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RETURN TO BRETTON WOODS?

Delivered by

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RETURN TO BRETTON WOODS?

Today there is widespread agreement that protection around the world should be greatly reduced; that **standards of living** everywhere will be higher if countries and people within countries are allowed to concentrate on doing those things that they do best. In Australia this was not always so. A great deal of the credit for the transformation of public opinion must go to Stan Kelly for his work on the Tariff Board and to Bert Kelly for his tireless efforts to instill sense into a hostile audience.

However, while many in Australia and elsewhere now agree that protection should be reduced, nobody does much about it. A growing number of economists and politicians, particularly in the United States, are arguing that protection can be helpful in special cases, sometimes as retaliation against others. Unfortunately, you can be sure that, when politicians modify the proposals of economists to gain votes for their own vested interests, any merit there may be in the original proposals will be destroyed and the protection imposed will have its usual harmful effects.

There are two serious log jams which stand in the way of progress and which foster speculation about special cases. One is the subsidies given to farmers in Europe and America, and the other is the volatility of exchange rates and the consequent under-valuation and over-valuation of currencies. Both lead to distortions in trade patterns and are an important cause of the balance-of-payments surpluses and deficits that bedevil negotiations to reduce trade barriers.

Subsidies to farmers and volatile exchange rates are, of course, not the only obstacles. Heavy expenditure on defence in Russia and America, the resulting fiscal deficits, fluctuating prices of oil and unmanageable international debts provide an unfavourable

environment for trade negotiations. However, apart from debts, there is hope that these obstacles may be more easily removed now that Russia and America are once more talking to each other.

Subsidies to farmers and volatile exchange rates are more difficult to handle. The subsidies, of course, arose from the political clout of a powerful vested interest; the farmers of Europe and America.

Nevertheless given goodwill on the part of the European Community, which unfortunately seems to be lacking, I believe it should be possible to clear this obstacle away within a few years. As populations increase and standards of living rise, the demand for foodstuffs will grow. There may be more green revolutions but without them I doubt if production will increase as fast. If this should prove to be true, it should not require a very great reduction in output in Europe and America to remove the worst consequences of the subsidies paid to farmers. It would, of course, be best for the reduction in output to be brought about by a reduction in the prices received by farmers. But using subsidies to pay farmers not to grow foodstuffs may be more acceptable politically.

The other obstacle to trade negotiations is the present chaos in rates of exchange. This impedes trade in two ways. Volatile exchange rates increase the risks of exporters. Particularly with manufacturers, profit margins are often small and not worth heavy capital expenditure when the risks are high. At the same time, Governments in importing countries are reluctant to reduce protection lest a currency change should expose manufacturers to a flood of imports.

In recent years some key currencies have not been at appropriate levels. Currencies in Japan, Korea and other

countries in East Asia became under-valued as a result of a great increase in productivity in the region. As a result, these countries developed large surpluses in their balances of payments which provoked agitation for increased protection in the importing countries, notably in the United States. Stability of exchange rates would set the scene for dialogue on greater freedom of trade.

Towards the end of the last world war the United States and its allies set themselves four economic objectives;

- (1) to stabilise exchange rates,
- (2) to contain and reduce levels of protection and to free world trade,
- (3) to maintain high or full levels of employment,
- (4) to reconstruct Europe and Japan and promote the development of the less developed countries.

Of these four objectives two, the attempts to stabilise currencies and maintain full employment, have clearly failed. There has been considerable progress in the reduction of tariffs but there are now growing threats of increased protection. The attempts to reconstruct Europe and Japan were brilliantly successful and development in parts of Asia has been spectacular.

In Latin America and the communist countries there has been considerable development but it has been inefficient and badly distorted, and further development is now facing serious difficulties. In Africa there has been little or no progress.

The purpose of this paper is to address the problem of stabilising currencies but for stable currencies it is necessary to have the sort of stable economic world that the allies sought with their four objectives. A brief review of the causes for the failure of so much

of the post-war plan is therefore needed to provide a background for the subject of the paper.

