From the Bretton Woods system to global stagnation

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Abstract
After the demise of the Bretton Woods system, the world economy entered an era of deepening liberalisation at both the national and the international level. There has been a phenomenal rise in international trade. Surprisingly, this has halved the growth rate of global GDP – and has yielded many other undesirable outcomes. This article argues that this is all the result of excessive trade imbalances emerging under liberalised trade and capital flow arrangements, as well as the 'race to the bottom' with respect to wages.

When describing the Bretton Woods system, one generally recalls its most discernible aspects: the imperative of constancy in the (negotiated) reciprocal exchange rates of national currencies and the fixed US dollar price of gold from US reserves available to the public authorities of those other countries that were participants in the system. For a long time, this arrangement seemed to work quite well, despite periodic tensions. But by the early 1970s it had started to erode. The authorities in up-and-coming Germany and Japan began to emancipate themselves and act less cooperatively vis à vis the US than before. This led to the 'temporary' suspension of the US dollar's convertibility into gold (1971). As a result, the international monetary system lost its previous 'natural anchor'. Under the influence of strengthening 'market forces' (including speculation), exchange rates began to move relatively freely. The first elements of the globalisation entered the scene in 1973. Of course, from this point onwards, exchange rate fluctuations became volatile, unpredictable and often excessive.

The Bretton Woods system: liberalism under surveillance

The fact is often overlooked that, for a long time, the world economy under the Bretton Woods system operated in a specific environment that would have to be regarded as economically fairly illiberal. The mere decreeing of exchange rates was an internationally agreed administrative decision. More significantly, individual partner countries pursued aggressively 'selfish' industrial policies. In most of them, multi-year development strategies requiring the use of protectionist tools – including the subsidisation, or even de facto nationalisation, of individual industries – were seriously pursued.

In macroeconomic strategy, fiscal policy – generally minimising the size of deficits – played first fiddle. The rule was a high progression of personal taxes and the heavy taxation of corporate

[1] Thanks are due to Vasily Astrov for helpful suggestions.

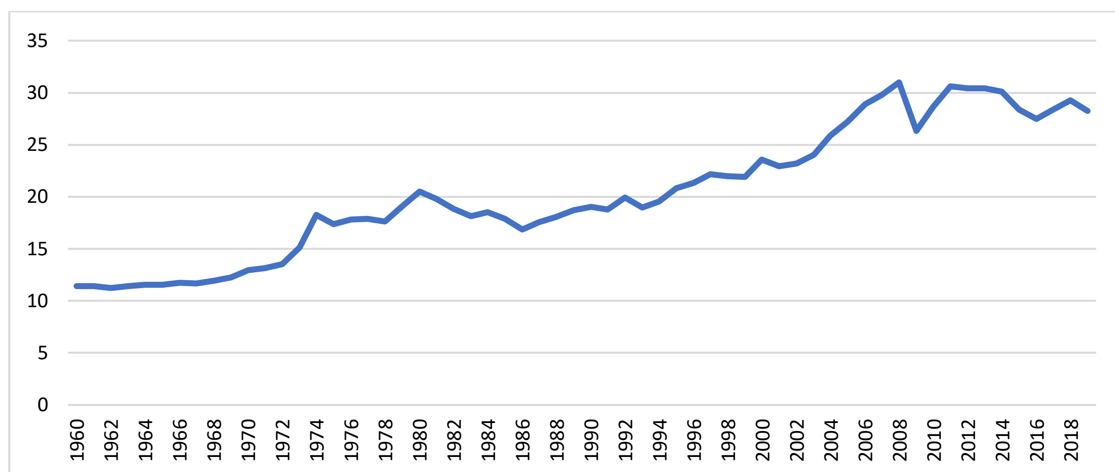
profits. Monetary policy played a secondary (if not tertiary) role. Banks and other financial institutions were subject to various regulations and limitations. (Private) capital flows were restricted and controlled, which had the effect of keeping international trade imbalances in check – and maintaining the desired constancy of exchange rates. Significantly, the sheer volume of foreign trade was, in most partner countries, further constrained by extensive systems of (often absurdly high) tariffs and various non-tariff restrictions.

