STRENGTHENING THE RULES-BASED INTERNATIONAL MONETARY SYSTEM

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At the end of the 1944 conference where the Bretton Woods Agreement was finalized, US Treasury Secretary Henry Morgenthau spoke for all 44 delegations when he proclaimed that the purpose of the agreement was to "do away with economic evils—competitive currency devaluations and destructive impediments to trade."[1] Despite tremendous progress and many accomplishments during the past 75 years, today we are again facing economic evils—some reminiscent of the past—and an entirely new global economy. This essay addresses the question, "In what ways must monetary policy cooperation and the role of central banking be reimaged to continue to provide an effective policy tool kit for the real economy?" To answer the question, I first consider how people addressed such problems 75 years ago, and I then show how we can adapt their strategy to our current challenges.[2]

1 Henry Morgenthau, "Closing Address to the Conference" (Speech given at United Nations Monetary and Financial Conference, Bretton Woods, NH, July 1944).

2 This essay draws on John B. Taylor, "Recreating the 1940s-Founded Institutions for Today's Global Economy" (Speech presented upon receiving the Truman Medal for Economic Policy, Kansas City, MO, October 2015) and John B. Taylor, *Reform of the International Monetary System: Why and How?* (Cambridge, MA: MIT Press, 2019).

THE PROBLEMS THE BRETTON WOODS SYSTEM WAS DESIGNED TO ADDRESS

Competitive devaluations and currency wars were a serious economic problem in the years leading up to World War II. The British devalued the pound in 1931 and thereby gained a competitive advantage, but the devaluation harmed other countries' exports and economies. Not to be left behind, other countries followed, including the United States, which devalued the dollar in 1934. Whether defensive or offensive, these "beggar-thy-neighbor" actions led to government restrictions and interventions in other countries. After trying such interventions, Italy, for example, devalued the lira by 40.93 percent in 1936, matching precisely the US devaluation of 1934.

Another serious international economic problem stemmed from extensive "exchange controls," in which importers of goods were forced to make payments to a government monopoly in foreign exchange. The government would determine what types of goods could be imported and how much to pay exporters. Exchange controls also involved multiple exchange rates, government licenses to export and import, and even officially conducted barter trade. Such practices deviated from the principles of economic freedom and caused all sorts of distortions and injustices.

To deal with these problems, the parties to the Bretton Woods Agreement developed a strategy: Each country would commit to two basic monetary rules, which would become the key foundation of the rules-based system.

First, countries would swear off competitive devaluations by agreeing that any exchange rate change of more than 10 percent from certain values, or *pegs*, would have to be approved by a newly created International Monetary Fund (IMF). As then Assistant Secretary of State Dean Acheson later explained in testimony to gain support from the US Congress, "The purpose of the fund is not to prevent any devaluation. It is to prevent competitive devaluation."[3] The agreement created what was called an *adjustable peg system*.

Second, countries agreed to remove their exchange controls, with a transition period because many had extensive controls in place. To be sure, the countries did not agree to remove *capital* controls, which include restrictions on making loans, buying or selling bonds, and making equity investments.

With these commitments, the IMF would provide financial assistance in the form of loans. Jacob Viner, professor at the Chicago School of Economics, explained the deal to the US Senate: "Other countries make commitments

3 "Statement of Hon. Dean Acheson, Assistant Secretary of State, Washington, D.C.," in *Bretton Woods Agreements Act: Hearings before the Committee on Banking and Currency, United States Senate* (Washington, DC: Government Printing Office, 1945), 26.

with respect to exchange stability and freedom of exchange markets from restrictive controls while we [the United States] in turn pledge financial aid to countries needing it to carry out these commitments." He argued that it was largely "an American blueprint for the postwar economic world.... It seems to me a magnificent blueprint."[4] Many other economists supported it, including Irving Fisher, Frank Knight, and Henry Simons.[5]

In important respects, the agreement succeeded. Exchange controls were removed, though it took more than a decade, and the currency wars ended, though the adjustable peg system itself fell apart in the 1970s, giving way to a flexible exchange rate system. The 1970s were difficult because monetary policy lost its rules-based footing, and both inflation and unemployment rose. But in the 1980s and 1990s, policy became more focused and rules-based, and economic performance improved greatly. Though the move was not part of the original agreement, virtually all the developed countries that signed it—and others, such as Germany and Japan—also abandoned capital controls. By the late 1990s, many emerging-market countries were adopting rules-based monetary policies, usually in the form of inflation targeting, and they thereby entered into a period of stability.

TODAY'S INTERNATIONAL MONETARY SYSTEM

Unfortunately, this benign situation did not hold, and the international monetary system now faces challenges eerily similar to those at the time of the creation of the IMF. In my view, the problem traces to a departure from rules-based monetary policies at both the national and international levels. These deviations have not only helped bring on and worsen the global financial crisis, but they were also a factor in the subpar recovery.

