



REFLECTIONS STIMULATED BY THE BOOK “TOWARDS A RENEWED BRETTON WOODS AGREEMENT”

WRITTEN BY GIOVANNI TRIA E ANGELO FEDERICO ARCELLI

by Rainer Masera,
Dean Business School,
Guglielmo Marconi University, Rome

Introduction

In 1944, when the Second World War was still raging, an official international Conference in Bretton Woods set the basis for a new financial system. Tria and Arcelli offer a holistic view for reform of the Bretton Woods agreements. Globalization is at a critical stage with the pandemic crisis impinging upon the trade and integration processes. Their book offers elements for a new scheme open to all economies of the world to redefine mechanisms of development, cooperation and finance. They indicate that the technological competition between the United States, China and Europe should become an engine for more equitable and renewed growth. My contribution today will be centered on Keynes' ideas in the Conference and their lasting validity.

1. Global Value Chains and Trade

The initial poster of today's webinar contained a reference to Global Value Chains and Trade. I take the liberty of referring to it in my initial remarks.

In the G20 Luigi Paganetto and others - notably Giovanni Tria and Pasquale Scandizzo - made very significant contributions to this very important topic. Let me start by clarifying two overlapping but separate concepts which are commonly referred to as equivalent: Global Value Chains (GVCs) and Global Supply Chains (GSCs). The processes of globalization and world trade in the past few decades have generally been analyzed by making reference to - and developing the - two models.

GSCs focus on the transportation and trade of materials between locations in different countries and areas of the world. Supply chains are production networks that assemble products originating in different countries - intermediate goods - and sell them in final markets. Trade in intermediate goods is approximately twice as large as that in final goods.

GVCs refer to the gains from international specialization in the production of goods and services, their supply, distribution and after sale activities coordinated across different and often far away countries. The GVC concept is therefore broader and more complex in nature. It refers to "upgrading" as a process adopting better technologies, reducing costs and improving efficiency. Process upgrading is paralleled by product upgrading with enhanced quality of the products. "Functional upgrading" is the final phase where global firms design products, marketing and branding by integrating multinational/multifirm productive facilities. The value creation feature draws heavily on Porter's (1985) mainly domestic value chain and competitive advantage models. GVCs represent instead networks of production and trade across countries/continents.

The analysis of GVCs should be grounded on appropriate trade theories, not only in terms of final but also of intermediate goods. The difficulties of use of the Heckscher/Ohlin/Samuelson models led de facto to acritical application of the basic Ricardian trade approach. This represents an oxymore because research on GVCs clearly identified the importance of governance patterns which contradict the hypothesis of atomistic competition. Gereffi (2018) shows the existence of two types of governance: buyer driven and

producer driven chains with lead firms upstream and downstream in the chain. Hierarchical captive and modular chain governance models describe relations between lead and other firms.

Many factors interact in the analysis of GVCs. An important driver is servitization - i.e. the intertwining of products and services, the former becoming also outcomes as services. The intangible, technological and financial features embedded in manufacturing acquire increasing importance. At the same time services can lose their traditional “perishable” character: on-line teaching and training are a clear example. The economic policy debate which erupted in the context of the Covid-19 crisis has centered on the trade-off between the gains from GVC international specialization, the vulnerability of intermediate firms and the risks of transmission of shocks and disruption in domestic and international markets of key manufacturing and medical products. Both servitization and Industry 4.0 reshape GVCs and underline the priority of achieving sustainability.

It has also been suggested that, in order to contain systemic risk, appropriate policy-induced reshoring may be required. Covid-19 lockdowns disrupted GSCs and GVCs. Beyond reshoring, the concept of supply chain resilience has acquired major importance. It is also clear that the adjustment process is seen more and more as a shared process between companies and governments (Fortunato 2020).

Hedging strategies and the reemergence of industrial policies are intertwined. The concepts of industrial policies are intrinsically connected to Chinese international trade, but they have also become a feature of the United States and more recently of the European international trade. In the three most advanced areas of the world they are taking also the form of new policy-oriented infrastructures of technological transfer, which have become a distinctive character of the multifaceted reality of international production and trade. The confrontation between the US and China over the design, implementation and deployment of 5G technology is evidence of the complicated trade-off between free and managed trade.

