Recreating the 1940s-Founded Institutions for Today's Global Economy

Remarks upon receiving the Truman Medal for Economic Policy

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It is a great honor to receive the Truman Medal for Economic Policy and to follow in the footsteps of Alan Greenspan, George Shultz, Paul Volcker, Allan Meltzer and Alice Rivlin—all people who I admire greatly and have learned much from. Talk about standing on the shoulders of giants! I thank the Harry S. Truman Library Institute, The Henry W. Bloch School of Management, the Economic Club of Kansas City, and the Missouri Council on Economic Education.

Seventy years ago Harry Truman signed the Bretton Woods Agreements Act of 1945. It officially created two new economic institutions: the International Monetary Fund and the World Bank. A year later he signed the Employment Act of 1946. It created two more new institutions: the President's Council of Economic Advisers (CEA) and the Congress's Joint Economic Committee (JEC). And in 1947 came the General Agreement on Tariffs and Trade (GATT)[2] and the Truman Doctrine, and in 1948 the Marshall Plan.

This flurry of economic institution building required real leadership by the United States, both the Administration and Congress. The legislation passed in two different congresses, the 79th controlled by Democrats in 1945 and 1946 and the 80th controlled by Republicans in 1947 and 1948. As Chicago economist Jacob Viner put it in 1945, "The United States is in effect, and, as concerns leadership, very nearly singlehanded, trying to reverse the whole trend of policy and practice of the world at large in the field of international economic relations…"[3] The CEA and the JEC would bring professional economics to both the international and the domestic tasks. The Truman Doctrine and Marshall Plan would support freedom and democracy with the principle that they are "essential to economic stability and orderly political processes" as enunciated by President Truman at a joint session of Congress.[4] And as Treasury Secretary Henry Morgenthau put it, the Bretton Woods agreements aimed to "do away with economic evils—competitive currency devaluations and destructive impediments to trade…"[5]

Despite tremendous progress and accomplishments, today we are again facing economic evils—some reminiscent of the past—and an entirely new global economy. Let us consider then

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[2] The GATT was negotiated under the Reciprocal Trade Agreements Act of 1934 and did not require legislation. It was agreed to in Geneva on October 30, 1947.

[3] Viner (1945).

[4] McCullough (1992), p. 548.

[5] Morgenthau (1944).

how people addressed these problems seventy years ago. Let's see if we can adapt their strategy to our current challenges. Yes, U.S. leadership made it possible, but what else about the strategy is worth applying today?

By way of background and full disclosure, I'm about the same age as these institutions. So I can empathize if there is a natural resistance to reform.[6] I've had two stints at the CEA, and a third at Treasury with responsibility for the IMF and World Bank; the latter was at a time, right after 9/11, when integrating economics into security and politics was essential, as with the Truman Doctrine and Marshall Plan.[7] And all my life I've taught the ideas of economic freedom, which in my view[8] consist of predictable policies, the rule of law, incentives provided by markets and a limited role for government. I've been fascinated by the challenge of bringing these ideas into practice. International issues are technical and arcane, but we cannot turn away. In today's global economy adherence to the principles of economic freedom abroad are as important as adhering to them at home.

It is common to think that these institutions were put together hastily in a few months during Truman's first term when so much else was going on.[9] But that's not true. Writing about the Bretton Woods Agreements Act in his book *Present at the Creation*, Dean Acheson reminds us that "The period of gestation…about doubled that of elephants."[10] The Act was signed by President Truman in July 1945, but it was conceived during the lend-lease talks in 1941, negotiated at Bretton Woods in 1944, and debated in the Congress in March and June 1945.[11]

One serious economic evil leading up to World War II arose from competitive devaluations and currency wars. The British devalued the pound in 1931, and they gained a competitive advantage, but they slammed other countries' exports and economies in doing so. 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, finally devalued the lira by 40.93% in 1936, matching precisely the US devaluation of 1934.

A second economic evil stemmed from extensive "exchange controls," in which importers of goods were forced to make payments to a government monopoly in foreign

[6] Some of the reform proposals over the years include those in Bordo and Eichengreen (1993), the Meltzer Commission (2000), and Truman (2006).
[7] I tried to emphasize this integration in Taylor (2007)
[8] These are elaborated on in Taylor (2012).
[9] President Roosevelt died on April 12, 1945, VE-day was on May 8 and VJ day on September 2. Other, mainly non-economic, institutions were also created, including the National Security Council, the Department of Defense, the Central Intelligence Agency, the North Atlantic Treaty Organization and Radio Free Europe, as discussed by Rumsfeld (2006) and stressed by Shultz (2007), who saw that collectively the new institutions created an "economic and security commons."
[10] Acheson (1969), p. 81.
[11] As explained by Irwin (1995), the GATT also had a long gestation period.