Quantitative easing (QE) started in earnest in 2009 in the United States. It was followed by a period in which the dollar was low relative to the yen, eventually leading to QE in Japan in 2013, which depreciated the yen, as was the expressed intent of the Bank of Japan. That was followed by QE in the eurozone in 2014, which depreciated the euro, as was the expressed intent of the European Central Bank.[6] The dollar-yen-euro story from 2009 to 2014 looks a lot like the pound-dollar-lira story from

4 "The Views of Jacob Viner, University of Chicago," in *Bretton Woods Agreements Act: Hearings before the Committee on Banking and Currency, United States Senate* (Washington, DC: Government Printing Office, 1945), 637–45.

5 See "Recommendations of Economists for United States Approval of the Bretton Woods Monetary Agreements," in *Bretton Woods Agreements Act: Hearings before the Committee on Banking and Currency, United States Senate* (Washington, DC: Government Printing Office, 1945) 460–65.

6 Taylor, *Reform of the International Monetary System*, traces the details of QE and exchange rates during this period.

1931 to 1936, even though US policy makers considered the exchange rate effect to be a by-product of their actions, not the direct intent. So QE begets QE, which begets QE, and so on.

Interest rate decisions at central banks around the world would also resemble currency wars during this period. Whether you ask them or watch them, you can tell when central bankers have followed each other. Extra-low interest rates in the United States were followed by extra-low interest rates in many other countries, in an effort to prevent sharp currency appreciations. There was a global spread and amplification of monetary policy deviations.

Capital also flows in response to interest rate differentials—even if attenuated by policy reactions. Capital first rushed into emerging markets and is now rushing out. The rush in was in the form of large borrowings in dollars by firms and governments of emerging-market countries, which now are causing problems as the dollar firms.

A host of government interventions and restrictions, especially in housing markets, have been used to prevent the low interest rates from causing bubbles. Macroprudential regulations, which have legitimate purposes, were also being used to counter the effects of the low interest rates. There's also been a revival of capital controls. The IMF has endorsed such controls, as part of its new Institutional View, calling them "capital flow management measures," or CFMs.[7] Some macroprudential regulations are devoted to international transactions and thus can become capital controls in disguise.

A NEW STRATEGY

The world needs a new strategy to deal with these problems. The new strategy could build on the old strategy of the 1940s. We now have evidence that the key foundation of a rules-based international monetary system is simply a rules-based monetary policy in each country. Research shows that the move toward rules-based monetary policy in the 1980s was the reason that economic performance improved in the 1980s and 1990s. More recent research shows that the spread and amplification of deviations from rules-based monetary policy are drivers of the current international instabilities. And research shows that if each country followed a rules-based monetary policy consistent its own economic stability—and expected other countries to do the same—a rules-based, internationally cooperative equilibrium would emerge.[8]

So today, as in the 1940s, the international community could forge a new

7 International Monetary Fund, "The Liberalization and Management of Capital Flows: An Institutional View" (International Monetary Fund, Washington, DC, November 14, 2012).

8 John B. Taylor, "A Rules-Based Cooperatively-Managed International Monetary System for the Future," in *International Monetary Cooperation: Lessons from the Plaza Accord after Thirty Years*, edited by C. Fred Bergsten and Russell Green (Washington, DC: Peterson Institute for International Economics, 2016), 217–36.

agreement whereby each country would commit to its own rules for monetary policy. In keeping with today's integrated global economy, it would not be an adjustable peg system but, instead, a flexible system in which each country—each central bank—describes and commits to a monetary policy rule or a strategy for setting its monetary policy instruments. The strategy could include a specific inflation target, some notion of the long-run interest rate, and a list of key variables and ways to react to them. Such a system would provide each central bank with a transparent tool kit to deal with the real economy. Experience shows the importance of making sure the process does not impinge on other countries' monetary strategies nor focus on sterilized currency intervention.[9] The rules-based commitments would reduce the volatility of both capital flows and exchange rates, while also removing some of the reasons that central banks have followed each other in recent years.

Such a process would pose no threat to either the national or the international independence of central banks. It would be the job of each central bank to formulate and describe its strategy. Participants in the process would not have a say in the strategies of other central banks, other than that the strategies be reported. And the strategies could be changed or deviated from if the world changed or if there were an emergency. A procedure for describing the change and the reasons for it would be in the agreement.

