

# ECONOMIC PAPERS

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Problems of interdependence in a  
multipolar world

Tommaso PADOA-SCHIOPPA

Internal paper



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Internal paper

Report presented at the Conference organized by the College of Europe (Bruges)  
and the Institute of European Studies (Bruxelles) on "EUROPEAN MONETARY  
SYSTEM AND INTERNATIONAL MONETARY REFORM"

Bruges, June 1981

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## PROBLEMS OF INTERDEPENDENCE IN A MULTIPOLAR WORLD (\*)

### 1. INTRODUCTION

In November 1978, after a period of strong turbulence, a phase of relatively smooth exchange rate developments was ushered in by the various understandings concluded with the United States authorities. A month later, with the launching of the European Monetary System, a new framework was given to intra-European monetary relations.

In October 1979, the Federal Reserve announced that it would henceforth be using new monetary control procedures. Since then the reliance on these procedures has grown stronger. As a result, United States interest rates have undergone sharp fluctuations and have imposed a similar variability on an apparently rising trend of the dollar:ECU and dollar:DM rates.

Last May, the United States Under-Secretary for Monetary Affairs, Beryl W. Sprinkel, publicly drew the conclusions which he thought ought to follow from the new monetary control procedures for the United States international monetary policy by stating before the Joint Economic Committee the intent "to return to the more limited pre-1978 concept of intervention". Both Europe and Japan are preoccupied by what some observers consider a radical version of the "benign neglect" policy that imposes, de facto, free floating interest or exchange rates upon Europe.

This conference provides an excellent opportunity to detail the reactions of a European to transatlantic monetary events of the spring of 1981 and to express the concerns that may be felt in the Community: sharp fluctuations in the dollar disturb trade between the Community and the United States, affect the price of oil and other primary commodities, aggravate tensions within the EMS, and disrupt the coordination of exchange and intervention policies.

Yet, if we were to focus entirely on today's events, we would not do justice to the complexity and to the depth of our monetary relations.

Indeed, this is not the first time that Europeans have voiced their dislike of American monetary stances. Did we not suffer from the dollar scarcity, from United States investments in Europe and from American seignorage? Later the inflationary potential of excess dollar balances left some of us aghast while others welcomed the United States dollars which - at long last - enabled them to escape the balance of payments financing constraints. How often have "substitution accounts" been discussed only to be replaced by an excessively strong dollar and inflationary oil prices?

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The long list of European complaints suggests that we should examine the United States-European monetary relations from a broader perspective in terms of both time and space. Money is an instrument of macro-economic management. We cannot therefore simply limit our investigations to interest rates, exchange rates and to monetary policy, but we must ask ourselves more generally how monetary policies have influenced trade and domestic production. Furthermore, United States-European relations have constituted the core of the International Monetary System in the past and, together with Japan, can be expected to retain primary responsibility for world macro-economic policy. Such a discussion of United States-European monetary relations thus inevitably leads us to investigate how - together - they have managed both domestic and world monetary affairs and to what extent their conceptions on how the system works have been adequate and compatible.

## 2. THE EMERGENCE OF A TRIPOLAR WORLD

In the last twenty years the relative position of the United States in the world economy has profoundly changed. While the Community's Gross Domestic Product was about half that of the United States in 1960, the two were roughly of the same size twenty years later (Table 1). During the same period, Japan's GDP rose from some 10 per cent of the United States' to about 40 per cent. Owing to these developments the United States influenced less and less the other two countries through mere interplay of economic flows.

On the other hand, the United States has become more open to foreign trade and services. In the early sixties, imports of these goods and services accounted for only 4 per cent of United States GDP: in the late seventies, this figure had risen to some 8-10 per cent. Community imports of goods and services, excluding intra-Community trade and services, were about 11 per cent at the beginning of the sixties and 14 towards the end of the seventies. Finally, the "openness" of Japan rose from some 9 to 13 per cent of gross domestic product over the same period. The figures are influenced to some extent by the rise in the price of oil which has led to an increase in the degree of dependence of the developed countries on imports. The respective shares in world trade (excluding intra-Community trade) of the United States and of the Community have remained remarkably stable during the past twenty years, hovering around 25 per cent for the Community and 15 per cent for the United States. However, Japan's share rose from 5 to 9 per cent.

Towards the end of the seventies, overall productivity as measured by per capita GDP at current prices and exchange rates, reached roughly the same level in the three areas: it stood at some ECU 7,800 in the United States as against 6,700 for the European Economic Community and 6,400 for Japan.

When we come to financial and monetary data (Table 2), the statistics become more difficult. Rough indications show that, in spite of considerable changes in exchange rate relationships, the dollar accounted for some 70 per cent of the euro-currency markets in 1980 as against 80 per cent at the beginning of the decade (Bank of International Settlements data). However, throughout the seventies, the euro-currency market has grown each year faster than the domestic monetary aggregates and much faster than nominal GDP, so that the quantitative importance of the dollar in world finance has increased whilst the output of the United States has diminished relatively. The share of the DM in official reserves has risen from some 6 per cent in 1973 to some 12 per cent in 1979. Comparable figures for the yen are 0.5 per cent in 1973 and 4 per cent in 1979. The share of the dollar fell from 85 to 78 per cent.

What do these figures tell us?

First, while the United States economic weight has decreased, its financial importance does not seem to have diminished much. On the other hand, the economic importance of the Community and of Japan has increased considerably, but this has not been paralleled in the financial and monetary field. These developments are related to the difficulties encountered in managing world macro-economies as there is no dominant power as in the fifties, while the United States nevertheless still seem to hold a preponderant position.

Second, world economic integration has continued to make progress and has even accelerated. Cyclical and policy interdependence is high.

The third conclusion concerns the gradually emerging European pole. This pole is obviously much less coherent than the other two: its foreign trade and GDP aggregates reflect to some extent only statistical magnitudes. However, the relative decline of the United States economic power and especially the exchange rate regime that has prevailed since 1973 has brought about a degree of individualization of the Community in the field of macro-economic policy that did not previously exist.

The evolution which led to the present floating regime and floating itself have "deprived" individual European countries of the organizing factor represented by the dollar. After a long period of increasing divergences and of a lack of any form of monetary organization, the co-ordination of monetary and exchange policies has been strengthened by the implementation of the European Monetary System which has thus resulted in an increasingly more orderly joint float against the dollar and the yen. This tends to individualize the third pole without it being possible to determine its nature exactly: for example whether it could be considered a DM zone, given the important role of Germany, or whether it could be seen as an ECU zone in which policy coordination is predominant. The third pole manifestly lacks a widely held international currency.

### 3. INTERDEPENDENCE AND FLOATING

Without taking any side in the debate on exchange rates regimes, I shall try to draw from the experience of the last years to emphasize some of the problems that may arise in an interdependent, multipolar world in which there is no agreed exchange rate rule.

The proponents of floating were not only aiming at improving the technical working of the then existing system by making exchange rate changes more timely, by bringing about a more adequate exchange rate structure, or by introducing a greater degree of exchange rate or interest rate variability to take account of larger capital mobility. They were also advocating greater independence for national policies. It was claimed that exchange rate flexibility was a way to comply with what could be called the "interdependence constraint".

On the other hand, floating rates have also brought new problems, that were not all expected by their proponents, such as J curve effects and destabilizing capital flows. Such problems have placed new and unexpected constraints on the elaboration of national policies.

