times but G20 crisis structure would kick-in for ‘abnormal’ times (e.g., early warning system + crisis management)
    - Spell out the governance of the IMS in this kind of world: A Basel for MP and FS? (i.e, keep it ‘technical’ (Eichengreen 2011))
- Joint responsibility doctrine + directive should be applied to international arrangements
Conclusions
Grand Experiments ... Great Crises I

• Smaller crises – of which there are many (see R&R) - appear to produce modest agreements/reforms

• Larger crises – of which there are few (e.g., GD, BW, € area) – create a desire for ‘grand’ re-designs/changes
Conclusions
Grand Experiments ... Great Crises II

• Why?
  – Too little attention to how the new structure will work?
  – Too little concern for a plan B if things go seriously wrong (stress testing?)
  – ‘irrational’ or ‘exuberant’ cooperation/coordination with ‘morning after’ regrets

• But how to test?
  – Case studies
  – More formal/statistical testing likely very difficult