It is also essential to note the role and importance of trade unions, which were generally the active and valued partners of government. Their cooperation was important in controlling inflation and unemployment, both of which were low – far lower than in later periods. Needless to say, levels of income inequality were also incomparably lower than later on.

Post-Bretton Woods: the expansion of world trade

The disintegration of the Bretton Woods system – not only the freeing up of exchange rates, but also the parallel (gradual) liberalisation of trade and international capital flows – contributed to a rapid expansion of world trade (in goods and services). This is illustrated in Figure 1.

Figure 1 / Exports of goods and services, as % of world GDP (1960-2019)



Source: WDI (World Bank).

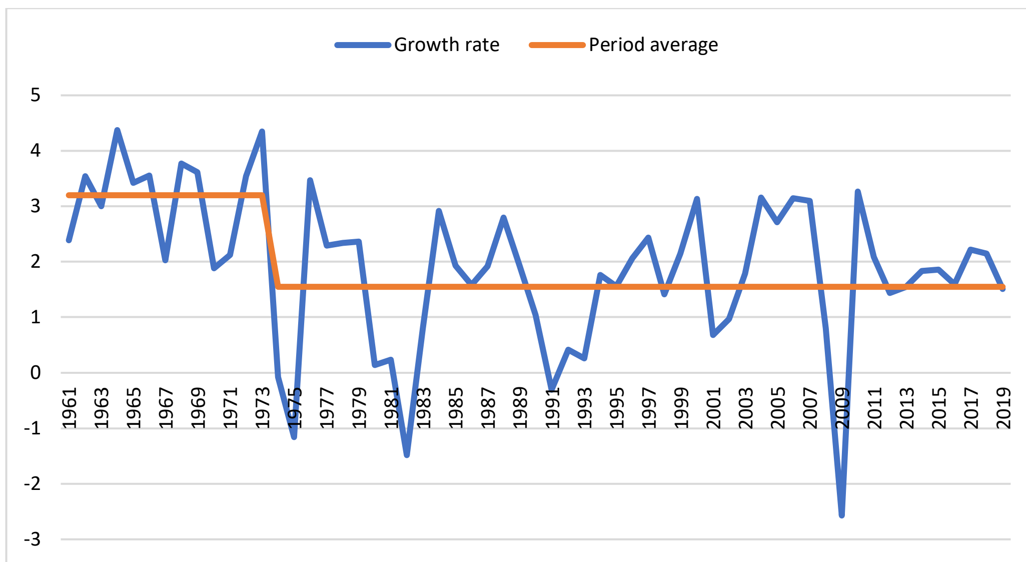
As can be seen, the share of trade in global GDP was fairly low in the 1960s (around 11%). The sharp increase recorded in 1974 and the following few years must be attributed to the progress of liberalisation. Only to an extent can it be said to reflect the effects of the 'oil shocks' of the time. From 1986 (after the disintegration of the OPEC cartel and the normalization of world oil prices), the trade share increased from close to 17% to over 30% in 2008 (i.e. until the onset of the global financial crisis). After that, up until 2019 it remained at between 27% and 30%.[2]

Has growing trade slowed global economic growth?

[2] In our narrative, we do not include data for the pandemic year 2020 and the post-pandemic years thereafter, for obvious reasons.

Any economist whose education begins (and often ends) with the theory of comparative advantage à la David Ricardo would expect such a sharp acceleration in international trade to result in a corresponding acceleration in global GDP growth. But he would be in for a surprise: global GDP growth (per capita) was immeasurably faster and more stable under the Bretton Woods system, as Figure 2 shows.

Figure 2 / Growth rate of global GDP per capita, in % (1961-2019)



Source: WDI (World Bank).

