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US-EC FINANCIAL AND MONETARY RELATIONS*

How to co-operate in an unstable non-system

US-European financial and monetary relations in recent years have not been free from irritation and recrimination. These have gone beyond the sphere of monetary experts. US financial policies have been criticized by prime ministers, by presidents, even by a king. Not long ago the king of this country expressed his disapproval, perhaps the first time since George III that Americans earned themselves a royal reprimand. Listening to the reproaches to and fro I sometimes feel like that judge who, after having heard the plaintiff, concluded he was right and then, after listening to the defendant, agreed with him; when someone in court protested that the judge could not agree with both, the latter pondered this over and then said: why, you're right too!

I share the European worry that the US tends to be inward-looking in financial and monetary matters, ignoring the international repercussions of its internal policies. At the same time I believe there is much truth in the American rejoinder that many of the problems Europe blames on the US are of its own making. Perhaps the most succinct way to summarize the view I am going to set out today is that on neither side of the Atlantic are policies sufficiently consistent to make international monetary cooperation effective. The lack of international monetary cooperation cannot fail to have negative effects outside the monetary sphere.

US policies

The international monetary role of the US is characterized at present by its twin deficits: an unsustainably large public

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sector deficit and an equally unsustainable current account deficit. These deficits are reflected in high interest rates and unpredictable, strongly fluctuating exchange rates. Both are bad for the world economy.

Among the adverse effects of high interest rates is the burden of the highly indebted countries. For the developing countries as a group, 1% decrease of the relevant interest rates would mean a direct reduction of the burden of annual interest payments in the order of $ 2 billion.
The effects of the strong fluctuations in dollar rates are less easy to quantify. But the uncertainty they engender can hardly fail to have an unfavourable effect on international investment decisions and they probably cause additional strains in the European Monetary System.

The reasons for the American tendency to ignore the external repercussions of their policies are in part the size and "closedness" of the US economy. To this were added what could be called "ideological" factors.

The size of the US economy and the modest part of international trade in proportion to national income - some 10% - has for many years determined the US attitude in international financial and monetary affairs. Other countries, in taking into account external repercussions, do so not primarily for idealistic reasons but because they are aware of their dependence on the rest of the world. In the case of the US, both dependence and awareness of it are less. There is a feeling that to take it into account would mean the tail wagging the dog.

The ideological factor, though not new - the expression "benign neglect" dates from the early seventies - has probably been strengthened by monetarist theories. These discourage authorities from having external policy objectives concerning the exchange rate or the structure of the balance of payments. In this view, if only the authorities pursue correct domestic monetary policies, international stability will automatically result.

They should not try to aim at a specific exchange rate or balance of payments structure since this would be an obstacle in attaining the domestic monetary objectives, while the authorities are not in a position to know better than the market the correct exchange rate or balance of payments structure anyway. Whether a country is a net lender or a net borrower should in this view be determined by the market. In my view proper monetary policies are certainly necessary. But I cannot agree that when such policies are in place the exchange rate and balance of payments structure can be left entirely to the market. There has to be an international consensus on the desirable balance of payments structure. The basis of that consensus should be that the industrial world has to be a net lender, not a net borrower. In the short run this does not apply to individual countries - given for instance the differences in cyclical situation between them - but in the longer run it should. Domestic policies which influence the balance of payments anyway, be it often in a way which was not intended, should be consistent with the desirable balance of payments structure. This implies that an industrial country should avoid a structural budget deficit exceeding domestic savings that are available to the public sector without crowding out the private sector. The desirable balance of payments structure also provides a basis for judging the exchange rate. It may not be a basis for fine tuning, but that should not justify acquiescence in the huge exchange rate fluctuations of recent years. This to some extent is the view that prevails in the EMS. The US authorities reject it and are not prepared to discuss policy coordination in these terms.

The resulting imbalances bother them less than they do other countries. This is not only because the size of the domestic economy makes it less sensitive but also because it led to the emergence of the dollar as an international currency.

This enables the US to pay other countries with dollars or, which is the same thing, not to pay but to borrow. Thus, while Europe has to pay the price in the end when it loses control of its public finances, when the US budget gets out of control it is not the US but others who foot the bill, among them once again Europe. Europeans watch this with a mixture of feelings, in which righteous indignation is paramount and envy not entirely absent.