In an ideal economic model, one would expect to find two important equalities; actual real rates of interest equal to the natural or equilibrium rate, and the rate of growth of wages equal to the rate of growth of productivity. In the imperfect world we live in, we cannot expect to reproduce these equalities. Nevertheless, for a stable economic world the inequalities must not be too large.

Keeping the real rate of interest near to or equal to the natural rate is merely one aspect of monetarism. The difficulty with monetarism is to measure the effective quantity of money at any time. It will vary with the velocity of circulation and with technical and structural changes in the money market. However, changes in the effective quantity of money will raise or lower the level of interest rates and when the economy is in a stable condition real interest rates will be near to or equal to the natural rate.

The natural or equilibrium rate of interest will vary from time to time and from country to country. In mature political and industrial countries the natural rate of interest has until recently probably been about three or four per cent. In the United States it has been perhaps as low as two and one-half per cent. It may be that the rate is now somewhat higher because of a heavy demand for capital and lower rates of saving. Whatever it may be, the natural rate cannot be changed quickly by anything a Government or a central bank can do, depending as it does on the capital-output ratio and the level of savings. Neither of these is very amenable to government intervention.

When the real rate of interest is below the natural rate it generates inflationary pressure and when it is above it has

deflationary effects. In the post-war years major countries kept real rates of interest well below the natural rate. Sometimes real rates were zero or even negative. They were therefore generating strong inflationary pressures.

The inflationary pressures arising from real rates of interest below the natural rate were reinforced by unions attempting to keep wages rising more rapidly than productivity at the same time as they were reducing productivity by restrictive work practices and shorter working hours.

In a closed economy, wages rising more rapidly than productivity result in inflation. In an open economy they are more likely to result in balance-of-payments difficulties. Perhaps Australia's intractable balance of payments problems may be partly explained in this way.

In a few countries, in Japan and in Korea, balance-of-payments surpluses emerged because of a combination of wages rising more slowly than productivity and high rates of saving. In some European countries, in the United Kingdom, in the United States and in Australia, low interest rates and high wage costs resulted in balance-of-payments deficits.

To these destabilising pressures must be added the economic and financial distortions created by the Vietnam war and the subsequent heavy expenditure on defence in Russia and in the United States, imprudent fiscal policies in a number of countries and high oil prices.

These, and the surpluses and deficits in balances of payments to which they led, helped to foment large sums of destabilising hot money surging around the world.

The distortions due to war and the sudden changes in the prices of commodities called for structural changes which are in any

case difficult to make. Something could have been done by measures which are politically unpopular such as increases in taxation, reductions in wages, high rates of interest and the depreciation of currencies. Responses of this kind, however, were grossly inadequate. Governments, including those in the United States, preferred the easier short-term policies of fiscal and balance-of-payments deficits and inflationary monetary and wage policies.

The fourth of the post-war objectives of the United States and its allies, the development of less developed countries, has had some success, but faults in the planning and financing have resulted in a menacing debt problem, in balance-of-payments deficits and hyper-inflation in some countries.

This review of the fate of the four brave objectives we set ourselves forty years ago leads me to a rather disheartened re-formulation of Murphy's law - if democracies can go wrong, they will. However the same can be said with even more truth about communist countries and military dictatorships.

In a world which was raising so many economic hurdles, it is not surprising that the Bretton Woods agreement to stabilise currencies eventually broke down. Nevertheless, the agreement itself had two fatal flaws. One was the failure to provide any proposals to curb outflows and inflows of speculative capital. This was not because delegates overlooked the problem. It was thoroughly discussed but no one was able to suggest how it could be done. We just hoped it would go away. And so it might have done in an economically rational world.

The other was the failure to complement the agreement to fix exchange rates with an agreement to adopt domestic monetary and economic policies compatible with these exchange rates. No doubt this was implicit in the articles. But the subsequent failure of

major industrial countries to observe this part of the agreement indicates the need to spell it out explicitly.

