REMARKS BY PAUL A. VOLCKER
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A NEW BRETTON WOODS???

Weeks ago, Dick Debs overcame my reluctance to participate in still another public meeting. And once that commitment was made, the inevitable question followed: ”Paul, we need a title for your remarks”.

Well, what could I say that could be new or provocative amid all the conversations about the markets, financial reforms in all their variety, or even the Volcker Rule itself?

Well, given the sponsorship of this meeting, what popped out of my mouth was, “What About a New Bretton Woods???” – with three question marks.

The two words, “Bretton Woods”, still seem to invoke a certain nostalgia – memories of a more orderly, rule-based world of financial stability, and close cooperation among nations. Following the two disasters of the Great Depression and World War II that at least was the hope for the new International Monetary Fund, and the related World Bank, the GATT and the OECD.

No one here was actually present at Bretton Woods, but that was the world that I entered as a junior official in the U.S. Treasury more than 50 years ago. Intellectually and operationally, the Bretton Woods ideals absolutely dominated Treasury thinking and policies. The recovery of trade, the opening of financial markets, and the lifting of controls on current accounts led in the 1950’s and 60’s to sustained growth and stability.

Even then there were recurrent stresses and strains, but the sense of a strong commitment to the new system prevailed: the potential resources of the IMF were enlarged, a network of swap agreements was created, and there was even some Treasury borrowing in foreign currencies! Today’s “quantitative easing” had a smaller-scale precedent in the early 1960’s. “Operation Twist”, was designed to keep long-term interest rates low as short-term rates were raised, at least in part to protect the dollar. Even more striking was the introduction of a variety of controls by the United States on the export of capital.

With prices stable in the United States, which still had a sizable current account surplus, the use of the dollar convertible into gold at the center of the system was seldom questioned.

Those essential conditions had changed by the time I returned to the Treasury in 1969, right on the front line in the conduct of monetary affairs. The ill-conceived Vietnam conflict and its fiscal and political consequences shook the financial ground. An insidious intellectual shift was also becoming important. Robert Triffen had persuasively pointed out the ultimate dilemma in building a monetary system and the provision of international liquidity on the base of a single national currency. The invention of the Special Drawing Rights was a response to that critique, but the limited provision of SDR's and sense of commitment was not enough to suppress the spreading concerns.

More broadly, the rationale of a regime of "fixed but adjustable" exchanges rates came into question. Later, those doubts were reinforced by a larger intellectual framework. The mantra of "efficient markets" and "rational expectations" seemed to suggest a stable and effective framework for a financial system, domestic or international, would not be dependent on – indeed should be independent of – official rules and structure.

Whatever the intellectual shift, by the early 1970's it became increasingly apparent that there needed to be a realignment – to my mind a substantial realignment – of the exchange rate relationship between the U.S. dollar and other leading currencies, most importantly at that point the Japanese yen. The suspension of gold convertibility of the dollar as a transitional means of inducing the realignment, however controversial at the time, became inevitable.

Efforts to reconstruct the Bretton Woods system, either partially at the Smithsonian or more completely in the subsequent negotiations of the Committee of 20, ultimately failed. The practical consequence, and to many the ideological victory, was a regime of floating exchange rates. Somehow, the intellectual and convenient political argument went, differences among national financial and economic policies, shifts in competitiveness and in inflation rates, all could be and would be smoothly accommodated by orderly movements in exchange rates.

The need to subject national policies to external influence could be greatly reduced and national economic sovereignty maintained.

Any need for controls, for official intervention in currency markets, even for stockpiles of national reserves would be greatly reduced, and even eliminated. In fact, the "system" (or as many would label it "non-system") could proceed effectively even without enforcing a common approach to floating. De facto, a hybrid system – a lot of floating, some fixing, some "do as you please" - developed with little role for the IMF itself in managing the "system". In fact, the occasional efforts to achieve cooperation in managing exchange rates – strikingly in the well-publicized agreements at the Plaza and the Louvre in the 1980's - were in response to national initiatives, with the IMF essentially a by-stander.

By now I think we can agree that the absence of an official, rules-based cooperatively managed, monetary system has not been a great success. In fact, international financial crises seem at least as frequent and more destructive in impeding economic stability and growth.

The United States, in particular, had in the 1970's an unhappy decade of inflation ending in stagflation. The major Latin American debt crisis followed in the 1980's. There was a serious banking crisis late in that decade, followed by a new Mexican crisis, and then the really big and damaging Asian crisis. Less than a decade later, it was capped by the financial crisis of the 2007-2009 period and the great Recession. Not a pretty picture. At the least, we have been reminded that while free and open capital markets may be needed to support vigorous growth, they are also prone to crisis. The more complex, interrelated and free from official restraints, the greater the collective risk.

For years, the benefits were reflected in the enormous growth and the reduction in poverty of emerging economies. The contrasting concerns are reflected in the slowing of growth and productivity in the industrialized world.