I shall single out three types of problems that emerge when governments, encouraged by floating, follow non-coordinated policies and, to a great extent, "let the rate find its own level". Ranked by decreasing time dimension they are the structural and allocation problems posed in the long run, the effects of cyclical divergences on exchange rates and trade, and the dominance of monetary policy in the short run. I will now turn to them drawing examples respectively from Europe, Japan, and the United States. I shall not, indeed, deal with exchange rate variability on a day to day basis as it seems to me that, within limits, it serves a useful role in inciting portfolio managers to prudence.

### 4. STRUCTURAL AND ALLOCATION PROBLEMS

Exchange rates are most often discussed within a short term horizon extending at most over a cycle. But there is also a very different type of long term exchange rate problem, which has not been discussed much, nor its structural impact on industry and on resource allocation fully assessed.

In the early seventies it was widely held that a country could support expansionary policies by a depreciating exchange rate. It was thought that, despite high inflation, such a country could not only sustain its exports and hence its employment through devaluations, but it could also improve its industrial structure as the profits earned in the export sector would lead to investment.

To some extent, Italy and the United Kingdom, at least up to 1978, followed such a policy, by compensating domestic and imported inflation by an even faster declining effective exchange rate; the real exchange rate depreciated sharply. This resulted in typical "open scissor" type graphs, such as those presented in Chart II.

For various reasons, however, the experience of the seventies has not supported such views with as much success as it had been predicted. Firstly, industrialists are well aware of the temporary nature of the depreciation of the real exchange rate achieved when inflation rates are high. They refrain therefore from investing their profits as much as hoped. Secondly, the depreciating real exchange rate grants, though only temporarily, a new lease of life to otherwise obsolescent industries; furthermore, if investments are being undertaken, they may be misallocated to industries that will turn out to be non-competitive once the exchange rate has returned to a more normal level. In any event, investments in industries whose profitability is mainly ensured by devaluation do not contribute much to the rejuvenation of a domestic industry. Thirdly, since domestic consumption is not cut back sufficiently by such a policy, there is little room for exports and investments. Finally, when inflation becomes unbearable and must be reversed, a "stabilization crisis overshooting" occurs and false signals are once more given to the markets, though in the opposite direction (see Chart II - United Kingdom).

In the opposite sense, continuously appreciating real rates, which were celebrated a few years ago as the driving force behind virtuous circles also may give rise to problems. Such a case is well illustrated by Germany: here the "open scissor" graph in Chart II is the inverse of the Italian case. The real exchange rate of the DM appreciated strongly between 1968 and 1972 in response to the realization that the dollar was overvalued and the the DM was undervalued. In 1973-76 the German stabilization effort led to a further appreciation. After another bump the real rate of the DM fell back, in 1981, to the 1970 level, i.e. to a level that used to be considered undervalued.

The appreciation of the DM, fuelled by capital movements that were related to the emerging role of the DM as an "international currency", was welcomed because of its stabilizing effects on the price level, especially after the first oil shock. And for some time, Germany seemed to enjoy the best of all worlds as protracted J curves, modernization and productivity increases in the export sector prevented the balance of payments from being hard hit by the appreciation of the currency. However, new foreign products gradually penetrated the German markets and finally the export sector also "adjusted". Once these long run phenomena began to make their influences felt, in combination with those of the oil shock and cyclical factors, it became apparent that the DM had been overvalued. It is important to note that such structural effects of an overvaluation appear with a lag that is measurable in a number of years rather than in the space of, say, twelve months.

These long term or structural overshootings in real exchange rates are particularly important in a tripolar world because economies in such a world, being very large and having a relatively small open sector, can maintain disequilibria for a long time before they become apparent. "Macro-dumping" is therefore a real threat to a tripolar world, because the country's expansionary monetary policy, via asset market phenomena, can "temporarily" depress the real exchange rate below a "long run equilibrium" rate.

Real exchange rate movements of the dollar and the yen, as illustrated in Chart II, provide other examples of such problems.

In the United States, the combined effect of changes in the effective exchange rate and relative price performance has resulted in movements in the "real" exchange rate which may be regarded as a measure of price and cost competitiveness. After a rapid improvement between 1950 and 1952, the United States entered a decade of stability in the real exchange rate. After 1962, economic activity expanded and productivity rose, but inflation remained subdued and United States "competitiveness" increased until 1967. Between 1967 and 1971, inflation rose and bottlenecks appeared. With a stable effective exchange rate, competitiveness declined. The fall of the real exchange rate between 1971 and 1974 resulted from the combination of the depreciation of the dollar and relatively low inflation rates.

The current account developments of the United States do not support the conclusions that could be drawn from a superficial reading of these indices. Massive surpluses were recorded during the fifties, when the United States still enjoyed a considerable technological lead, but they shrunk during the sixties, in part because of the high level of domestic demand. In the seventies large deficits appeared, essentially for two reasons. On the one hand, notwithstanding a strong lead in highly advanced technology, many United States products were not competitive on world markets (big automobiles are one symbol). On the other hand, the United States began to import many consumer goods with high income elasticity, and became dependent on imported oil. Thus, for a long time, the decline in the United States real exchange rate was insufficient to compensate for the structural factors which led it to become progressively less competitive.

## 5. CYCLICAL DIVERGENCES

Cyclical movements have continued to distinguish economic activity in the seventies and have led to a type of exchange rate overshooting which can be contrasted with the performance of an exchange rate system in which both national and international authorities take a stronger view on the exchange rate.

In a regime under which governments take a longer term view of their exchange rates and act consistently with that view through intervention or other instruments, the balance of payments adjustment mechanism exercises self-correcting influences and the government is led, in due time, to conduct its policy in a way more favourable to international equilibrium. When the rate is left to float, the signals that can be derived from the foreign sector may be alarmist and typical overshooting spirals can be observed: the current account imbalance is worsened by J curve, or inverted J curve, effects. The current account performance then unleashes capital flows that bring the exchange rate further away from what would be a more adequate level. Eventually, very strong policy measures must be adopted to reverse the situation. These measures may be at the origin of exaggerated movements in the opposite direction.

There are many examples of such cyclical problems, and I shall illustrate the case of Japan since the movements of the yen are both recent and of great trading interest to us. Between 1976 and 1981 we have witnessed formidable swings in the value of the yen - in both effective and real terms - that can hardly be justified in terms of either long run competitiveness or relative inflation rates and which, although not exclusively of a cyclical nature, may usefully serve to illustrate the point. We must first remember that, until very recently, Japan has maintained strong capital controls so that the exchange rate was mostly influenced by the current account and some short term capital movements. In 1978, the Japanese authorities were forced to let their rate appreciate and took further expansionary measures, in response to the Bonn

Summit. Shortly before the second oil shock unfolded, the yen had already begun to fall. This decline was accelerated by the effects of the oil shock; at the same time, the authorities adopted severely restrictive fiscal policies but maintained low interest rates. These measures were strongly supportive of exports, which rose considerably.

Japan's position was obviously difficult, because of its extreme dependence on oil and also because of the highly expansionary cyclical position in which it found itself and for which it was only partially responsible. It was therefore inherently difficult to determine an adequate new exchange rate, especially under conditions of genuine uncertainty.