If we are to have stable exchange rates countries must be prepared to accept some monetary discipline. This was enforced under the gold standard by movements in gold reserves. When gold reserves were falling countries had to raise interest rates and adopt stringent fiscal policies. When gold reserves were rising interest rates were lowered and fiscal policies relaxed. Under the Bretton Woods agreement there was no mechanism of this kind and countries in fact followed domestic policies that were incompatible with the Bretton Woods exchange rates. This might not have mattered if they had been prepared to alter their exchange rates to make them consistent with their domestic policies. For various reasons, countries stubbornly refused to do this and sometimes moved their currencies in the wrong direction. Australia was amongst the countries that lowered interest rates when they should have been increased and raised the exchange rate when it should have been lowered.

As with rates of interest, there is an appropriate or equilibrium rate of exchange to which the actual rate of exchange needs to be kept nearly equal. When it is lower, it generates inflationary pressures but if these can be contained it leads eventually to a surplus in the balance of payments. When it is higher, it is deflationary and leads to a deficit in the balance of payments.

Unlike the natural rate of interest, however, the appropriate rate of exchange can be altered by Government actions through monetary and fiscal policy; so countries have a choice. They can make the actual rate of exchange equal to the appropriate rate by altering either the actual rate or the appropriate rate. Provided the actual rate does not differ too greatly from the appropriate rate, it is best to adopt monetary and fiscal policies to bring the appropriate rate into line with the actual rate. This provides the

monetary and fiscal discipline that we must have if we are to have a stable economic world. When the two rates of exchange, the appropriate and the actual, differ too greatly, the discipline needed to bring the appropriate rate into line with the actual rate becomes too harsh, as it did sometimes under the gold standard. It is then necessary to alter the actual rate and bring it into line with the appropriate rate. But, if this is done too often and by major countries, it leads to the chaos in exchange rates we are now experiencing.

In the United States, the inflationary pressures of the post-war years had, by 1970, caused the actual rate of exchange to diverge from the appropriate rate by more than could be corrected by monetary and fiscal policies. The dollar was devalued in 1971 by 7.9 per cent and in 1973 by a further 10 per cent.

For some years Friedman and the monetarists had been arguing that exchange rates should be left to the market. According to Friedman, the market would be a much better judge of the correct rate of exchange than would bureaucrats in central banks. The succeeding twenty years of floating exchange rates has shown that this is far from the truth. The appropriate rate of exchange does not vary greatly from day to day or normally even from year to year. The extraordinary volatility of rates since the abandonment of the Bretton Woods agreement is clear evidence that the market is in fact a very poor judge of the appropriate rate of exchange.

Volatile exchange rates are a serious obstacle to efficiency in international trade. Unless central banks can control floating rates of exchange so that they vary only slowly from day to day and not dramatically even from year to year, they will prove a poor substitute for fixed rates of exchange.

Floating rates have another disadvantage in that they do not provide any monetary discipline. If fiscal and wage policies lead to rising prices, the market will automatically depreciate the currency, thus protecting the country from balance-of-payments problems and unemployment. The only discipline will be provided by public opposition to rising prices. The evidence from many countries plagued by inflation is that this is inadequate. Sometimes it is not until inflation turns into hyper-inflation that Governments are prepared to use effective measures to control an accelerating rise in prices and wages.

It seems clear that the best hope for a stable economic world is to revert to the Bretton Woods agreement, but when we do it needs to be supplemented by agreements by member countries that they will use their best endeavours to keep real rates of interest as nearly as possible equal to the natural rate of interest, to keep wages rising at the same rate as productivity and to use monetary and fiscal policies to keep the appropriate rate of exchange as nearly as possible equal to the fixed rate of exchange. For countries that can demonstrate that they are trying effectively to do this, the central banks of the world should be ready to provide the massive amounts of funds that might be needed to counter adverse market pressures. However, once the market was given reason to believe that countries would honour their agreements, the amounts needed for this purpose would probably be small.