The complexity of these factors has been compounded by the increasing attention to environmental risks and to the scrutiny of GSC according to the new stringent ESG requirements. Hedging strategies have become a common response in many countries and in most companies, with alternative nearshoring supply solutions, stockpiling and complex insurance instruments.

2. From GVC and trade to Bretton Woods and back

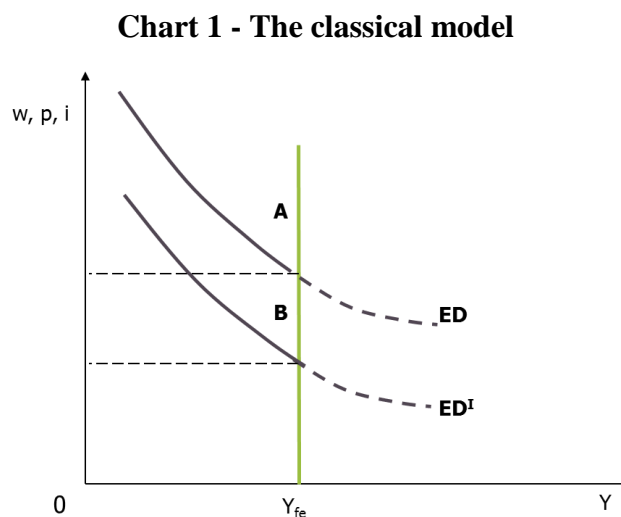
The issues evoked are of immediate and “global” concern. A (long term) retrospective reference may however be appropriate. As was indicated, a commonly adopted analytical and policy approach continues to be Ricardo’s (1817) model. This is rightly so, provided that it does not imply acritical allegiance.

There can be no dispute on the overall advantages of open international trade and the costs and risks of protectionism. But when economists talk about trade, it is nearly always the aggregate gains and the self-adjusting character of trade imbalances that they emphasize, without paying adequate attention to the realism and the relevance of some key hypotheses behind Ricardo’s models. At the cost of some oversimplification I recall here four key assumptions:

- Say's Law. The law of the markets states that production is the source of demand. Income is always used, there is no underemployment equilibrium (savings glut). In the words of Ricardo “*money cannot call for goods, but goods can call for money*”.
- The equivalence of public debt and future taxes.
- Comparative advantage. There is only one key factor of production: labor which is taken to be immobile.
- Full employment of factors of production. All therefore reap benefits from free international trade.

Thomas Malthus was an early critical voice, which went unheeded.

Keynes argued in the *General Theory* (1936) that during the Great Depression an overall glut of production and deficiency of demand did occur and required government action to sustain and stimulate demand. He did not deny the advantage of open trade and strongly objected to autarkic solutions. He did however point out that policies and exchange rates had to provide the appropriate support and identified the adverse consequences of return to the gold standard at pre-war parities for the onset of deflationary forces. His analytical and policy position was clearly not in line with an acritical adherence to the classical model which, as we have seen, discards the principle of effective demand (Charts 1 and 2), and affirms the neutrality of money and the classical dichotomy.



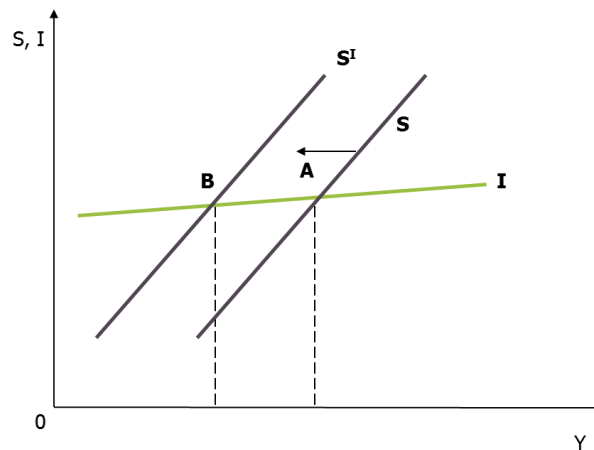
The principle of effective demand (ED) was not accepted by the mainstream classical school (Say, Ricardo, Smith), although it had been analyzed notably by Malthus.