Yet, the floating exchange rate system appears to have increased rather than reduced this uncertainty. Firstly, important J curve effects considerably magnified the swing in the exchange rate. Secondly, the absence of a strong view of the rate by the government, its foreign partners and by international authorities, increased market uncertainty. Thirdly, floating and controls helped the Government to maintain artificially depressed interest rates; the huge foreign exchange intervention of the Bank of Japan had thus reduced effects. In a system of jointly managed rates, the question of the "rate to hold" would have come up, monetary policy would have had to tighten interest rates, and interventions, if necessary supported by official borrowing, might have been more substantial.

There are consequences that cannot, in the real world, be dissociated from the enormous swings in the yen: the low level of the yen in 1979 and in early 1980 has contributed to foster Japanese market penetration in Europe to a degree that is perhaps not warranted by longer term trends in Japanese price and cost competitiveness and has nurtured protectionist feelings and reactions. This large swing has thus exerted lasting real effects that would have been avoided if the Japanese government and the international community had taken a different view of the yen and of policy co-ordination.

This example illustrates the problems that emerge from the pursuit of "an independent policy course in an interdependent world". The rapid correction of the imbalance in Japan's current account - desirable as it may be from this nation's individual standpoint - was only a temporary benefit because it gave rise to far-reaching secondary reactions of a protectionist nature.

## 6. MONETARY POLICY: TODAY'S DEVELOPMENTS

The third type of problem is illustrated best by the events of the last weeks and months and relates to the question raised by the recent course of monetary policy in the United States.

As is shown in chart III, in the two years since the start of the European Monetary System there have been substantial fluctuations of the dollar against Community currencies. During the first few months of the European Monetary System the dollar was on a rising trend, but this was soon reversed and in the second half of 1979 the dollar fell sharply, by over 5 per cent against the ECU. In 1980 the increased volatility of United States' interest rates - associated with the change in the techniques of monetary control initiated the previous October - gave rise to more pronounced fluctuations in the dollar. In the first quarter of 1980 the dollar rose by 10.4 per cent against the ECU, but then fell sharply by 9 per cent in the second quarter. In the second half of 1980 through to mid-February 1981 the dollar rose once more, appreciating by nearly 24 per cent against the ECU. Subsequently and as a result of further interest rate increases in Europe, the dollar fell by 4.4 per cent to the end of March. We have all witnessed the latest resurgence of the dollar which has risen by about 10 per cent in the two months between end March and end May, in tandem with yet another upward swing in United States interest rates.

A similar degree of volatility can be observed in United States and European nominal and real interest rates. The extreme volatility of United States nominal interest rates in the period from the end of 1979 until now is well-known and is illustrated in chart III. The effect on European interest rates is also shown in that chart where it can be seen that European countries have been forced somewhat to follow the American developments, although attempting to dampen them down as much as possible. What is less widely realized is that real interest rates have fluctuated widely as well. In the United States (chart V) ex-post real interest rates have climbed from broadly zero at the beginning of 1979 to a peak of about 4 per cent by the end of 1980 and well in excess of 5 per cent more recently. In Germany, taken as a representative European country, the ex-ante real rate of interest has recently reached record levels. It is hard to reconcile such volatility of real interest rates with any clear policy objective.

These sharp fluctuations in the dollar are a cause of concern to the Community; firstly because of the direct - albeit lagged - effects on trade between the Community and the United States and of U.S. competition with the Community in external markets; secondly because of the possible effects of dollar fluctuations on the prices and cost of primary products, particularly oil; and thirdly because sharp external currency movements can aggravate tensions within the European Monetary System and disturb coordination of exchange rates and intervention policies.

The influence of fluctuations in the dollar:DM exchange rate on the relative position of currencies within the European Monetary System band can be seen in chart IV. When the mark has been strong against the dollar it has often been strong against other European Monetary System currencies and when it has been weak against the dollar it has been weak within the European Monetary System band. This is due to the fact that the DM is a closer substitute of the dollar than other Community currencies, and, therefore, any "flight" from the dollar is accompanied by a movement into the DM and vice-versa. Of course, only a part of European Monetary System tensions are due to this dollar:DM relationship and I am personally convinced that the lack of a "dollar policy" is too often blamed for difficulties and tensions that are due to our making. This does not reduce, however, the relevance of the phenomenon.

In a situation of very high financial interdependence, the ups and downs in the United States interest and exchange rates confront the European Community with difficult choices. It could eliminate exchange rate volatility vis-à-vis the dollar by pegging its interest rates to United States interest rates. In this case the Community would be guided by a variable the movements of which are explicitly disregarded as meaningless by the very authorities who determine them. Moreover, both European interest rates and money supply would be determined by short run domestic developments in the United States and by the personalities and institutions of that country. Alternatively, the Community could itself adopt the United States procedures of giving absolute priority to quantity-oriented monetary control; exchange rate volatility could then be compounded. Imagine the extreme case in which all major countries adopted United States procedures: in these periods when short term economic fluctuations failed to offset one another, there would be extreme exchange rate volatility. It seems highly unlikely that private speculators would even it out. Thus we seem to be left with no other choice than the one we are making in practice, and that consists of a mixture of devaluation and restrictive policies, of passivity, solidarity and expressions of concern.

From the abandonment of simple rules for international monetary coordination, such as fixed or freely floating exchange rates, one should certainly not draw the negative conclusion that coordination is unnecessary or automatically assured by ensuring "domestic order". Interdependence is still there and would require appropriate action even among perfectly stable and well-managed economies, as long as economic policies are actively conducted in each of them. Instead of that negative conclusion, two positive conclusions have to be drawn from the existing state of monetary relationships.

Firstly, that a much wider range of policies, objectives, instruments, etc. have to be discussed in the fora where officials discuss problems stemming from interdependence. An exchange rate rule was a simple way, perhaps too simple for our complex world, to summarize the links between partners. Today we have to engage on the much more complicated and politically delicate exercise of discussing and comparing our policies in all their aspects including some which have a less evident relationship with the external sector, like the techniques adopted for monetary control.

Secondly, to the extent to which the recognition of interdependence involves not only an exchange of information but also leads to action or to changes that are, in substance, acts of international policy, then this is closer to the "discretionary pole" of the rule vs. discretion spectrum than it would be under the simple, objective regime of an exchange rate rule.

For both these reasons, international policy coordination has become more difficult, not less necessary, than in the past and it requires that we go rather deeply into each others "internal affairs".

## 7. U.S. MONETARY POLICY AS SEEN FROM EUROPE : A) OBJECTIVES

To do so, I shall offer a commented text-book description of the United States monetary policy after October 1979, when the Fed changed its operating procedure, to see at what level a European observer may have disagreements with his transatlantic friends.

The first aspect of the new American monetary policy is the increased weight attributed to the final objective of restraining inflation.

One must always be wary of dubbing policy declarations as historical events and I could not accept that the October 1979 measures signal the final burial of Keynesian monetary policy. The great English economist has been buried so many times already in the last few years that it reminds me of the phrase that Italo Svevo attributed to one of his characters: "to stop smoking is very easy, I have already done it several times ...". However, even without proclaiming that a new monetary era has begun in October 1979, I think it is safe to say that a shift of emphasis took place on that date and that short-term support of economic activity lost weight, in favour of price stability, in the complex of objectives pursued by means of monetary policy.