From time to time countries will fail in their attempts to adapt the appropriate rate of exchange to the fixed rate of exchange. This might be because of political pressures forcing too rapid an increase in prices or wages, or it might be because of structural changes. These could be caused by war, by developments such as the oil price increase, by a developing country forcing structural changes on mature economies, by new inventions

or by a change in relative prices. For example, a heavy fall in commodity prices might drive the appropriate rate of exchange in Australia well below the fixed rate.

When the appropriate rate of exchange diverges too far from the fixed rate, we do not want to repeat the mistake of the gold standard by trying to force the appropriate rate back to the fixed. Instead, the fixed rate should be moved until it is equal to the appropriate rate. Perhaps this should be done when the appropriate rate differs from the fixed rate by more than five per cent, though at this level the change should not be mandatory. If it were, speculators would become active as the divergence approached the five per cent level. It should be mandatory at the ten per cent level, but before this level was reached speculators would, in any case, have forced the change.

If will be some time before countries feel confident enough in their capacity to hold their currencies at agreed levels for a return to Bretton Woods to be possible. Meantime the group of seven may be seeking the route back. They meet from time to time and agree on ranges for key currencies. Their central banks provide support to keep these currencies within the agreed ranges. The next step might be for the central bank of each country to calculate what it believed to be an appropriate rate and announce a range within which the market could operate, with the bank being ready to buy or sell the currency if its value moved outside this range. To prevent destabilising speculation, it would be necessary for the central bank to have the support of the central banks of the major countries, and for this there would need to be agreement that the appropriate rate was correctly calculated. The supporting central banks would also need to be satisfied that the fiscal and monetary policies of the country concerned were consistent with stability of the exchange rate.

The object would be to maintain the range announced for some time, and, if the rate had been correctly calculated, this should be possible. For if exchange rates are realistically calculated, the appropriate rate will not vary greatly from day to day and, if it should move away from the announced range by a small percentage, it should be possible to bring it back by acceptable monetary and fiscal policies.

However, if exchange rates are to be kept stable, we must recognise that countries have to give up some of their freedom of action. If wages rise more rapidly or more slowly than productivity there will need to be a corresponding change in the exchange rate. And if the real rate of interest is not kept near to the natural rate of interest there will again have to be a change. Changes in the exchange rate to accommodate peculiarities of domestic policy would however be gradual and not lead to the volatility that has plagued us recently.

The countries of the European Community are contemplating the introduction of a common currency. This might take one of two forms. The common currency might simply circulate alongside the national currencies or it might replace the national currencies. I have suggested that we should return to Bretton Woods with member countries agreeing to adapt their economies to the exchange rates fixed under the agreement, but with provisions for changes in the exchange rate if they fail too badly.

It is this limited degree of flexibility in the exchange rate that distinguishes the Bretton Woods agreement from the gold standard. A common currency that replaced national currencies would remove this flexibility. It would indeed impose even more severe discipline than was enforced under the gold standard. At least under the gold standard, if the discipline became too harsh,

a country could devalue its currency. With a common currency there would be no way out. The member countries would be forced to follow common economic and monetary policies. This works well enough within states with a single national government. The 50 states of the United States have such a common currency but they also have a common Government and as a result a common monetary policy and economic and social policies that do not differ too greatly. Even so special assistance has to be provided to some states.

A common currency replacing national currencies would be very difficult to operate in Europe and would not be feasible over any wider area.

In conclusion, I think I should say that, while the monetary and fiscal policies of major world powers since the end of the second world war have been deplorable, I find optimism in the fact that, despite the abuses to which the economic system has been subjected, it has survived remarkably well. Compared with the crises of the 1890s or the 1930s, traumas of recent years have been comparatively mild. This gives me some hope that, with more sensible economic behaviour, we may yet in the next forty years realize the objectives we set ourselves forty years ago.