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. They deviated from the principles of economic freedom, and caused all sorts of distortions and injustices.[12]

To deal with these problems the Bretton Woods reformers developed a strategy. Each country—each party to the agreement—would commit to two basic monetary rules which would become the key foundation of the rules-based system. First, they would swear off competitive devaluations by agreeing that any exchange rate change over 10% from certain values, or pegs, would have to be approved by a newly-created IMF. As Dean Acheson explained in Congressional testimony, "The purpose of the Fund is not to prevent any devaluation. It is to prevent competitive devaluation."[13] It 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. The countries, however, did not agree to remove *capital* controls, which include restrictions on making loans, buying or selling bonds, and equity investments.[14]

With commitment to these two rules, the IMF would provide financial assistance in the form of loans with the help of an outsized contribution from the United States. Jacob Viner explained the deal: "Other countries make commitments with respect to exchange stability and freedom of exchange markets from restrictive controls while we in turn pledge financial aid to countries needing it to carry out these commitments." He concluded that "It is largely an American blueprint for the post war economic world…. It seems to me a magnificent blueprint."[15] And many other economists supported it, including Irving Fisher, Frank Knight and Henry Simons.[16]

In important respects the blueprint 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 and gave 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 not part of the blueprint, virtually all the developed countries that signed the original agreement—and others like 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 entered into a period

[12] See Ellis (1947) for details on exchange controls.
[13] Acheson (1945), p. 26.
[14] See Neely (1999) for details on capital controls.
[15] Viner (1945), however, objected that the "the whole spirit and trend of the fund agreement is definitely favorable to exchange control as far as transactions on capital account are concerned."
[16] See Recommendations of Economists for United States Approval of the Bretton Woods Monetary Agreements (1945).

of stability. Some emerging market countries, such as Brazil, began to remove capital controls, and the IMF recommended adding their removal to the articles of agreement.[17]

Unfortunately this benign situation has not held, and today the challenges facing the international monetary system eerily resemble those at the time of the creation. In my view the problem traces to a departure from rules-based monetary policies at both the national and international level. These deviations not only helped bring on and worsen the global financial crisis, they have been a factor in the sub-par recovery and the recent global volatility and slow growth.

Consider currency movements. Quantitative easing (QE) started in earnest in 2009 in the United States. It was followed by a period where the dollar was low relative yen. It was followed by QE in Japan in 2013 which depreciated the yen, as was the expressed intent of Japan governor Haruhiko Kuroda. That was followed by QE in the Eurozone in 2014 which depreciated the euro, as was the expressed intent of ECB president Mario Draghi. The dollar-yen-euro story from 2009 to 2014 looks a lot like the pound-dollar-lira story from 1931 to 1936, even though U.S policy makers today consider the exchange rate effect to be by-products 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 also resemble currency wars. Whether you ask them or watch them, you can tell that central bankers are following each other. Extra low U.S. interest rates were followed by extra low interest rates in many other countries, in an effort to prevent sharp currency appreciations. Those low interest rates appear to have resulted in a boom-bust pattern in emerging market countries evident in the recent commodity cycle. So there is 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 many now warn about.

A host of government interventions and restrictions on housing markets have been used to prevent the low interest rates from causing bubbles. Macro-prudential regulations, which have legitimate purposes, are also being used to counter the effects of the low interest rates. There's also been a revival of capital controls. Even the IMF has endorsed capital controls, calling them "capital flow management" or CFM for short.[18]   Some macro-prudential regulations are devoted to international transactions and thus can become capital controls in disguise.

In my view we need a new strategy to deal with these problems. The new strategy could build on the old strategy of the '40s.   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 why economic performance improved in the 1980s and 1990s. More recent research shows that

[17] Communique of the Interim Committee (1997), paragraph 7.
[18] IMF (2012).

the spread and amplification of deviations from rules-based monetary policy are drivers of 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.

So as in the 1940s we should forge an agreement where each country commits to certain rules. In keeping with today's global economy, it would not be an adjustable peg system, but a flexible system in which each country—each central bank—describes and commits to a monetary policy rule or strategy for setting the policy instruments. The strategy could include a specific inflation target, some notion of the long run interest rate, and a list of key variables to react to in certain ways. Experience shows that the process should not impinge on other countries' monetary strategies nor focus on sterilized currency intervention.[19] The rules-based commitments would reduce capital flow volatility and remove some of the reasons why central banks have followed each other in recent years.

