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The link between the current international monetary non-system, financialization and the Washington consensus

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ABSTRACT

The main purpose of the present work is to build a bridge between three concepts: the current international monetary system, financialization and the Washington consensus. Under this approach, the current international monetary non-system (that replaced the Bretton Woods system) imposed by Nixon in 1971 led to the oil shocks that in turn intensified the inflationary pressures of the rest of the decade. The bold resolution to end inflation in 1979 via high interest rates brought about a process of financialization that was cause and consequence of trade and financial liberalization. Interest rates eventually went back to levels comparable to those prevailing before the Volcker shock, which brought about a decline in firms' demand for credit that obliged banks to seek for other clients, i.e. the rest of the world and households. The ideas embedded in the Washington consensus contributed to the development of this financialization/liberalization process, and these gained strength as the previous regime (characterized by low unemployment rates and high inflation) was being replaced by the current regime paradoxically called the 'Great Moderation'. The process of financialization can be explained by the analysis of the capital structure of U.S. firms.

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1. Introduction

The current international monetary regime of flexible exchange rates is flawed. National and international economic authorities tend to promote competitiveness, price stability as well as trade and financial liberalization, whereas these measures (when carried too far, as is nowadays the case) enhance inequality, unemployment and financial instability.

Clearly, this statement must not be interpreted in the reverse causal sense that economies should pursue an agenda aimed at being uncompetitive, promote excessive inflation and extreme protectionism. Instead, it should be seen in retrospect, thus as a reflection that over the past four decades economic authorities have focused on (paraphrasing [Stiglitz, 2008, p. 42](#)) "too narrow a set of objectives, and on too limited a set of instruments" in order to undo the harm caused by previous mistakes; i.e. the Bretton Woods system.

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In order to boost competitiveness, the IMF recommends wage moderation to developed and developing economies² as the preferred recipe for these to grow and develop. These recommended measures usually come along with the promotion of productivity-enhancing industries that often make use of capital-intensive techniques, which in turn allows firms to remain in an unskilled-labor-saving production scheme.

Price stability is often perceived as an end, but it is rather a means of achieving competitiveness while at the same time guaranteeing that wealth will not be “inflated” away in the future.³

Trade and financial liberalization are also key factors in this strategy, for they can be seen as natural extensions of the “no barriers to entry” axiom that is explained in the very first chapters of microeconomics textbooks. Of course, with no tollbooths along the way capital may circulate across borders with no bound, thus making it easier for the world economy to approach its desired state of perfection, or so the story goes.

These policy objectives (competitiveness, price stability and liberalization) are at the core of what is called the Washington consensus, a development strategy proposed by John Williamson in 1989 that aimed at examining “the extent to which the old ideas of development economics that had governed Latin American economic policy since the 1950s were being swept aside by the set of ideas that had long been accepted as appropriate within the OECD” (Williamson, 2009, p. 7). The main thrust of the present article is that, by pursuing these ideals, national and international economic authorities have done more harm than good.

This can be explained in the following way. Since the end of WWII there have been a number of major changes in the international monetary system that can be seen as a non-fortuitous sequence of events. That is, with the adoption of the White Plan (instead of the alternative Keynes Plan) after the war, the Bretton Woods system (1945–1971) proved unable to provide the stability the international financial system required. As a consequence, the Nixon administration suspended the gold-dollar convertibility, thus unilaterally ending the *limping* gold standard⁴ better known as Bretton Woods system, which in turn intensified the inflationary pressures of the seventies. With the devaluation of the dollar (caused by the collapse of BW), OPEC member countries retaliated with oil price hikes and embargoes that pushed consumer and investment prices up.

In the words of Michael Graetz (2011, p. 18) “[o]il producing nations lost purchasing power throughout the world as the value of the dollar fell because their oil prices were set in dollars. In September 1971, a month after Nixon’s speech, at an OPEC meeting in Beirut, its member states increased oil prices by nearly 9 percent explicitly to compensate for the devaluation of the U.S. currency. And the value of the dollar continued to decline for several more years. By mid-1973, the dollar price of gold had risen to more than \$90 an ounce; by the end of the decade, it exceeded \$450”.

As a policy response to this, in 1979 interest rates went up sharply (the Volcker shock), thus ending the inflation problems created by the oil shocks. Since that year several changes took place that, among others, led to the set of policies that are embedded today in the Washington consensus.

The paper is organized as follows. The following section deals with the Bretton Woods institutions, and how their roles have changed over time, and how these relate to the current international monetary non-system that replaced the Bretton Woods system of fixed (or semi-fixed) exchange rates. Section 3 links the current monetary system to the process of financialization, focusing on the United States economy. Section 4 relates this process to the set of policy prescriptions made in the Washington consensus. Section 5 concludes.

2. Bretton Woods institutions during and after Bretton Woods

Following the end of WWII, the set of rules in the international financial system agreed upon at the Bretton Woods conference involved the creation of two international organizations: the International Monetary Fund and the World Bank (originally called International Bank of Reconstruction and Development). Their roles and ideology have changed over time.

During the Bretton Woods years, the IMF guaranteed that the exchange rates of member countries remained tied to the dollar (the key currency, in turn tied to gold) within respectable limits. In contrast, today it allows central banks to accumulate dollars in order to safeguard the value of their currency under the exchange rate regime of their choice.⁵ Up

² For instance the World Economic Outlook published by the IMF (2014, p. 60) mentions that, in Japan “policy measures could prove less effective at boosting growth than envisaged if they fail to raise inflation expectations, nominal wages, exports, and private investment”. Also, when discussing the case of Belarus (p. 65) it states that “[a]lthough financial support from Russia could provide Belarus with some short-term breathing space, steps to reduce wage and credit growth and to increase exchange rate flexibility should be taken expeditiously to narrow imbalances”.

³ For an interesting account of the psychological factors of why people dislike inflation, see Shiller (1996).

⁴ “If (...) convertibility is restricted, for example to the requests from central banks, we are in the presence of a *limping* gold exchange standard, in which case the automatic mechanisms governing the gold standard no longer operate, and the concept itself of convertibility has to be redefined: now convertibility simply means that private agents have the right to freely exchange the various currencies between each other at fixed rates” (Gandolfo, 2002, p. 32, emphasis in the original).

⁵ The fact that the dollar was the key currency during the BW years and that there was a single issuer of this currency that can live beyond its means (the U.S.), and that this is again the case in the present, has led some to define the current international monetary and financial system as Bretton Woods reborn. For a discussion of why this is misleading see Eichengreen (2004).

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