“*Every frugal man a public benefactor*” (Smith, *Wealth of Nations*, p. 371).

Source: Author.

The view taken here is more in line with the Keynesian paradox of thrift (Chart 2).

Chart 2 - Paradox of thrift: Keynes



In the Keynesian system effective demand is a key concept. Excess savings can take place. In this condition (the fallacy of composition) the chain of causation is reversed: it is investment leading to saving (Hicks, 1977, p. 22).

To repeat in the classical economy saving leads to investment. In the Keynesian framework the reverse causation can apply, with investment leading to saving. More accurately, saving and investment are determinates of the system, not the determinants. The true determinants are: i. the propensity to consume and ii. the schedule of the marginal efficiency of capital and rate of interest. In this perspective, a more accurate representation of the phenomena under discussion in this chart and in chart 4 below would be based on a shift of the (autonomous) investment schedule. The graphical specification adopted follows the more common approach used to analyze global excess savings.

A decreased propensity to consume can diminish employment and lead to excess savings (Keynes, 1936, p. 187).

Source: Author.

The excess saving model is generalized in an open economy with the trade account registering structural surpluses.

This was the position taken by Keynes in his debate with White at the Bretton Woods Conference - which had been anticipated in his Tract on Monetary Reform (1923, The gold standard is already a barbarous relic) and in his pamphlet (The Economic Consequences of Mr. Churchill 1925) -. To repeat, he did not question the openness of international trade - of which he was a staunch advocate - but indicated that ex ante surveillance should apply to both surplus and deficit countries. The laissez faire adjustment mechanism would impinge mainly on deficit countries and would prolong the recessionary phases. The choice of deflation over devaluation was criticized. Keynes proposed a symmetrical system for promoting adjustment. This could work directly through the surveillance by the Fund to be created, but preferably through the creation of an International Clearing Union (ICU) which would issue its own money - the bancor. To start with, deficit and surplus countries would be charged penalizing interest rates on their bancor accounts and/or devalue/revalue their currencies by amounts agreed with the ICU. The burden of adjustment would be reversed compared to the traditional adjustment mechanism: if by the end of a given time period the surpluses would not be reabsorbed, they would automatically be used to clear other countries' deficits. More specifically, the Keynes "use or lose it" approach was based on using the surpluses to increase imports, to build productive factories in deficit countries and ultimately to cancel the negative balances of deficit nations¹.

¹ With the US being the largest surplus country, it is easy to understand why White would not accept the Keynes proposal.

Keynes policy prescriptions were predicated on the need to avoid the repeat of deflations and depressions and assumed therefore the non-general validity of Say's Law.

The reconstruction period after World War II² and the initial phase of the globalization process after the fall of Berlin's Wall seemed to provide evidence on the non-repetitive character of savings gluts. But strong counter evidence began to build up.

3. The savings glut and monetary policy

The contributions of Ben Bernanke can be singled out. His arguments in a nutshell were that: i. (1995) the causes of the Great Depression have their roots in the interwar policies of many leading countries with the misguided return to the gold exchange standard and the adoption of deflationary policies, notably in Germany (Bruning)³; ii. (2005) at the turn of the new Millennium the positive features of globalization and "relatively" free trade could be undermined by the large and enduring surpluses of Germany, China, Japan and the Netherlands, which were the reflection of insufficient effective demand. It must be underlined that the saving glut framework became a dominant view not only in the United States and in the FED, but was accepted - beyond the Great Financial Crisis - by the ECB itself, which helped explain its gradual recourse to a negative interest rate policy.

"There is a temptation to conclude that since very low rates generate these challenges, they are the problem. But they are not the problem. They are the symptom of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy.

It is this phenomenon - the global excess of savings over profitable investments - that is driving interest rates down to very low levels. And so the right way to address the challenges raised by low rates is not to try and suppress the symptoms, but to address the underlying cause.