There is little to disagree with this change of emphasis. I think it is now accepted by economists of all "schools" that money is, so to speak, an input to the production, investment and consumption process and that its efficiency as an input depends on its stability. This means that inflation hampers growth in a basic, structural sense and that the short term benefits to be obtained by pumping money into the economy are not worth the long term costs of inflation. Indeed, some European countries, Germany and the Benelux countries in the EEC Switzerland and Austria outside it, understood this very early and their relative success is one important reason why other countries are now more convinced in their opposition to inflation.

Not having found anything to disagree within the final objective of United States monetary policy, let's consider the so-called intermediate target variables.

These are expressed in the United States as rates of increase in the monetary aggregates which are set normally for the period from the last quarter of the present year to the last quarter of the year ahead. Target ranges are set for narrow and wider definitions of the money supply. The actual numbers for the lower and upper range for each aggregate are rates of increase thought compatible with, and necessary for, the achievement of the final targets.

The philosophy behind the fixing of these targets has been expressed at the highest level by the Chairman of the Board of Governors of the Federal Reserve before the Senate Banking Committee : "Our intent is not to accommodate inflationary forces; rather we mean to exert continuing restraint on growth in money and credit to squeeze out inflationary pressures. That posture should be reflected in further deceleration in the monetary aggregates in the years ahead, and is an essential ingredient in any effective policy to restore price stability". However he added : "I know that the case is sometimes made that monetary policy can alone deal with the inflation side of the equation. But not in the real world - not if other policies pull in other directions, feeding inflationary expectations, propelling the cost and wage structure upwards, and placing enormous burdens on financial markets with large budgetary deficits into the indefinite future".

Another prominent member of the Federal Open Market Committee, Anthony Solomon, has put it in these terms : "Gradual reduction of money and credit growth as the centrepiece of broad monetary strategy has indeed almost ceased to be a matter of controversy. In a period of prolonged and substantial inflation, virtually all schools of economic thought can accept such an approach and I certainly do myself. But I would like to suggest that it would be a mistake to assume that slowing monetary growth by itself offers a simple or painless, purely "technical", solution to our inflation problem..... On the whole, the experience abroad tends to confirm the suspicion that slowing monetary growth by itself may not be enough to control price inflation within acceptable periods of time and without unacceptable side effects. A good record on achieving money growth targets has not necessarily ensured a good performance on the inflation front - and conversely. Over periods of up to three or four years, there seems to be at best only a rather loose relationship between the growth of the aggregates and price inflation. Over longer periods, to be sure, the relationship is closer".

## 8. B) TECHNIQUES

Looking for disagreements between Europe and the United States we have therefore to go further through our textbook description and examine the so-called operating target.

Under the pre-October 1979 method, the Trading Desk in New York operated to peg the Federal Fund's rate, i.e. the interest rate charged by banks with excess reserves for lending them to banks in need to bring their balances with the Federal Reserve bank up to the required level. The drawback of adopting a level of interest rates as a short-term operating target was that, in order to keep this rate within its tolerance range, the manager of the open market desk had to supply any amount of reserves

that was demanded by the banks at that level of the Federal Funds rate. Whenever the money supply was rising strongly, banks' demand for Federal Funds increased equally and open market purchases had to be stepped up to prevent the Federal Funds rate from moving outside its tolerance range. In addition, there was some reluctance by the Federal Reserve Board to adjust, at its monthly meetings, the tolerance range speedily and by sufficient amounts to correct deviations in the money supply from its target path, partly because it was not always clear if the deviations in the money supply figures were only temporary aberrations likely to reverse themselves, or on the contrary more fundamental changes in trends, partly because the interest rate was regarded as a politically sensitive indicator. Consequently, frequent short-term deviations in the money supply led to an erosion of public confidence in the willingness or the ability of the Federal Reserve to stick to its own targets.

The new operating target adopted on 6 October 1979 is the amount of unborrowed reserves supplied to the banking system through open market transactions. There is still a tolerance range for the upper and lower level of the Federal Funds rate, but this range is now so wide (e.g. from 8.5 to 14 percent in June 1980) that the rate is largely left to find its own level. Thus, in order to gain control over reserves supplied to the banking system, the Federal Reserve has more or less abandoned discretionary control over the level of interest rates.

The Federal Reserve is careful to point out that there is nothing sacred in the new rule and it is supposed to be applied "cum grano salis". In front of the Senate Committee, Chairman Volcker emphasized "that swings in the money and credit aggregates over a month, a quarter or even longer should not be disturbing, provided there is understanding and confidence in our intentions over more significant periods of time". Anthony Solomon goes as far as commenting that the Federal Open Market Committee had exaggerated in pursuing monetary targets during the second quarter of 1980, causing unnecessary downswings of the interest rates.

Even with these qualifications, however, there is a difference of emphasis between Europeans and Americans on the importance to be given to money aggregates and interest rates in conducting monetary policy. I say "between Europeans and Americans" because this is both the subject of today's seminar and, I would say, the geographical distinction of the arguments in the Spring 1981. It is necessary, however not to forget the existence of all those who take a radical "quantity" view on this side of the Atlantic as well as those who continue to advocate a more price-oriented approach in the United States.

The first reason which would justify paying greater attention to interest rates is somewhat pedestrian but, in my view, important. That is that while everybody knows what an interest rate is, the price they pay (receive) to borrow (lend) money, the issue of what is money is much more complicated, both conceptually and statistically. A casual look at the several definitions of money in a given economy (not to speak of inter-country differences) is enough to prove this statement. Some recent difficulties created by the development of new financial assets, especially

in the United States (NOW accounts), or the peculiar effects created by the lifting of quantitative controls (the "corset") in the United Kingdom, just make this eternal problem worse. A small sign of this difficulty is the fact that Paul Volcker, in front of a Senate Committee, had to spend something like three of his total eleven pages just to show how M1A and M1B figures were altered by the growth of NOW accounts. Close to this reason is the fact that interest rates are observed continuously without delay.

A second reason is that interest rates are, so to speak, a universal variable while monetary aggregates are much more segmented. A change in the rate affects all market participants, having widespread consequences in terms of relative costs, resource allocation, and economic behaviour. This is not so for a temporary deviation of a monetary aggregate from the chosen path. If a few billion of whatever M you like are lying somewhere in the economy for some time nothing happens, nobody's behaviour is really affected. To seek control of the aggregates instant by instant, dollar by dollar would be to ignore realities and to produce more shocks and uncertainties that it eliminates.

If demand curves were stable and known, there would be a known one-to-one correspondence between price and quantity and it would make no difference which of the axes one looks at. As they are not, we do not exactly know what price corresponds to what quantity and hence we have to choose what to control. If one believes that in the long-run the demand for money is rather stable, one would tend to avoid huge swings in interest rates also as part of a well-balanced "aggregate-oriented" monetary policy. A look at "real" interest rates may be a useful guidance to those who think that prices affect economic behaviour.

## 9. C) EXCHANGE RATES

A last issue is the policy of foreign exchange market interventions.

I think that in this domain the differences between "American and Europeans" are more than just a matter of emphasis.

The Under-Secretary in the Treasury, Mr. B. Sprinkel, has officially declared that the United States "... intend to return to the more limited pre-1978 concept of interventions by intervening only when necessary to counter conditions of disorder in the market". In November 1978, as it will be remembered, after a dramatic run-down on the dollar, the Carter administration had announced the commitment to a more active intervention policy. The new policy is, therefore, a return to the status quo ante.

