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THE AMERICAN ECONOMY, EUROPE, AND THE FEDERAL REPUBLIC OF GERMANY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the Conference on

The Bicentennial of German-American Relations

Sponsored by the

Social Science Research Institute of the Konrad Adenauer Foundation

in Cooperation with the

American Embassy in Bonn

at the Political Academy

Eichholz, Germany

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It is a pleasure to help commemorate the bicentennial of American-German relations at the invitation of the Konrad Adenauer Foundation and the United States Embassy, especially in a year that marks also the hundredth birthday anniversary of the late Chancellor. The fact that this great leader of postwar Germany was born when the United States of America was only one hundred years old lends a special perspective to the economic interaction of the United States with Europe, and especially with the Federal Republic, on which I want to focus today.

There can be little doubt that the post-World War II period, which in so large a part carries the imprint of Adenauer, represents the most fruitful years in United States-German economic relations. Early in this period, the Federal Republic defined the main economic principles that were to guide its economic policies, centering on free markets, the preservation of sound money and stable prices, a liberal foreign trade policy, social responsibility, and a constructive partnership between capital and labor founded on free collective bargaining.

These principles were distilled from the harsh lessons, economic and political, taught by German history. They had not always been the beacons which guided German economic policy. Their determined application after World War II produced what, at the time, was called the "German miracle." Once postwar reconstruction was completed, these principles helped to secure for Germany a prosperity second to none among its neighbors, and to make its economy one of the principal pillars upon which Western production, trade, and finance rest.

The principles that largely have guided the Federal Republic in its economic affairs have also long been subscribed to by the United States. They are not uncontested, however, in my country. Our belief in the need for stable prices and honest money has not been forged in the traumatic experience of two inflations like those suffered by Germany. Our allegiance to free markets and free movement of goods and capital may at times have seemed to waver. Those of us who believe in these principles have been able to draw strength and conviction from German steadfastness in adhering to these principles, and from the manifest benefits that they bestowed on the German economy.

In the trying period through which the American economy has been passing since pronounced inflation began in the second half of the '60's, the people of the United States have been told from time to time that they could have less unemployment if they were willing to tolerate more inflation. This advice shows a very proper concern with unemployment, but fails to take into account the consequences of neglecting inflation. We have now suffered these consequences several times. Successive periods of over-expansion have led, first, to even higher rates of inflation and then to recession and even higher unemployment. The economy kept moving up the inflation-unemployment spiral. Today, we are still suffering from the heavy unemployment brought on by the last round of over-expansion. We have succeeded only in part in winding down the inflation that preceded it. To observers in the United States who pointed to German inflation experience after World Wars I and II, it used to be said that "it can't happen here." Now that we have had a taste of two digit inflation, I have heard that remark less often. I believe that we have learned our lesson and will bear it in mind.

No country has succeeded in avoiding altogether the pressures of inflation. In part at least they have had their roots in areas beyond national control, such as acts of God or man affecting prices of food, oil, and other primary products. But Germany has set a good example in holding down the rate of inflation. In doing so, it is also exerting a wholesome discipline on others because countries that encounter German products in the markets of the world must look to their own competitiveness or suffer the consequences.

The United States has made heavy sacrifices in order to fight inflation. We have suffered a level of unemployment that we cannot accept and are determined to reduce. Fortunately this reduction in unemployment is already underway. Given the substantial national and personal losses imposed by unemployment, we must continue our efforts to alleviate distress while prudently adapting to emerging circumstances our income maintenance programs by which many of these hardships are being softened.

In the recession from which our countries are emerging, liberal trade policies have undergone a severe test. From the evidence thus far, they are surviving largely intact. Some of us here remember what happened during the depression of the 1930's. Countries tried to alleviate domestic distress by cutting down imports through tariffs, quotas, exchange controls, or competitive exchange depreciation. International trade declined dramatically; every country was a loser. In the present recession, we have very largely succeeded in avoiding such mutually damaging policies. We have been able to do this in part because we have learned, however imperfectly, to counteract the forces of recession and to keep our economies from going into deep depression. But we have been able to maintain the free flow of trade and capital under difficult conditions also because of our strong conviction about the fundamental soundness of these policies.

As our economies advance once more, each country can be helpful to others by the stimulation that it provides. It used to be said that when the American economy caught cold, the rest of the world caught pneumonia. On the last occasion, the United States caught considerably more than a cold. But fortunately the economies of the world, and particularly the Federal Republic, have shown a degree of strength that should make them less susceptible to temporary American ailments.