In the final period of the Bretton Woods agreement (1960-1973), for which we have reliable statistics, global GDP per capita grew at an annual average of 3.2%. In the entire subsequent period ('post-Bretton Woods' – 1974-2019), the average annual rate was half that (1.55%). Moreover, whereas growth in the first period was relatively stable, in the second it became extremely volatile, characterised by major fluctuations. Painful recessions (especially for the labour market) were unavoidable during this period. The average unemployment rate under Bretton Woods was 4.9% in the US, 1.3% in Japan and 2.4% in the 12 countries that later formed the core of the euro area. In the post-Bretton Woods period, by contrast, the average unemployment rates were 6.3%, 3.2% and 8.7%, respectively.

The recessions were not the outcome of some 'exogenous shocks': they were the result of systemic economic change post-1973 (liberalisation, deregulation, privatisation and – ultimately – the financialization of economies), as well as of political change: a retreat from friendly cooperation with trade unions; a reduction in the scope of social policy; the restoration of the priority of monetary policy; and a 'fight against inflation' at the cost of rising unemployment. While the 1976 recession can partly be attributed to the effects of the first 'oil shock', the subsequent recessions of 1982, 1991 and 2009 were created by the 'innate' mechanisms of increasingly liberalised national economies and the ever-deeper liberalisation of international economic relations.

Was David Ricardo wrong?

Standard economic theories prove mathematically that trade liberalisation must result not only in an increase in the volume of trade, but – above all else – in additional benefits for the international

community as a whole (i.e. for all, or most, trade participants). And these benefits should grow as trade costs (including, for example, transport costs) fall and as newer and more efficient production technologies become more readily available – as has undoubtedly been the case in recent decades. Why, then, has the liberalisation and expansion of trade after the abandonment of the Bretton Woods system not resulted in accelerated GDP growth for the world?

I believe that conventional theories, which argue the benefits of free trade, are out of kilter with economic reality. At their core is the assumption that trade takes place on the basis of barter: in David Ricardo's archetypal model, Portugal and England exchange wine and cloth. The point is that barter is inherently sustainable – it does not lead to trade imbalances. But in reality, not only does trade use just money, but its real purpose is actually to make money, to accumulate financial assets – and not just to exchange 'wine' for 'cloth'.

The alternative theory (yet to be fully articulated), which allows for the emergence of trade imbalances (manifested by the growing indebtedness of some countries to their trade partners), would not justify the thesis of the necessary beneficence of free trade. But it could justify the thesis that the emergence of such imbalances may adversely affect the size (and hence the growth) of world GDP. Note that, at the national level, a trade deficit reduces the size of GDP, while a trade surplus increases it. In the face of a trade imbalance, the GDP of deficit countries falls, while the GDP of countries in surplus rises. The point is that the GDP losses of deficit countries may be greater than the gains of surplus countries. In sum, unbalanced trade would therefore diminish aggregate GDP for the world as a whole.[3]

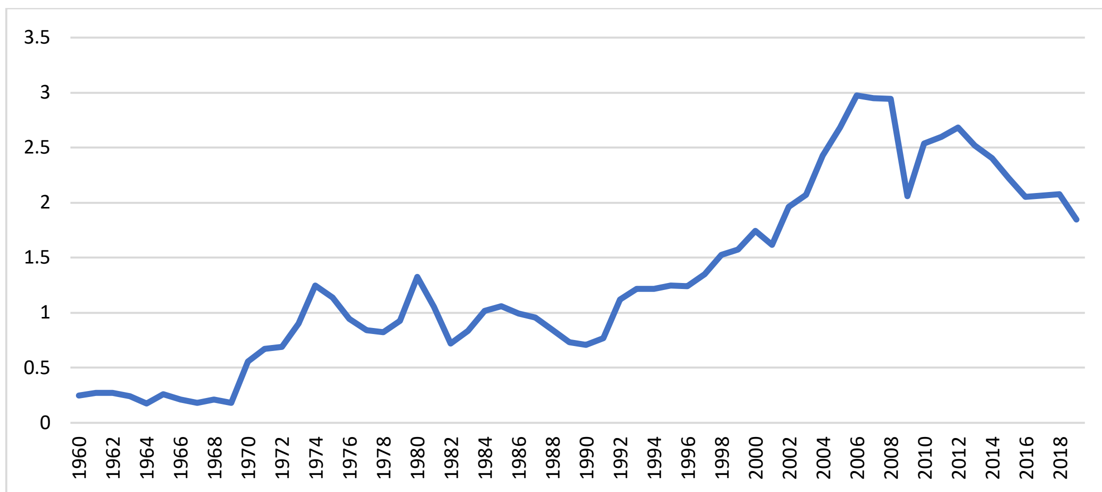
The build-up of trade imbalances after 1973