For several reasons, the position in Europe is, in this respect, traditionally different from the one described by Under-Secretary B. Sprinkel

A first reason, peculiar to Europe, is that, as I have shown above, Europe is much more open to international trade than the United States. As a consequence of that, an "eye" on the exchange rate is an "eye" (possibly a very sharp one) on that domestic economy; avoiding excessive depreciations means subduing inflationary tensions.

There are, however, also more general reasons. Some are the same, mutatis mutandis, as those mentioned above as regards the relative weight of interest rates and money aggregates in conducting monetary policy. The fact that you have to give a certain quantity of, say, DMs to have one dollar is much more "solid" than the fact that a money aggregate has grown by X percent in a given period.

There is, finally, a somewhat more philosophical argument involved. Under-Secretary Sprinkel made it clear that the new administration does not favour interventions because: "Significant and frequent interventions by governments assume that a relatively few officials know better where exchange rates should (or should not) be than a large number of decisions-makers in the market, and that public funds should be put at risk on the basis of that assumption".

It is clear that the (price) result of a competitive market is a very weighty variable, being, indeed, the end result of a very large number of transactions. This does not imply, however, that one cannot have

one's own idea on the "right" price and bet on it. Indeed operators do this all the time (\*).

But if we admit that anyone can make his own idea about the appropriateness of the "market price" without being accused of "lèse-majesté", why should we just exclude from the game the arm of collective judgment (is not the government just this?). To admit that the game is tough and competition stiff does not mean that one should not even enter the ring.

In addition, intervention may be needed to avoid disruptions to trade and inconsistency with fundamental economic factors. Quite apart from cases of erratic movements due to disorderly market conditions, circumstances may arise where intervention designed to dampen exchange rate variations will be opportune.

Large and sudden changes in the exchange rate can disrupt trade relationships between countries by altering competitive conditions in a manner which does not reflect changes in relative costs, factor endowment and other "fundamental" factors. In these cases, there is a danger of protectionist pressures, which can trigger a chain reaction limiting the free flow of trade, exacerbating inflation and seriously hampering growth. In such circumstances, even in the absence of evident disorderly conditions, action designed to restrain or slow down movement of the rate may be required.

However, dramatic changes in the exchange rate can spotlight, often more sharply and opportunely than other variables, deep economic changes in the country concerned as compared with others. In certain cases such exchange rate movements will be acceptable because they reflect explicit policy choices (such as a revaluation for the currency of a low inflation country). Nevertheless, if a movement is very sharp and sudden

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(\*) In theoretical terms, the same point has been made very clearly by Grossmann and Stiglitz : "If competitive equilibrium is defined as a situation in which prices are such that all arbitrage profits are eliminated, is it possible that a competitive economy always be in equilibrium ? Clearly not, for then those who arbitrage make no (private) return from their (privately) costly activity. Hence the assumptions that all markets are always in equilibrium and always perfectly arbitrated are inconsistent when arbitrage is costly." (Sanford J. Grossmann and Joseph E. Stiglitz, On the impossibility of informationally efficient market : American Economic Review, June 1980, vol. 70, N° 3, pp. 393-408.

it will generally be unwelcome to the country concerned. In such circumstances, intervention aimed at damping the movement may be beneficial, although it should be underlined that the border line between "leaning against the wind" and "manipulation" of exchange rates is very easy to trespass and therefore great care has to be put in performing this kind of intervention.

Any action aimed directly at the exchange rate will spill over into other fields, even if the authorities attempt to offset its direct effects on internal monetary conditions. In particular, conflicts may arise between the exchange rate objectives and aggregate-oriented monetary policies or interest rate policies. The existence of these spill-over effects implies that, in general, a compromise will have to be found between exchange rates and other objectives of economic policy. It also implies that policy actions in other fields will influence the exchange rate. As a consequence any exchange rate policy has to be seen as a component of overall economic policy whose internal consistency has to be preserved.

## 10. CONCLUSIONS

I shall try to summarize my remarks in a few points.

First, the world monetary and economic order that prevailed in the first two post-war decades has disappeared in the seventies. The break of the double, fixed link, between gold and the dollar, and between the dollar and the other currencies, the emergence of a multicurrency reserve system, the floating of exchange rates, the shift of the power to fix energy prices from oil companies to OPEC, are all at the same time manifestations and causes of the end of that order. They are interrelated expressions of the same historical developments.

Second, that order has not been replaced by a new one. Interdependence being as close as before, and probably closer, an organization to grant "peaceful" economic and monetary relationships is as necessary as it was under the old order provided by the "pax americana".

Third, in the existing world institutional setting, problems stemming from interdependence can only be dealt with by way of bi- and multilateral consultations, in the (perhaps too) numerous fora where officials and/or politicians meet: OECD, IMF, G-10, Summits, etc. The assumption on which such consultations are made is an acceptance of the proposition that each member's policies have effects on their partners, and that it may not always be true that what is good for one is good for the others. An implicit or explicit denial of this proposition by one of the partners is a dangerous step, particularly when none of the partners is sufficiently strong and well-behaved to impose order on the others.

Fourth, when there are no agreed rules (like, in the past, fixed exchange rates), and severe stagflation makes policy choices politically very hard, consultations are a difficult and fragile instrument to deal with interdependence. In such circumstances, consultations have to touch upon a wide range of policy objectives, instruments, and techniques.

Fifth, if asked to speak about US policies in a consultation round, I would say that there is little reason for a European to disagree either with the high priority given to anti-inflation policy in the US, or with the importance given to the control of monetary aggregates. However, the choice of techniques of monetary control unnecessarily increases the strains imposed by a tough monetary policy both on the economic system and on the external partners. The relief coming from improved techniques would, however, be marginal. On the other hand, an approach to exchange rate policy based on a rule of no intervention is hard to accept for European countries. As the exchange rate involves two currencies, disagreement in this area is particularly undesirable.

Sixth, and last, the fact that there may be only limited disagreement on U.S. policies means that we recognize that these policies are good for the U.S. It does not mean that they are good for their partners, or that they do not hurt. For several European countries, in particular, the level of real interest rates necessary to keep their currency from depreciating to a level inconsistent with economic fundamentals, is much higher than the level required for domestic reasons.

Thus, the ball comes back into our court. What can we Europeans do to get out of this impasse? Two things, I would say: to show that our approach works in practice and to be united. And, I would add, these two things largely coincide. That opens up another field, that I shall not explore here. But, to put in a nutshell what ought to be said in this respect, I could find no better words than those used by Anthony Solomon less than two years ago:

"If we can't lead the way, through meaningful policy coordination between the U.S. and Western Europe, there is little reason to expect broader success. Understanding of each others perspectives is prerequisite to building a stronger relationship. We should acknowledge and build on our mutual successes. Close U.S.-European cooperation dominates the post-war record. But there are also irritants and sources of tension. The United States continually hears European calls for stronger U.S. leadership in the economic area, and specifically in the monetary area. Yet when the United States does attempt to exercise leadership, there is frequently a notable absence of European willingness to follow. This is not a recent phenomenon. It is understandable if there are differences of view over the substance of such questions. There inevitably will be. The substance can be debated. But Europe itself has and should acknowledge a growing responsibility to exercise leadership, not only in the expression of its view, but in contributing to the solution of common problems. The responsibility cannot be one-sided, and Europe collectively has major potential for leadership of its own. What is not constructive is for Europe to cloak its substantive disagreements, and avoid accepting its own responsibilities, by resting on accusations of failure of U.S. will and leadership. Much of the problem may well relate to the particular phase of European efforts to unify through the Community, it is in a unified Europe that real and constructive leadership becomes possible. But the present decision-making processes make that possibility difficult to realize. Hopefully, this problem will evaporate as the unification process evolves - it is generally least evident in the trade area, where the European Community has formal competence - but it does represent a real impediment to meaningful policy coordination on a global scale."