Such a process would pose no threat to either the national or 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 was an emergency. A procedure for describing the change and the reasons for it would be in the agreement.

Note that the strategy is not just for the G7 or the G20 or some regional grouping. It is completely global. As in the 1940s the process could begin informally with a small group and then spread out, perhaps circulating mark-ups of the relevant sections of the original articles.

This reform is by far the most important ingredient needed for recreating the international financial system. It will be difficult because there is still disagreement about the diagnosis and the remedy, though that was true in the 1940s too.[20] Ben Bernanke (2013) argues, for example, that the competitive depreciations of the 1930s and the past few years are simply part of the process of world monetary policy easing. Moreover, many countries are still in the midst of unconventional monetary policies, so a transition period is needed.

But other reforms are also essential. A second reform would set up rules for eventually removing capital controls. Currently, 36 countries now have open capital accounts, but 48 are classified as "gate" countries and 16 as "wall" countries with varying degrees of capital controls.[21] Again, the reform could occur with a transition period and should be accompanied by adequate enforcement of safety and soundness regulations on financial institutions. Though controversial, the reform would be conceptually the same as the agreement to remove exchange controls in 1944.

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[19] That is a lesson from the Plaza Accord of 1985 as explained in Taylor (2015).

[20] Benn Stiel (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 seen in the transcripts published by Schuler and Rosenberg (2015).

[21] Fernández, Klein, Rebucci, Schindler, and Uribe (2015)

Another ingredient to the rules-based system would be a rule for the IMF itself to apply when making loans to countries. The most practical way to proceed would be to restore the exceptional access framework. This sensible rule was first put in place in 2003, but was broken in the case of Greece in 2010 when loans were made in a clearly unsustainable situation, contrary to the framework.

Another reform would wean the IMF from making unnecessary loans as part of its advice giving and monitoring activities. When the real need is simply for the IMF to give advice to a country in implementing or monitoring reforms, there is no need for a loan. The most practical way to proceed would be to greatly expand the use of the Policy Support Instrument[22] which was introduced in 2005 for this purpose and has been used in seven African countries.

And there should be a more inclusive process for selecting the managing director of the IMF. The managing director could well be from an emerging market country rather than from Europe as has been the custom. The impacts of departures from rules-based policies have been particularly hard on emerging markets as the frequent complaints about spillovers remind us.[23]

But recreating the ‘40s founded institutions for today’s global economy must go beyond the IMF. The World Bank was originally created to supplement private capital flows for reconstruction and development. But today capital flows and savings to finance investment are abundant—some even see a glut. The investment to GDP ratio in India is 31% with only a few basis points financed by multilateral development banks. In sub-Saharan Africa, economic growth since 2000 has quadrupled public sector revenues, which are now 40 times larger than US aid. Remittance flows from individuals in the US are four times greater than US foreign aid: $123 billion versus $31 billion in 2012. [24]

So aid should focus on the poorest countries and regions where private capital is still reluctant to flow. And it should be in the form of outright grants rather than loans, which frequently have to be forgiven with deleterious effects on fiscal institutions and governance in poor countries. Grants should include accountability systems with measurable results.

Aid from the World Bank should also be based on the Millennium Challenge Account (MCA) concept. This concept was incorporated into some US aid disbursements a decade ago; it requires that countries receiving aid must follow certain policies consistent with the principles of economic freedom. Evidence shows that the MCA concept helps improve economic policies and economic outcomes.[25] A by-product of improving economic conditions abroad will be fewer refugees and economically-motivated migrations.

Next consider the Employment Act of 1946 which was passed with the recognition that economics has a role to play in economic policy. The original CEA bill was interventionist, but

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[22] See my description in the book by Ted Truman (2006).
[23] See Carstens (2015).
[24] See Birsdall and Leo (2015).
[25] See Parks and Rice (2013).

a more sensible legislative outcome was achieved in the final version of the Act.[26] After a good start in the 1940s the CEA turned political in the early 1950s, playing a "public advocacy role" that "made the council so political and controversial that the CEA was almost abolished by Congress in 1952." Arthur Burns restored credibility when he became chair in 1953 and refused to advocate administration policies.[27]

This episode indicates the need for vigilance in the development and application of sound economic advice. The situation is more difficult today than in the 1940s with the National Economic Council and the Domestic Policy Council existing alongside the CEA. It is disappointing that legislation in 2012 removed the requirement that the two members of the CEA who are not in the chair need to be confirmed by the Senate. Their counterparts in policy positions in other government agencies or in interagency delegations to other countries still must be confirmed; even the alternative executive directors at the international financial institutions need to be approved by the Senate. A simple reform would recreate the original intent of the Employment Act of 1946 by requiring that all three members of the CEA be approved by the Senate.