During the Bretton Woods period, the combined trade deficits of all the countries in the world represented a fraction of 1% of world GDP (see Figure 3). In the post-Bretton Woods period, they initially fluctuated at around 1%. The triumphant liberalisation taking place globally in the 1990s and beyond is reflected in the continued rapid expansion of the combined deficits: on the eve of the global financial and economic crisis of 2008, they had reached 3% of global GDP.

I believe that the progressive imbalance in world trade was one of the direct causes of the weak and erratic growth of world GDP in the post-Bretton Woods period. Recall that trade deficits represent at the same time the emergence of financial liabilities of deficit countries vis à vis surplus countries. In a liberal world economy, accumulating trade deficits can be temporarily financed by 'liquid capital', which abounds during the good times. Sooner or later, however, the credit-inflated 'boom' must come to an end, resulting in a minor crisis, or a major one – or occasionally even a catastrophe. It is therefore obvious that the systematic and massive accumulation of liabilities due to trade deficits usually ends badly – not only for deficit countries, but also for those running a surplus: they are forced to accept the insolvency of over-indebted countries (and in consequence to take a financial hit) and, in addition, are deprived of their export markets.

Figure 3 / Combined trade deficits (in goods and services), as a percentage of global GDP (1960-2019)

[3] This point can be demonstrated analytically – see Leon Podkaminer, 'Trade imbalances are undesirable: A note', *Real-World Economics Review*, 80 (2017).



Source: own calculations based on WDI data (World Bank).

Wages: the ‘race to the bottom’

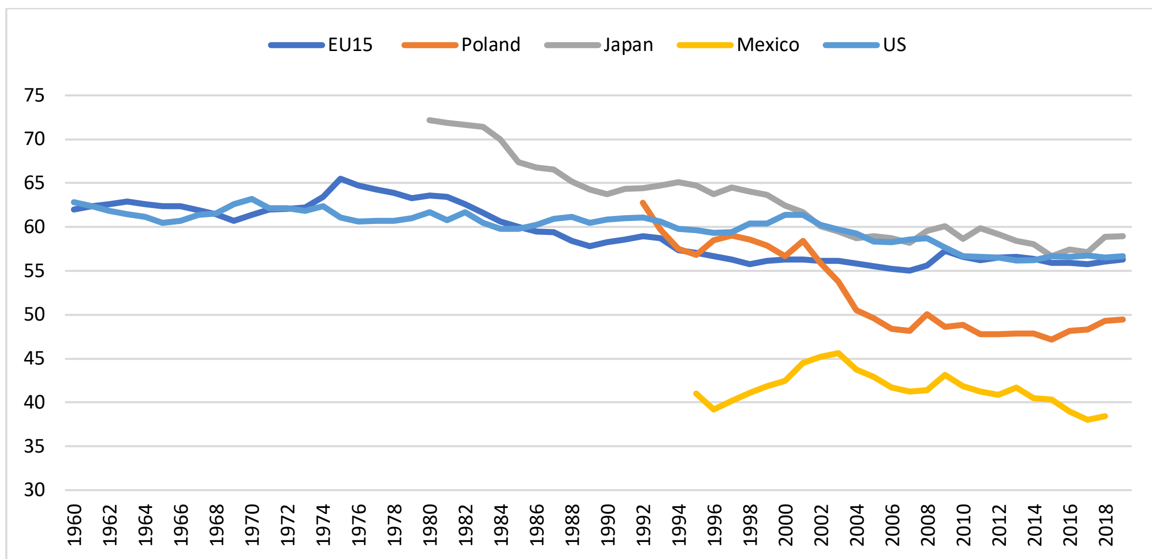
Under the Bretton Woods system, the share of wages in GDP was (relatively speaking) high (see the trajectories for the US and 15 Western European countries in Figure 4). The high wage share, and thus the relatively low profit share, was evidently no obstacle to high investment rates, low unemployment and inflation, and rapid economic growth. But all that was to come to an end with the disintegration of the Bretton Woods system and the progressive liberalisation of the world economy. Since 1975, the wage share has been falling in the US and Western Europe – as well as in Japan (since 1980) and Poland (since 1992). In Mexico, characterised by a very low wage share, the decline began in 2002 (i.e. already under NAFTA, the North American Free Trade Agreement).