Brussels  
July, 1981

## TABLES AND CHARTS

- Tables:
1. Some structural characteristics of the world economy
  2. Currency composition of international financial assets

- Charts:
- I. Twenty years of U.S.-European monetary relations
  - II. Relative GDP price deflators, effective and real exchange rates, balance of payments
  - III. Short term interest rates and exchange rates, 1978 - May/June 1981
  - IV. Fluctuations of the DM against the dollar and in the EMS band
  - V. Consumer prices and short term real interest rates

Table 1: Some structural characteristics of the world economy

	<u>1960</u>	<u>1965</u>	<u>1970</u>	<u>1975</u>	<u>1979</u>
<b>1. <u>EC and Japan GDP as % of US GDP</u></b>					
EC-9	54	62	64	90	102
Japan	n.a.	13	21	33	43
<b>2. <u>Relative shares in world trade (excl.intra-EC trade)</u></b>					
EC-9	26	26	24	22	24
Japan	5	5	8	8	9
USA (1)	15	15	18	15	18
<b>3. <u>Openness : imports of goods and services as % of GDP</u></b>					
EC-9 (2)	12	11	11	13	14
Japan	-	9	9	12	13
USA	4	4	5	7	10
<b>4. <u>Productivity (in ECU, at current prices and exchange rates)</u></b>					
- GNP per capita					
. Japan	n.a.	,853	1,937	3,631	6,367
. USA	2,655	3,306	4,685	5,761	7,777
. EC-9	1,105	1,627	2,438	4,290	6,735
- GNP per employed person					
. Japan	n.a.	1,631	3,682	7,242	13,119 (3)
. USA	6,765	8,332	11,107	13,437	16,330
. EC-9	2,528	3,828	5,903	10,717	16,739
- Compensation per salary earner					
. Japan	n.a.	n.a.	2,434	5,702	10,172 (3)
. USA	4,474	5,351	7,553	8,986	11,095
. EC-9	1,640	2,487	3,820	7,427	11,165

Source: Eurostat

All figures are rounded.

(1) US : Fob + .10 per cent

(2) Excluding intra-Community trade and services (estimated)

(3) 1978

Table 2: Currency composition of international financial assets

<u>A. Currency denomination of Euro-market Liabilities (1)</u>		<u>1968</u>	<u>1970</u>	<u>1971</u>	<u>1973</u> <sup>(2)</sup>	<u>1974</u> <sup>(2)</sup>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
US dollar												
estimate A				76	73	77	78	79	76	74	72	75
estimate B	80	78	72	72	68	71	73	74	70	68	65	69
Deutsche mark	9	11	15	15	17	15	15	15	17	18	19	16
Japanese yen									1	1	1.5	1.5
<u>B. Currency denomination of official reserves (3)</u>												
US dollar					85	84	85	87	85	82	78	
Deutsche mark					6	7	7	7	8	10	12	
Japanese yen							1	1	1	2	4	

All figures are rounded.

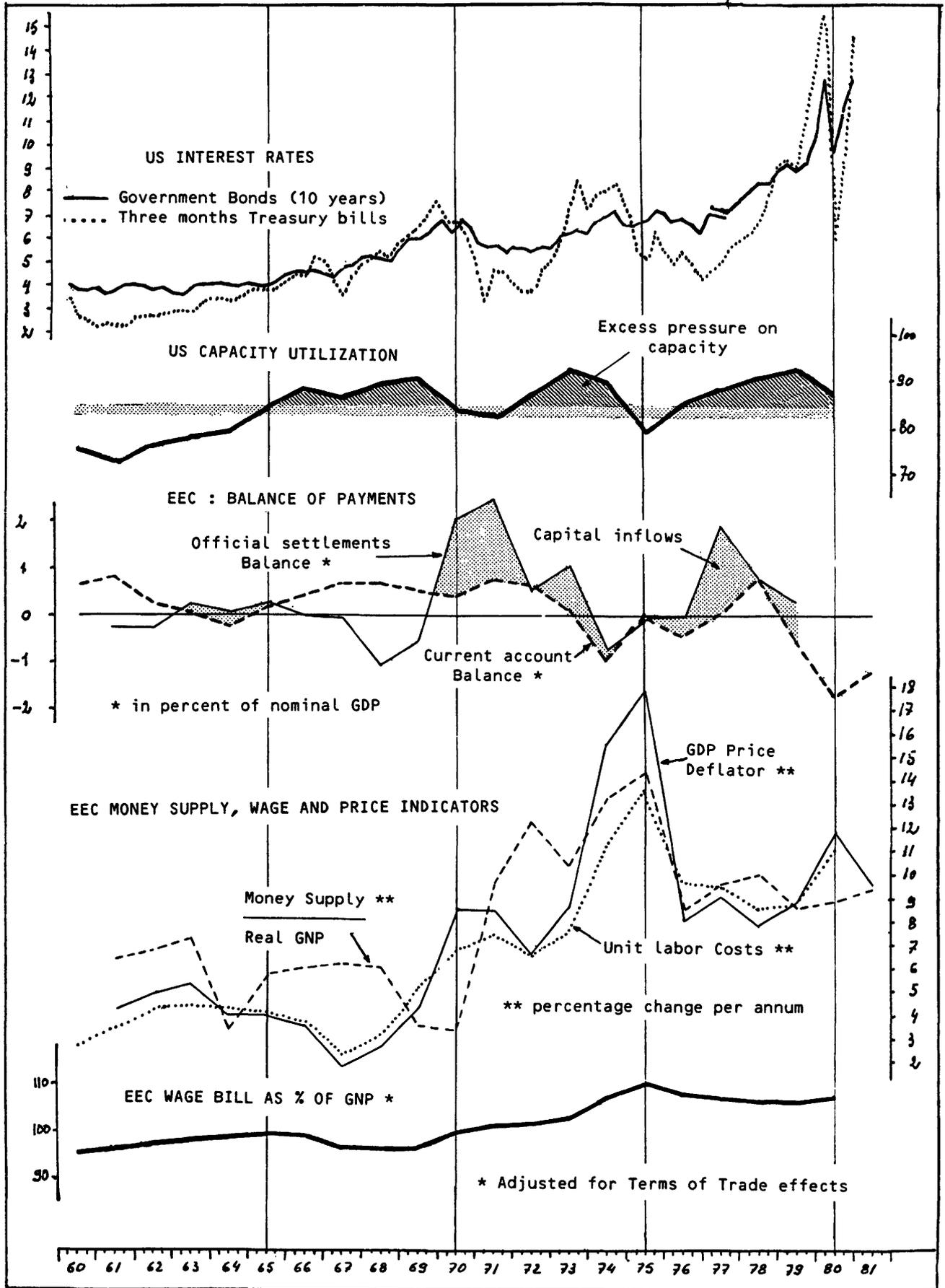
(1) Source A: Morgan Guaranty Survey; an estimate relating to non-European as well as to European markets.