We can all recite a rather long list of culprits contributing to the financial crisis: excessive leverage, outlandish compensation, failures in regulatory oversight, simple greed, and on and on. What I want to raise is what seems to be a neglected question. Amid all the market and institutional excesses, all the regulatory omissions, most of all, the legitimate questions about the underlying failures of national economic policies, has the absence of a well-functioning international monetary system been an enabling (or instigating) condition? Specifically, did the absence of international oversight, of discipline in financing, of exchange rate management permit – even encourage – unsustainable imbalances in international payments and in domestic economies to persist too long?

Many have pointed, for instance, to the huge imbalances at the beginning of this century in international payments between the United States on one side and China and Japan on the other – the largest economies in the world. Those imbalances were easily financed. The result was that a high degree of liquidity at low interest rates could be maintained in the United States, despite the virtual disappearance of domestic savings. The sub-prime mortgage phenomenon was an outgrowth. At the same time, exceptionally high levels of savings and investment in China supported exports without working toward a more balanced economy, including the domestic consumption that would be necessary to sustain Chinese growth in the years ahead.

Where was an effective adjustment mechanism? Was the "exorbitant privilege" of the dollar as a reserve currency also a "dangerous temptation" to procrastinate - an impediment to timely policy adjustments, risking eventual breakdown?

The current travails of the Eurozone (the equivalent of an absolute fixed exchange rate regime) carry interesting lessons. A single currency with the free flows of funds among the member states simply could not substitute for the absence of a unified banking system and incentives for disciplined and complementary national economic policies.

That is all a long introduction to a plea – a plea for attention to the need for developing an international monetary and financial system worthy of our time.

Implicitly, bits and pieces of needed reform are being recognized by strong efforts to standardize commercial bank capital requirements and, for the first time, to introduce liquidity standards. The need for official oversight and surveillance beyond the commercial banking system is well recognized, even if much remains to be done to develop and standardize practices. There is effort underway to achieve a common approach toward the resolution of failing financial institutions of systemic importance; it is hard to perceive of any successful resolution process that proceeds only nationally.

In the midst of crisis, in 2008 and 2009, an intellectual consensus was reached within the G-20 about the need for forceful fiscal and monetary policies. More or less coordinated official intervention in markets took place on an enormous scale. Cooperation among central banks helped deal with pressures on exchange markets. The provision of ample liquidity by the key national central bankers is still taking place as we meet. But those measures don't really count as structural reforms.

Now, new questions have been raised about the sensitivity of markets in small and emerging economies to even small policy adjustments by the Federal Reserve. While the concerns and complaints of some officials in those countries at the time may seem exaggerated, the volatility of short-term capital flows does raise important issues. And, there can be no doubt that major changes in circumstances and policies in industrialized countries do inevitably have world-wide repercussions.

Well, even if you agree with my concerns, you will reasonably ask where the analysis leads. What is the approach (or presumably combination of approaches) that can better reconcile reasonably free and open markets with independent national policies, maintaining in the process the stability in markets and economies that is in the common interest?

That is a question I cannot answer today with a sense of conviction and practicality. What I do know is that governments do not have before them the necessary analysis and well-conceived approaches that could command attention and support.

The creation of the G-20 at the exalted level of Presidents and Prime Ministers has been a political accomplishment. The agreed changes in IMF governing structure are important in achieving a sense of political legitimacy for its governing structure and decision-making. But that is not enough – it means little without substantive agreement on the need for monetary reform and practical approaches toward that end.

We are a long way from that. But what can be done now is to lay the intellectual ground work for approaches that can, for instance, identify and limit prolonged and ultimately unsustainable imbalances in national payments. We should be able, within a broad range, to manage exchange rates among major currencies in a manner that discourages the extreme changes that are inconsistent with orderly adjustment. We can and should consider ways and means of encouraging – even insisting upon – needed balance of payments equilibrium.

Nor would I reject some re-assessment of the use of a single national currency as the dominant international reserve and trading vehicle. For instance, do we want to encourage or discourage so important a development as regional trade and currency areas?

A new Bretton Woods conference? We are long ways from that. But surely events have raised, whether we want to admit it or not, some fundamental questions that have been ignored for decades.

We may have escaped a repeat of the Great Depression of the 1930’s. Happily, despite all the political turmoil in parts of the world, we have also escaped, narrowly escaped, a financial collapse destructive of major economies and needed cooperation. But obviously, that is not enough.

All that has happened reinforces what we typically affirm: a strong, innovative and stable financial system is fundamental to open trade and to the prosperity of all nations. Participation in such a beneficial system that has become truly international implies certain responsibilities.

Walter Bagehot long ago set out succinctly a lesson from experience: “Money will not manage itself”. He then spoke from the platform of the Economist to the Bank of England. Today it is our mutual interdependence that requires a degree of cooperation and coordination that too often has been lacking on an international scale.

Can we not, in approaching that challenge, restore something of the spirit and conviction that characterized the planning, the negotiation and the management of the Bretton Woods System that I once knew 50 years ago? Our host today, the Bretton Woods Committee lights the candle, but we have a long way to go.