Regarding the CEA's sister agency, the JEC, its recent efforts to stimulate nonpartisan thinking on policy reform—as for example in its call for a Centennial Commission on Monetary Reform—is a step in the right direction.

Next consider the GATT, now operating under the World Trade Organization. The GATT completed 8 successful rounds of multilateral tariff and trade barrier reductions since it was founded. But despite many international meetings, no round has been completed in 20 years. Instead, countries have focused on bilateral or regional trade agreements.

One radical idea would be to go back to a suggestion made long ago by Milton Friedman.[28] He recommended abandoning the method of reciprocal negotiation and reducing trade barriers "unilaterally as Britain did in the nineteenth century." This ignores the political economy reason for the reciprocal method, namely that exporters benefitting from lower trade barriers abroad counteract domestic producers threatened by foreign competition from lower trade barriers at home. The recent battle over Ex-Im bank re-authorization shows how difficult unilateral action can be. But, depending on that outcome, it's an idea worth investigating. As Friedman puts it, "Let us live up to our destiny and set the pace not be reluctant followers."

Now let's consider the strategy of the Truman Doctrine and the Marshall Plan, which naturally go together. Indeed, Dwight Eisenhower argued the aid to Greece and Turkey that defined the Truman Doctrine should include other countries. But that idea was postponed by one

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[26] See Santoni (1986). I would be remiss if I did not also note, in the context of the important creations I highlight in this talk, that there were government interventions during the Truman administration that would challenge some of the principles of economic freedom, including the imposition of wage and price controls in 1950 and the seizure of the steel mills in 1952.
[27] See Shultz and Dam (1977), p. 174 and Greenspan (2005).
[28] Friedman (1962), p. 73.

year because, according to Dean Acheson, "we already had more to deal with than the time available permitted."[29]

The strategy was created to deal with the international, cross-border encroachment of the Soviet Union on freedom, including economic freedom. In calling for support of the strategy from the Republican-controlled Congress, Truman's led off by saying: "I believe it must be the policy of the United States to support free peoples who are resisting attempted subjugation by armed minorities or by outside pressures. I believe that we must assist free peoples to work out their own destinies in their own way. I believe that our help should be primarily through economic and financial aid…."[30]

True, we have different challenges in the post 9/11 world, but we see the same international cross-border encroachment on freedom, including economic freedom. In my view the United States should commit to promoting economic freedom as part of its foreign policy strategy. It should also strongly support economic leaders who are committed to economic freedom in their own countries. This is the lesson learned from the transitions from government control to market economies two decades ago, especially in Poland. The U.S. government strongly supported Polish economic reforms—the removal of price controls, of barriers to new businesses, and of subsidies of old state enterprises, along with a restoration of the rule of law and property rights. Today international support packages tend to do just the opposite: encourage more government subsidies and controls.

It is hard to argue against the principle that an effective foreign policy strategy requires paying close attention to economics as well as to security and politics. Yet often this three pillar principle falters in practice; at least that is my observation from working on foreign policy matters. I once wrote an article in the *Washington Post* about a congressional hearing on U.S. policy in the Middle East. At the witness table was General David Petraeus, offering his expertise on counterinsurgency warfare, and next to him was Ambassador Ryan Crocker, able to answer virtually any question on politics. And next to them you could see the seasoned on-the-ground expert on economic issues….Oops, actually you could see no one.

In a sense economic issues have always been an integral part of foreign policy. But in the current global situation the role is more important than ever with so many opportunities and pitfalls. Since 9/11 there have been many proposals for institutional reform, such as including economics along with security and political issues in the U.S. combatant commands. A specific legislative proposal would do so by amending the Goldwater-Nichols Act of 1987 which fostered coordination of the military services. These ideas have gone nowhere.

So here perhaps the task of recreating is more a matter of attitude and commitment than institutional reform. A clear commitment to a strategy of counteracting "economic evils," as noted seventy years ago by Secretary Morgenthau, should be part of an overall foreign policy strategy. The specific reforms of the economic institutions which I have outlined here could

[29] Acheson (1969), p. 219.
[30] McCullough (1992), p. 548

form the basis of that strategy. In that way I believe we will be all set for another 70 years of tremendous progress and accomplishments. Thank you.

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