All other data: BIS, Currency breakdown of external positions of banks in the reporting European countries.

(2) The figures for official reserves refer to 1973 I and 1974 II respectively.

(3) IMF, Annual Report, 1980

**CHART I TWENTY YEARS OF US-EUROPEAN MONETARY RELATIONS**



## CHART II

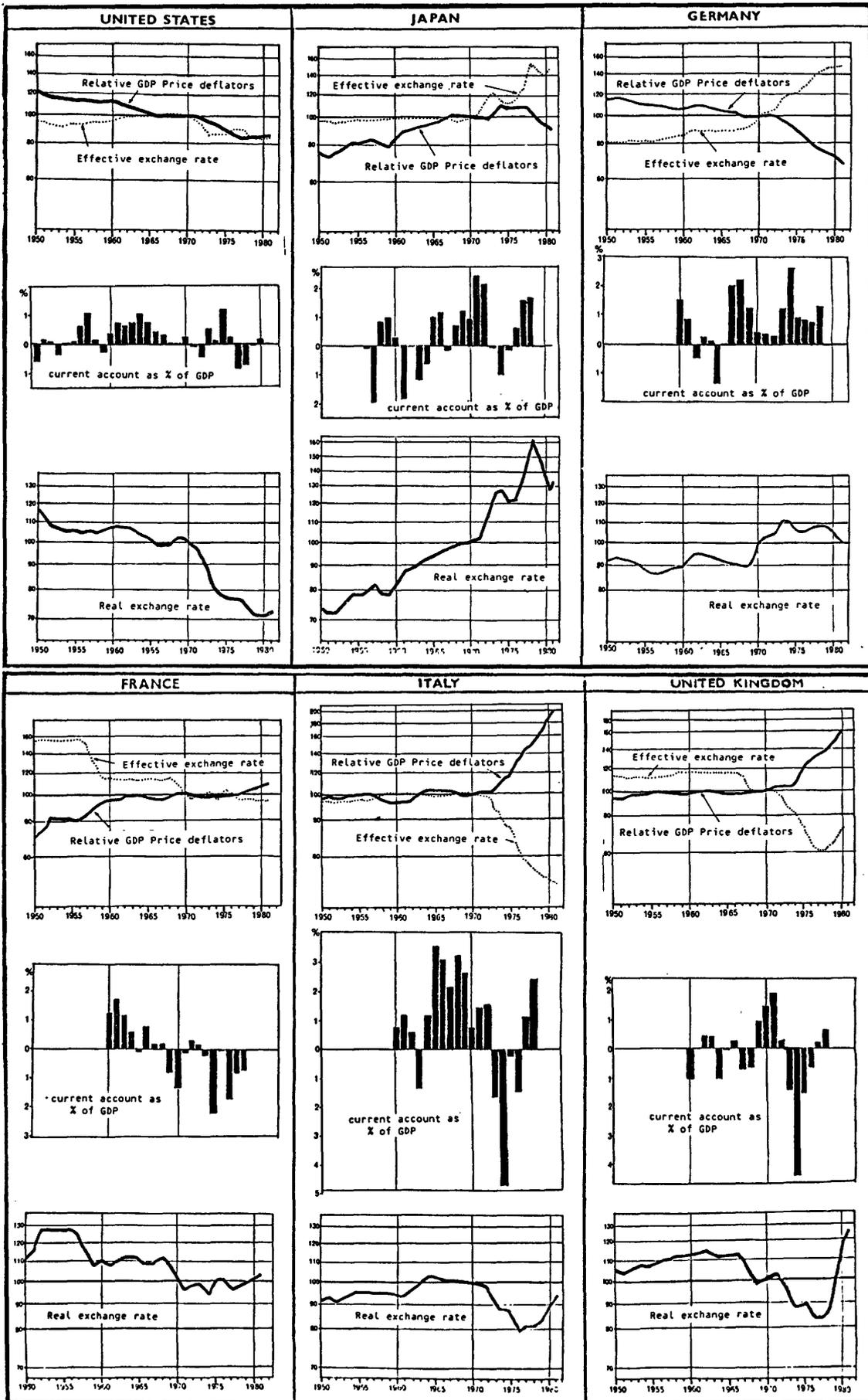