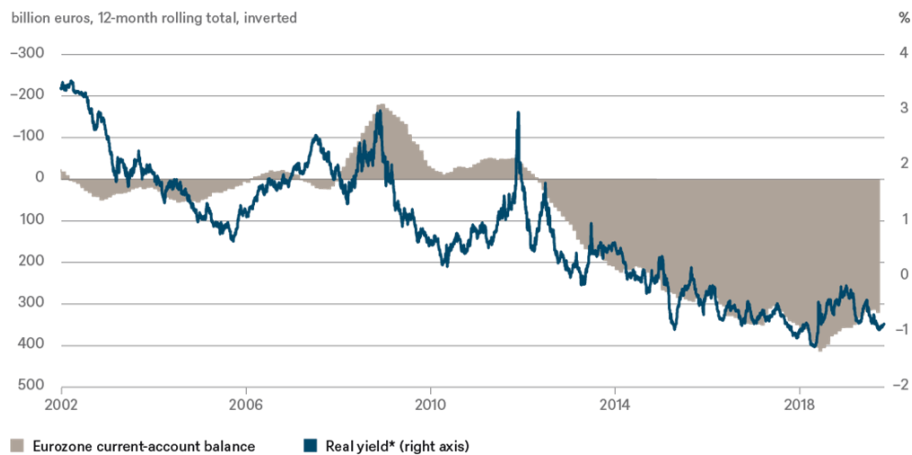
This requires that we tackle both the long- and short-term drivers of lack of demand, and that we draw for that purpose on both monetary policy and other types of policy." (Draghi 2016).

Chart 3 is indicative of the relationship in the past two decades between real yields on government bonds and the growing current account surpluses of the area.

² The Marshall Plan adopted by the United States took however many leaves from Keynes' "use or lose" model.

³ Significant support to this line of thought is offered by Fazio (2020).

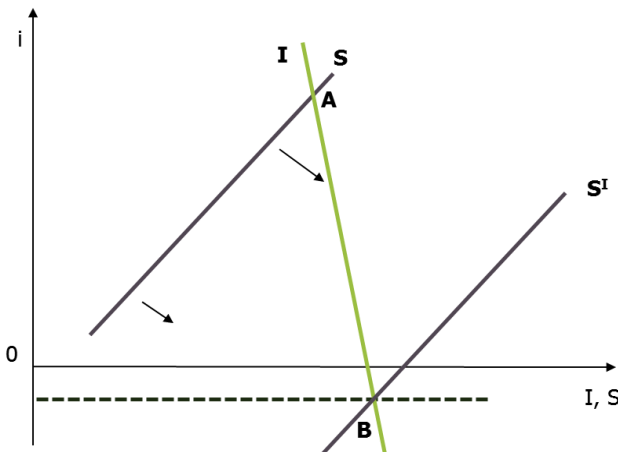
Chart 3 - Eurozone: current account balance and real government yields



* Yield of ICE BofAML 1-10 Year Euro Inflation-Linked Government Index.
Source: DWS (2019).

Let me go back to Keynes: he refuted the idea that the rate of interest depended on and influenced saving. The view was firmly expressed that “*the rate of interest is that rate at which the demand and supply of liquid resources are balanced. Saving does not come into the picture at all.*” (Keynes, 1937). If this is the case, the question becomes whether the (near) exclusive reliance on the interest adjustment mechanism for prolonged, possibly indefinite, periods is appropriate and sustainable. The savings glut leads to highly expansionary monetary policy. Temporary equilibrium is reached only with negative interest rates (Chart 4).

Chart 4 - The monetary correction model under stress: the failure of the interest rate mechanism



The savings glut leads to highly expansionary monetary policy. Temporary equilibrium B is reached with negative interest rates. But, if protracted overtime, sub-zero rates lead to adverse consequences: mispricing of risk, excessive risk-taking and financial vulnerabilities, the undermining of the bank credit model and distortions in savers behavior. Ultimately, this can result in excessive leverage and systemic risk.
Source: Author.

