The behaviour of prices

Economic theory is in large measure a story about prices. Price signals tell producers what is in demand and what is not. Prices in capital markets serve to regulate savings and investment and prices in labour markets guide workers to invest in skills that are most in demand. In modern macroeconomic practice, concern about the role of high and variable inflation in distorting price signals and undermining economic efficiency formed the bedrock of the disinflationary monetary policies of the 1980s and 1990s. The stagnation and ultimate collapse of centrally planned economies is generally understood to have been significantly abetted by suppression of price signals.

In short, if one is looking for a truly powerful and pervasive factor to explain large scale dysfunction in the international economy, with sufficient power to undermine the effects of the massive expansion of trade that was experienced in the post-WWII period, one would start by examining the information content of international prices.

The breakdown of the Bretton Woods arrangements is associated with an immediate and surprisingly large surge in the prices of internationally traded commodities (see Figure 2). While the actual devaluation of the US dollar following the breakdown of the fixed exchange rate regime was not all that large, in the transition to a floating exchange rate regime, commodity prices appear to have literally come unhinged—and the first move was sharply up (which notably was against the long-term trend in real terms).

There are straightforward linkages that can be made between the observed explosion of price volatility in the post-Bretton Woods era to the development failures observed in the decades that followed the exchange rate regime change. In country after country, development failure is associated with stories of failed investments financed by borrowing that could not be repaid, and a flowering (if one can use that word) of conflict and corruption. Such developments can flow naturally from a sudden leap in prices of a commodity. Responding to price signals, people invest; if they lack the funds, they borrow to take advantage of