CHART III

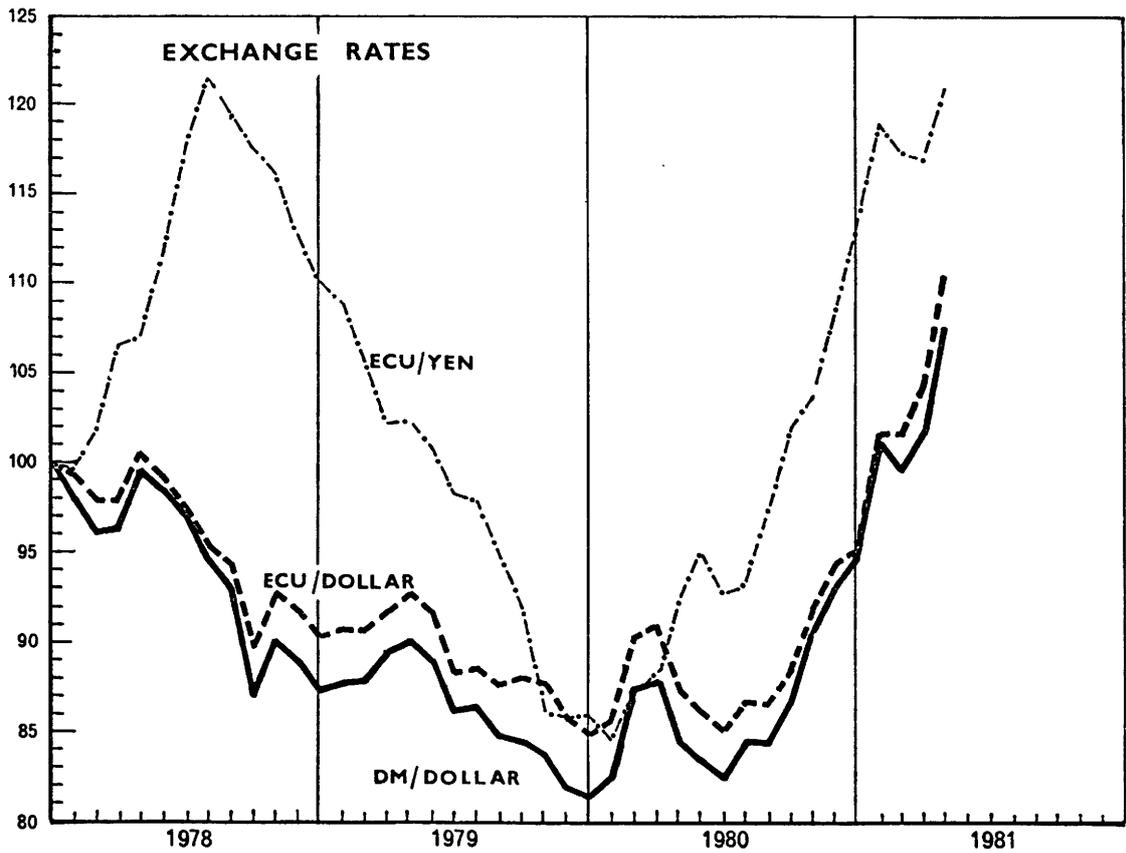
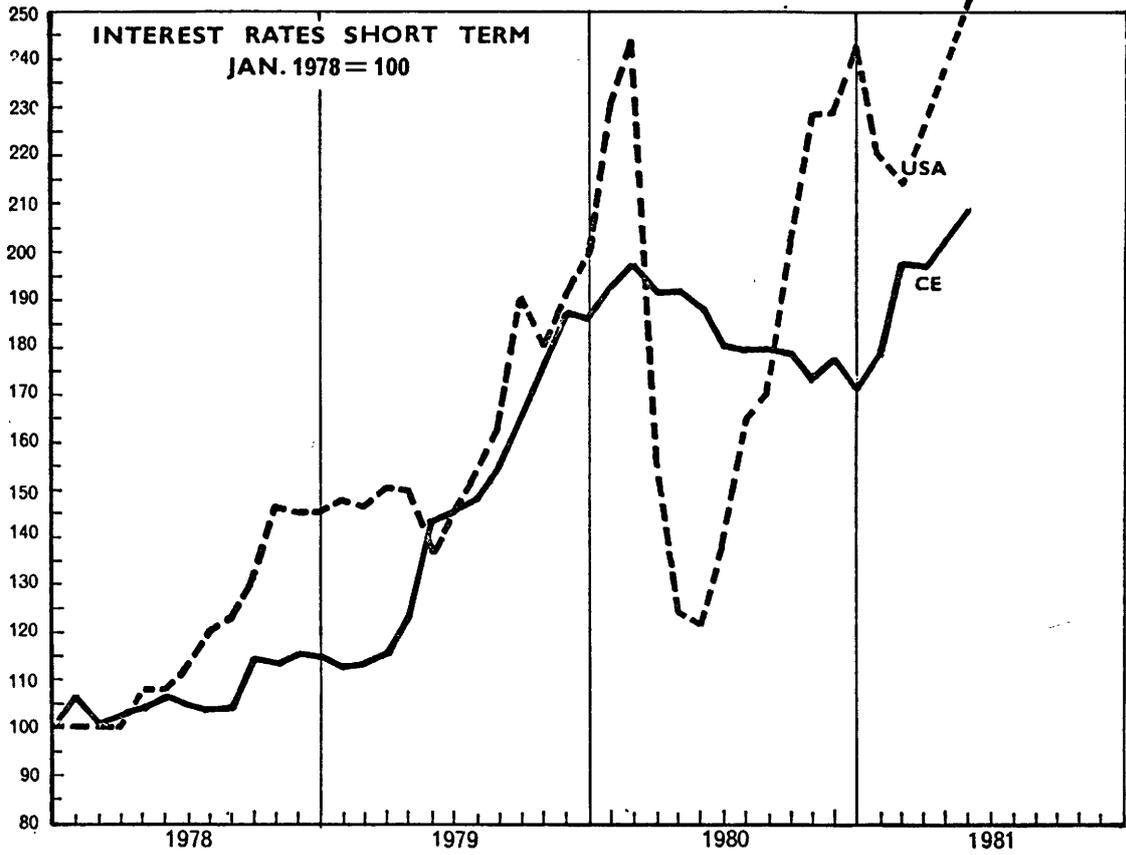


CHART IV

FLUCTUATIONS OF THE DM AGAINST THE DOLLAR AND IN THE EMS BAND

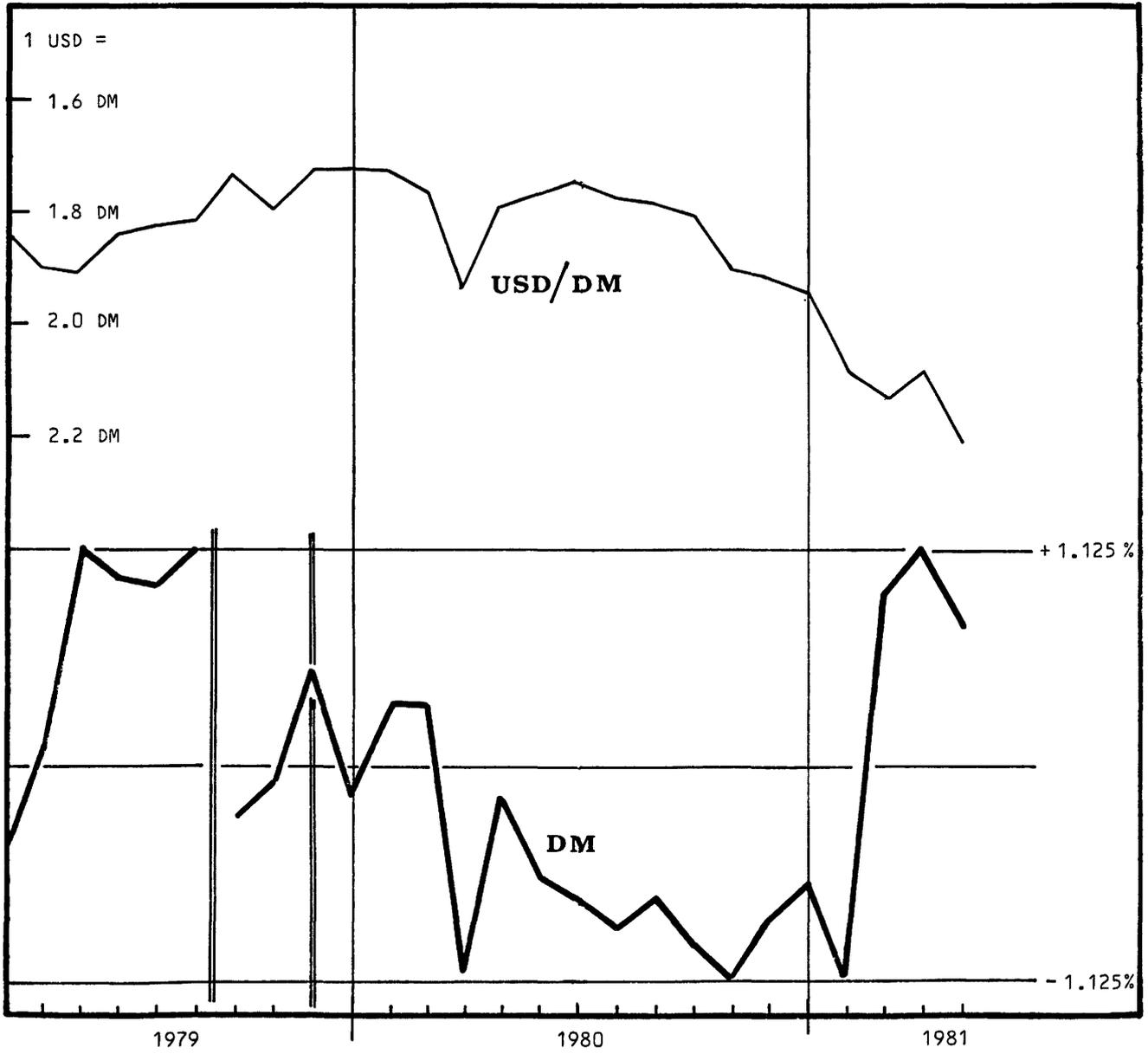


CHART V - CONSUMER PRICES AND SHORT TERM REAL INTEREST RATES