4. The Covid pandemic and excess savings

The Covid crisis has special features: it is exogenous and broadly symmetrical. It is however yet another manifestation of excess savings with the need for exceptional fiscal and monetary support measures. The policy approach adopted worldwide and notably in the United States and in Europe was appropriate and warranted.

Beyond the measures to mitigate the demand-related economic fallout, the common emphasis is on “good” infrastructure investment (anticipated rate of return higher than cost of finance). They support effective demand, but, above all, they augment the growth rate of total factor productivity and contribute to shelter the economies from the risks of climate change which have acquired both real and financial (green swan) dimensions.

The accumulation of infrastructures broadly defined and the financing mechanisms proposed, with marked based schemes and private/public initiatives - centered on the view to crowding-in private investments - are key to resume a resilient growth path and to start the solution of the accumulated debt through growth, without a self-defeating recourse to exceedingly tight financial straight-jackets (for an analysis of these points see Paganetto 2020 and Masera 2020).

A difficult traverse begins now. The debate on the revision of global value chains is one manifestation. More generally, the question of a gradual return to a less stimulative policy stance is beginning to emerge. In the United States the new \$1.9 trillion Biden fiscal package under discussion in the Senate and the affirmed intention of the FED to maintain an ultra-low interest rate policy, begin to raise the issue of risks of moving from Scylla to Charybdis. In other words, there could be a recognition lag in reverse, before realizing that the economy is going back to a recovery which might be more V than K-shaped, as appears to be the case in China. Many draw attention to the distortionary effects of a prolonged recourse to ultra-low interest rates: there is the question of potential moral hazard in respect of governments’ actions and the risk of sustaining zombie companies. The addiction of equity and bond capital markets to continued stimuli is an increasing source of preoccupation.

Some have gone as far as expressing fears that the prodromes for inflation/hyperinflation might be present. It would be interesting to know the views of Professors Tria and Arcelli - and of Professor Phelps - on these topics and how the renewed Bretton Woods agreements could help steer the right policy course at world level.

Bibliography

- Bernanke B. (1995), “The macro economics of the great depression: A comparative approach”, *Journal of Money, Credit and Banking*, n. 27.
- Bernanke B. (2005), “The global saving glut and the US Current Account Deficit”, *Virginia Association of Economists*, Richmond, March 10.
- Draghi M. (2016), “Addressing the causes of low interest rates”, *ECB*, Frankfurt, May 2.
- DWS (2019), “When saving is not a virtue”, December 6.
- Fazio A. (2020), “L’inflazione in Germania nel 1918-1923 e la crisi mondiale del 1929”, Treves, Roma.
- Fortunato P. (2020), “How Covid 19 is changing global value chains”, *Unctad*, New York, September.
- Gereffi G. (2018), “Global value chains and development”, *Cambridge University Press*, Cambridge.
- Hicks J (1997), “Economic perspectives”, *Oxford University Press*, Oxford.
- Keynes J.M. (1923), “Tract on monetary reform”, *Macmillan*, London.
- Keynes J.M. (1925), “The economic consequence of Mr. Churchill”, *The Royal Economic Society*, *Palgrave Macmillan*, London.
- Keynes J.M. (1936), “The general theory of employment, interest and money”, *Palgrave Macmillan*, London.
- Keynes J.M. (1937), “The ex-ante theory of the rate of interest”, *Economic Journal* Vol. 47, December.
- Masera R. (2020), “For a resilient, sustainable and inclusive recovery in Europe: Challenges and proposals in response to the pandemic crisis”, *Law and Economics Yearly Review*, n. 1.
- Paganetto L. (2020), “Europa e le sfide globali. La svolta del Green Deal e del digitale”, *Eurilink University Press*, Roma.
- Porter M. (1985), “Competitive advantage: Creating and sustaining superior performance”, *Simon and Schuster*, New York.
- Ricardo D. (1817), “On the principles of political economy and taxation”, (first edition), *Murray*, London.
- Smith A. (1776), “Wealth of nations”, *Edwin Cannan Edition 1904*, *Methuen*, London.
- Tria G. and Arcelli F. (2021), “Towards a renewed Bretton Woods agreement”, *Transatlantic Leadership Network*, Washington D.C.