The IMF would have an important role in maintaining this international agreement to state and follow a monetary rule or strategy. First, it would naturally take a monitoring role by providing a common format for describing each country's strategy in a transparent way, as well as keeping track of and reporting on each country's strategy. Second, it would provide guidance to countries and central banks, and share procedures to help them to communicate their strategies internationally. The policy rules or strategies would likely be different for small open economies than for large economies, and the IMF would allow for such differences. Other than ensuring transparency and clear reporting, the IMF would not have to stipulate that countries follow specific rules, but only that they follow some rule.

Note that this strategy is not just for the G7 or the G20 or some regional grouping. It is completely global—something for all the members of the IMF. As in the 1940s, the process could begin informally with a small group and then spread out, perhaps through circulating markups of the relevant sections of the agreement.

This reform is by far the most important ingredient needed for re-creating a rules-based international financial system. It will be difficult to carry out because there is still disagreement about

9 That is a lesson from the Plaza Accord of 1985, as explained in Taylor, "A Rules-Based Cooperatively-Managed International Monetary System for the Future."

the diagnosis and the remedy, though disagreement and debate were features of the period leading up to the Bretton Woods Agreement in the 1940s too.[10] Some argue, for example, that the competitive depreciations of the 1930s and those of the past few years are simply part of the process of world monetary policy easing.[11]

Though many countries are still in the midst of unconventional monetary policies, the US Federal Reserve is now in the process of normalizing its balance sheet and its interest rate policy. It appears to be moving onto a path to bring monetary policy back to a rules-based framework. Many of the changes have occurred recently, even as, in reports and speeches, the Federal Reserve has been emphasizing its monetary strategy and the use of monetary policy rules.[12]

The Fed's approach paves the way to an international monetary normalization and reform of the kind proposed here. Such a reform is attractive because each country can choose its own strategy and still contribute to global stability. And the time may be ripe, as witnessed by many recent calls for international monetary reform. The former head of the Reserve Bank of India, Raghu Rajan, emphasized that "what we need are monetary rules."[13] The European Central Bank president, Mario Draghi, argued that "we would all clearly benefit from . . . improving communication over our reaction functions."[14]

Other related reforms would also be important, such as setting a long-term goal of open capital markets and a corresponding sequenced removal of capital controls. Currently, 36 countries have open capital accounts, but another

10 Benn Stiel, *The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order* (Princeton, NJ: Princeton University Press, 2013) describes the contentious disagreements back then, especially in the battle between John Maynard Keynes and Harry Dexter White, some of which continued at the 1944 conference, as may be seen in the recently published transcripts: Kurt Schuler and Andrew Rosenberg, eds., *The Bretton Woods Transcripts* (New York: Center for Financial Stability, 2015).

11 See, for example, Ben S. Bernanke, "Monetary Policy and the Global Economy" (Speech at Department of Economics and Suntory and Toyota International Centres for Economics and Related Disciplines Public Discussion in Association with the Bank of England, London School of Economics, London, March 25, 2013).

12 See, for example, Jerome H. Powell, "Semiannual Monetary Policy Report to the Congress" (Given before the Committee on Financial Services, US House of Representatives, Washington, DC, February 27, 2018) and Board of Governors of the Federal Reserve System, *Monetary Policy Report* (Federal Reserve System, Washington, DC, July 13, 2018).

13 Raghuram Rajan, "Why the World Needs New Monetary Policy Rules," *World Economic Forum*, March 22, 2016, www.weforum.org/agenda/2016/03/why-the-world-needs-new-monetary-policy-rules/.

14 Mario Draghi, "The International Dimension of Monetary Policy" (speech, ECB Forum on Central Banking, Sintra, Portugal, June 28, 2016).

48 are classified as "gate" countries and 16 as "wall" countries, with varying degrees of capital controls.[15] The reform would involve a change in the IMF's Institutional View, and it should occur with a transition period, accompanied by measures to improve market resiliency in individual countries, along with adequate enforcement of safety and soundness regulations on financial institutions. Though controversial, the reform would be conceptually the same as the 1944 agreement to remove exchange controls.

CONCLUSION

This clear commitment to a strategy of counteracting "economic evils," as described 75 years ago by Secretary Morgenthau, could be part of an overall international economic reform. The specific reforms of the international monetary institutions that I have outlined here could form the basis of a broader strategy of economic growth, stability, and development that includes the World Bank, other international financial institutions, and the World Trade Organization. In that way, I believe we can reset the international economic system for another 75 years of progress and accomplishments. Such a reform would be a way of recommitting to the spirit of Bretton Woods and to the benefits of a rules-based international economic system as a key force for global peace and prosperity.

15 Andres Fernández, Michael W. Klein, Alessandro Rebucci, Martin Schindler, and Martín Uribe, "Capital Control Measures: A New Dataset" (IMF Working Paper No. 15/80, International Monetary Fund, Washington, DC, April 2015).