In this connection, it is of interest to note that statisticians have meanwhile begun to measure the impact of changes in U.S. economic activity upon other countries. It turns out that a rise in American gross national product seems to have only a rather moderate measurable impact on the economy of the Federal Republic. The calculations of our econometricians suggest that for every one per cent increase in U.S. GNP, German GNP rises by something like 0.04 to 0.05 per cent, i.e., four or five hundredths of one per cent. This calculation takes into account the indirect effects via third markets as well as the secondary domestic expansion in Germany resulting from a rise in exports. Thus the American GNP gain in the second half of last year of about 9 per cent at an annual rate might seem likely to make less of an impact on German GNP than one might have thought.

Further and very preliminary research suggests that expansive actions taken simultaneously and cooperatively by several countries do have a somewhat greater effect, raising the original impact by something of the order of one-half. Taking all these findings together, as they are, it seemingly follows that more expansive action in the United States does not by itself contribute a great deal to German recovery.

But I am far from thinking that this is the whole story. In reading the German press and speaking to German businessmen and politicians, I become aware that conditions in the United States are being closely watched. The American economy is regarded as something of a bellwether, or as a kind of barometer, of economic prospects generally. A continuing American slump would, I believe, have had very depressive repercussions abroad simply through this influence on the climate of opinion. By the same token, the rapid rise that the American economy enjoyed in the second half of last year and the good expansion that we believe to be ahead helps to strengthen the business climate in Germany and other European countries.

In any event traditional anti-cyclical policy today seems to face certain limitations and so do its beneficial repercussions abroad. People have become aware that stimulative measures, such as easier money, tax cuts, and especially government spending, become inflationary if pushed very far. When people see government action that they consider likely to bring on inflation, they react negatively. Households cut their purchases to guard against a rainy day. Businessmen cut their investment spending to limit risk. Hence, monetary and fiscal policy directed toward recovery, in order to be successful, will have to be increasingly conscious of the need for moderation. Pushed too far, some of its effects become self-defeating.

Fundamentally, therefore, it is through continued adherence to our principles of free markets, free movement of goods and capital, and reasonable price level stability that we can best help one another. By giving confidence to households and businesses, by providing a framework of institutional stability, we can encourage the forces that must carry forward the expansion if we are to reach again the high levels of activity that we want.

Let me turn now to the area of international finance where major departures from past practices have occurred, and where it has become necessary to chart new paths. Some of us, no doubt, look back with nostalgia to the period of fixed rates -- thinking of it as a time when we did not have to contend with wide fluctuations in exchange rates, at least before we encountered financial crises which characterized the end of that period. But the maintenance of that system would have required a degree of international discipline that nations were unwilling to accept. Different countries had different rates of economic growth and productivity and different degrees of tolerance for inflation. Different countries also had different degrees of interest in continued exchange rate stability, and were affected in different ways by the institutional arrangements that were operative under the dollar exchange standard.

Germany, in particular, found that the fixed rate system promoted large inflows of funds that threatened domestic price stability. The United States felt that the benefits of the fixed rate system did not compensate for the resulting exchange-rate rigidity or for the domestic constraints emanating from an obligation to keep the dollar convertible. Fixed rates would have required countries to subordinate domestic monetary policy and perhaps other policies to the needs of regulating international financial flows, or else to try -- with limited success at best -- to control those flows directly. I believe that, given the choices before us, we were wise to choose freedom of monetary policy for domestic stabilization and a continued free flow of funds internationally, even at the expense of having to give up the stability of exchange rates.

We are now engaged in finding our way in this sea of floating rates. There is much opportunity for cooperation, precisely because there seems to be much opportunity also for getting in one another's way. It is important, therefore, to examine our mutual interests in the matter.

The United States, a large economy with a much enlarged but nevertheless still relatively small foreign sector, is comfortable with floating. To be sure, the United States has not yet experienced all phases of floating. The dollar has repeatedly dropped to levels that many observers regarded as undervalued. It has not, since the original devaluations, been pushed upwards with comparable force. Thus we lack experience of such a condition within the context of floating rates. Of course, we had experienced overvaluation under the old regime of fixed rates. The American reaction then was a vigorous move to bring the dollar rate down, indicating that we did not find overvaluation comfortable.

For the United States, as for every other country, the exchange rate is a two-sided affair. Exporters usually like it low, and they are joined in this desire by those who are concerned primarily about the level of employment, at least whenever unemployment is substantial. Importers usually like the rate high, and their preference is shared by those who are importantly concerned with holding down inflation. Differences on this account, however, are muted in the United States by a broad consensus that exchange rates should be determined by the market in the light of economic fundamentals, and by a widespread view, also, that there is little that can be done by way of intervention in exchange markets to alter an exchange rate determined by fundamentals.