Monetary relations with the US are further complicated by a number of factors. One is a divergence of views within the administration. There is a general desire to reduce the budget deficit, though no agreement on how to do it. However, while some of its spokesmen acknowledge the harmful effects of the huge budget deficit, which is a necessary step towards remedying it, others tend to deny or belittle these effects, notably those on interest rates and the balance of payments.

There are also differences in the degree of willingness to take the exterior into account. The Federal Reserve System - at least in Washington and New York - would probably be more ready to cooperate with other countries in for instance intervention operations than in fact proved possible in recent years. This might have contributed to prevent the overshooting of the dollar rate which was so obvious to Europeans towards the end of last year. The Fed - as can be seen from the published records of the Federal Open Market Committee - is also aware of the effects of high interest rates on debtor countries and, as a consequence, on US banks. And they are aware of the fact that a steep decrease of the dollar tends to increase inflation, an effect denied by orthodox monetarists (who regard the money supply as the sole cause of inflation). A serious complication is added by the attitude of the Congress, recently illustrated by the agony which preceded the final approval of the increase of IMF quota's. The long list of amendments introduced on that occasion were hardly proof of understanding, and care for that matter, of the requirements of international monetary cooperation. This attitude understandably makes the administration extremely reluctant to enter into any engagement that might involve the Congress.

Having said all this, let me try to balance my criticism to some extent. If the US has been reluctant to accept external constraints with regard to domestic policies, one cannot say that the rest of the world were more willing to do so if they could help it. Not being reserve centers, most countries could not escape constraints in the way the US could. But they could borrow in other forms. There seldom was any reluctance to agree to more international credit on easier terms, it never was difficult to find a majority outside the US that favoured money creation in whatever form irrespective of the need to hold reserves. In the IMF it was the US which under the successive administrations checked the permanent international pressure for reserve creation. Possibly the successive American administrations were strengthened in their opposition by the knowledge that if they agreed Congress would object on domestic considerations. Even so I believe that in doing so the US performed a useful function, though not necessarily always for the right reasons.

Connected with this was its opposition to constant pressure to turn the IMF into a kind of United Nations or, failing that, to transfer decisions on money creation to the United Nations. Treasuries and central banks of most industrial countries opposed this, and for good reasons. But I am not sure how firm some of them would have been in the absence of the consistency in the American view in this matter.

And most important of all, of course, economic recovery in the US played a crucial role in helping the rest of the world to start coming out of the recession.

Therefore criticism of the US, though justified in several respects, should not ignore those elements that were beneficial. Nor should those Europeans who justly reproach the US for its reluctance to coordinate policies forget that the negative effects of that reluctance would harm us less if only we ourselves would be prepared for more coordination amongst ourselves.

European monetary cooperation

An obvious European reaction to mitigate the negative effects of US policies would be intensified efforts for European cooperation. This was the case five years ago, when an uncontroled slide of the dollar was among the main reasons for the foundation of the European Monetary System. More recently it could also have mitigated the effects of high US interest rates.

If the EMS countries would form a solid bloc with sustainable and therefore credible exchange rate relations between them, they would be less affected by large exchange rate movements vis-à-vis the dollar than they are now. That would enable them to some extent to insulate their interest rate policies from US interest rates. If one takes the EC as a whole, trade with third countries amounts to merely 12% of aggregate GNP, making it comparable to the United States in this respect.

Unfortunately, exchange rate relations within the EMS in the past have seldom remained credible for long.

One reason was diverging policies and diverging fundamentals. This sooner or later - and in fact increasingly sooner - led to realignment expectations and speculation.

Secondly, defense against speculation was often less than effective. There used to be an understandable reluctance against raising interest rates to defend ones currency. But the only alternative is to accommodate speculation, thus perpetuating it.

Thus, realignment expectations in the past often proved self-fulfilling, and speculation rewarding. For when realignments were forced upon the authorities, they often wanted to make them large enough to be credible to the market. The disappointing inflation performance in some EC countries is being blamed on the high dollar, but could equally be attributed to the excessive realignment of a year ago. Moreover, political rather than economic considerations played an increasing role. They were the main reason that changes of exchange rates took the form of a general upheaval intended to take the limelight off specific devaluations which were considered to be politically embarrassing.