The shrinking share of wages in GDP can be explained in several ways. Personally, I am not convinced by the explanation that focuses on the impact of technological change, as it replaces human labour with machines. The fairly widespread relocation of labour-intensive activities to developing countries is, after all, motivated by low labour costs, not by any particular availability of robots.

The declining wage share seems to be a natural consequence of the liberalisation (and deregulation) of market economies. Emerging recessions and weak economic growth after 1973 led to a resurgence of high unemployment and contributed to a decline in the role of trade unions. Economic policy priorities also changed, and monetary policy, guided by the imperative to ‘fight inflation’, returned to favour – even at the cost of massive unemployment. Fiscal policy, which was supposed to stabilise growth and limit unemployment, lost its importance. All these phenomena favoured limiting wage growth. Wages ceased to keep pace with rising productivity.

A sharp reduction in the share of wages in GDP (and the concomitant rising income inequality) is conducive to a drop in economic growth. The reason is quite simple: the propensity to consume from wages is higher than the propensity to consume from profits and high incomes.

Figure 4 / Wage share of GDP in %, selected economies (1960-2019)



Note: EU15 includes EU member states as of April 2004, including the UK.
Source: AMECO.

Weak consumption growth in individual countries creates an incentive to seek outlets (and profits) in foreign markets. This is one of the reasons for the trends in world trade illustrated in Figures 2 and 3. At the same time, success on foreign markets is conditioned, among other things, by low labour costs. What we have here, then, is a veritable vicious cycle: since domestic demand is weak, foreign markets must be sought; in order to win (and keep) them, it is desirable to reduce production costs – i.e. unit labour costs (as a last resort, offering wages that do not compensate for productivity increases). But by reducing unit labour costs, one simultaneously retards the growth of domestic demand...

In addition, under conditions of liberalisation of trade and capital flows, firms minimise (labour) costs by shifting many production activities to poorer countries with even lower labour costs (and often low taxation of profits). The natural consequence becomes a 'race to the bottom' – a race in activities that reduce labour costs, including, of course, wages themselves (even in lower-wage countries, such as Poland and Mexico).

Need for a new Bretton Woods?

The 'downward' race to the lowest possible wage and cost level is ultimately the source of the weakness of the liberalised world. It would be quite difficult to stop the race without the reintroduction of at least some of the 'illiberal' arrangements that were in place under the Bretton Woods system. In this context, it is worth noting the emergence of some protectionist notes in the political declarations emanating from the US – and even the European Union. On the other hand, the internal economic organisation of the European Union itself (and of the euro area in particular) continues to foster intense wage competition between the member countries. The anaemic and erratic economic growth of the EU as a whole is largely the aftermath of unhealthy wage competition. This weakness will not be cured by even stricter adherence to the various fiscal austerity measures conceived by politicians and economists faithful to the old dogmas. The dynamization of the EU requires an understanding of the need to limit the scope for liberal principles in the policies of individual member states – and especially in their relations with each other. The task would involve some coordination of social/wage policies across the EU.

Importantly, individual member countries must be discouraged from running huge and protracted trade surpluses with regard to their partners.[4]

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[4] See K. Laski and L. Podkaminer, 'The basic paradigms of the EU economic policy-making need to be changed', *Cambridge Journal of Economics*, 36:1 (2012).