The United States, moreover, at this time has no clearly defined objective with respect to its balance of payments or balance on current account. At the time of the devaluation of 1971, the United

States had a balance-of-payments objective. In the Smithsonian negotiations the United States made clear that it required a specific improvement in its overall balance-of-payments account from deficit to small surplus. At some point in the future, the United States might again develop a current account objective, for instance if, as some observers fear, we should begin to suffer a capital shortage that might make it inadvisable to be a large-scale capital exporter. Such a current account objective, whatever it might be, would of course have to be reflected in an exchange rate likely to bring about the desired current account balance in a free exchange market.

As we observe our friends in Europe and especially in the Federal Republic, we seem to observe another set of concerns about the floating rate system. Countries that are heavily dependent upon trade may well feel that stable exchange rates with their principal trade partners are of great importance to them. The desire for a joint float, as manifested by the "Snake," seems to evidence this. If this arrangement enhances the prosperity of the participating countries, not only they but also the rest of the world stands to benefit. But vigilance will be needed to make sure that bloc floating does not lead to any violation of our common principles of free movements of goods and capital, and that it does not lead to distortions of trade as between countries with respectively higher and lower rates of inflation.

The function of the U.S. dollar in a system of floating rates is another issue that requires careful thought. For the United States, such benefits as were derivable from the dollar's use as a reserve currency have diminished perceptibly with the ending of the fixed rate system. The exchange rate rather than foreign willingness to buy and hold dollars now takes care of equilibrating our international accounts. Under floating, the holding of dollars by foreign countries to finance an American balance-of-payments deficit conveys no great advantages to the United States.

The role of a reserve currency, on the other hand, evidently entails burdens, as evidenced by the reluctance even of financially very strong countries, including the Federal Republic, to allow their currencies to assume or be pushed into such a role. But it is evident also that even under a floating system, countries want to have foreign exchange reserves and somehow these reserve needs must be met. This applies all the more because today there is, in fact, no limit to the volume of reserves that they can acquire, if they are prepared to buy or borrow dollars or other foreign currencies. The implications for world liquidity under such a system, I believe, have not yet been sufficiently analyzed.

The dollar, however, serves not only as a reserve currency, but also as an intervention currency. When the dollar is used for intervention, this affects not only the exchange rate of the particular country that is doing the intervening. It affects the value of the dollar with respect to all other currencies that float, causing these currencies to depreciate and the dollar to appreciate when the dollar is being bought and vice versa when the dollar is being sold. Since the market for the dollar is large, moderate amounts bought or sold should not make much of a difference. Large amounts do create a significant exchange-rate movement for the dollar.

Careful examination of how best to proceed in this highly technical but nevertheless very important area is needed. We already have some important elements of agreement. At the Rambouillet meeting, it was agreed that intervention is appropriate to deal with erratic exchange rate movements or disorderly exchange market conditions. Earlier, the International Monetary Fund adopted guidelines for floating. These imply special caution in connection with so-called "aggressive" intervention, i.e., intervention that accelerates an already ongoing rate movement, such as selling a currency that is already falling or buying one that is already rising.

Special complications arise when countries that are members of the "Snake" are concerned. There exists a choice, then, whether to intervene in national currencies or in dollars. Recent experience shows that intervention in dollars, when the need for intervention does not arise from developments concerning the dollar, may distort the dollar rate. This has undesirable consequences not only for the United States, but for many other countries for whom the dollar rate is important.

Finally, the repercussions of intervention upon domestic bank liquidity and the money supply need to be taken into account. The use of the dollar for intervention does not pose a major problem for the United States in a monetary policy sense because foreign purchases and sales of dollars do not generally influence the U.S. money supply although at times they have affected the structure of interest rates. In any event, effects on the money supply can readily be neutralized by the open market operations of the Federal Reserve. Likewise, the Federal Reserve's purchases and sales of foreign currency do not have lasting effects on the U.S. money supply. They, too, can be neutralized by open market operations. Similar neutralizing operations are possible in principle for all countries, including the Federal Republic. Frequently, however, they present technical difficulties, and therefore exchange market intervention does have monetary consequences. It would be useful to give thought to the further development of techniques that would permit neutralization of the monetary consequences of intervention.

These are problems of an evolving system that, in time, I believe will find their solution. The Federal Republic and the United States have a solid basis upon which to found such evolution, in the foreign exchange area as well as in other areas. We are agreed on basic principles. As we approach success in implementing them, the technical problems will fall into place. It is the principles by which we have been guided over so many years that we must firmly keep in mind.

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