All this hardly contributed to interest rate autonomy of the EMS as a bloc. Rather it contributed to uncertainty. And that may well be reflected in an uncertainty premium keeping interest rates higher than need be.

A policy aimed at interest rate autonomy has apparent contradictions which can make acceptance difficult. It can only be achieved at the cost of strict domestic policies, whereas many want it in order to be free in their domestic policies. It can imply raising interest rates in the short-run, whereas it is wanted in order to be able to lower them. Given these limitations it is not surprising that some are looking for easier ways to achieve autonomy: for autonomy without tears. There has always been a tendency in the EC to concentrate on technical gimmicks as an escape from policy constraints. Couldn't we obtain autonomy against the dollar by creating a dollar of our own, the Ecu? We could: the only thing we need is having it replace our present national currencies and creating common European markets comparable to the American ones. Unfortunately that means a phase in integration not quite yet achieved. Then couldn't we achieve autonomy by surrounding ourselves with a wall of exchange restrictions? Given the objective, that would imply uniform exchange restrictions against third countries applied in Europe by both deficit and surplus countries, which it is not so easy to imagine. Here too lack of homogeneity seems to render uniformity impractical. Quite apart from the fact that exchange restrictions have seldom proved effective, and seldom result in low interest rates. Thus, autonomy vis-à-vis US interest rates does not mean that we can act as we like. It does not free us from the need for monetary discipline. But the dollar constraint, which can be irrational if US policies ignore external repercussions, could to some extent be replaced by EMS discipline, which can be beneficial as long as it reflects the purpose of the EMS: to establish a zone of monetary stability in Europe.

US-EC Cooperation

In 1975 the US and France, after much bickering about whether or not a system of stable exchange rates was an acceptable objective, finally agreed on a formula subsequently enshrined in the Articles of Agreement of the IMF: not on a system of stable exchange rates, but on "a stable system of exchange rates". Each side could give its own interpretation. It is obvious now that the result was not stable exchange rates. Neither was it a stable system. The question is whether it was a system at all. One might call it an unstable non-system. It did not prevent the authorities from coping with emergencies since all participants realized that this was in their own good interest. I am fairly confident that they will cope with emergencies in the future as well. But one should hope for more. For the emergence of a system which to some extent will prevent emergencies from arising. In my view a system by definition implies the acceptance of international commitments and constraints. On paper, all members of the IMF have accepted the obligation to promote stability and entrusted to the IMF the task of surveillance of their exchange rate policies. However, this is a far cry from accepting external constraints in practice. That is what I meant when questioning in how far we have a system. But I could happily go along with secretary Regan's formulation that the real challenge is to develop the system we already have and to strengthen the Fund's surveillance activities.

The real issue is, of course, not one of words. It is how to reconcile internal and external objectives, what external constraint - or discipline - to accept in domestic policies.

In this respect the EMS countries recognize - at least in principle - that international monetary cooperation implies that internal and external objectives will have to be reconciled. They are not always successful in that reconciliation, i.e. in agreeing what measure of external discipline is necessary. As long as they disagree about that among themselves prospects for better transatlantic cooperation are limited. You cannot obtain it by blaming one another for its absence. Neither by instituting "target zones" between the Ecu and the dollar. In the present situation those would be meaningless. The Ecu would stand for a number of European currencies with widely different balance of payments positions. The US would not submit to external constraints whether the dollar was within the target zone or outside it. As long as that is the case, the institution of target zones would constitute the same kind of gimmickry some want to introduce in the EMS.

Global stability should start within Europe. If Europe would succeed in moving towards a more solid bloc with credible and sustainable exchange rates, this might have two advantages in the monetary sphere. On the one hand it would, as I said, become less vulnerable to the effects of dollar fluctuations. On the other, perhaps somewhat paradoxically, it might be in a position to attain a better cooperation with the US and thus reduce dollar fluctuations. Thus, effective European cooperation could be a first step towards increased global monetary stability.

That would also improve the political atmosphere, even at the summit. Criticism of US monetary and financial policies by Giscard and Schmidt could to some extent be shrugged off as personal hobbies, left over from the time they were ministers of finance. In the case of Mitterand and Kohl that is no longer possible. Thus, a renewed effort to bring about a stable system, while implying the acceptance of constraints, would bring benefits far exceeding the monetary sphere.