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INSTITUTIONAL COOPERATION IN THE WORLD ECONOMY

Remarks by

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

in the Key Issues Lecture Series

University of Chicago

Chicago, Illinois

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Coordination -- harmonization -- cooperation -- consultation:
these, in descending order, are the terms by which nations recognize,
sometimes reluctantly, that they are not alone in the world. My topic
today deals with the third element on this diminishing scale of official
international relationship -- cooperation. "Cooperation" falls well short
of "coordination," a concept which implies a significant modification of
national policies in recognition of international economic interdependence.
It falls short also of "harmonization," a polite term indicating a somewhat
greater reluctance to limit one's freedom of action. But "cooperation" is
more than "consultation," which may mean little more than that other interested
parties will be kept informed.

Forms of Institutional Cooperation

International cooperation is practiced by national institutions
directly or through international institutions. Some forms of cooperation
are wide-ranging and flexible, such as summit meetings. Others are extremely

narrow, such as, for instance, the OECD Arrangement on Export Credits. Some forms of cooperation are sporadic and ad hoc, like the Bretton Woods conference and the Smithsonian conference, or like occasional tariff rounds. Others occur on a fixed schedule, like the annual meetings of the International Monetary Fund (IMF) and the World Bank (IBRD), or the monthly meetings of the Bank for International Settlements (BIS). Some involve full-time and continuous discussion and decision-making, like the executive boards of the IMF and IBRD. Others are intermittent, like the annual ministerial meetings at the Organization for Economic Cooperation and Development (OECD) or those of the governing boards of the IMF and World Bank. Some forms of cooperation are by their nature required to arrive at some sort of agreement, such as the budget sessions of the European Communities' Council of Ministers or the Interim Committee of the IMF in reviewing IMF quotas. For others, the maximum achievement may be a communique, such as North/South conferences. Finally, some agents of cooperation have money to work with, like the IMF, the IBRD and the BIS. Others have none, or very little, and can only pass resolutions or the hat. The world is full of intergovernmental and other international organizations, most of which could readily be fitted into the foregoing illustrative sets. The characteristics described go far to determine the nature of the discussions, the degree of responsibility with which they are carried out, and the prospects for accomplishment.

Summits

From the vast range of areas of international cooperation, I shall select here the very few with which I have some familiarity from observation or participation. In good part, they deal with economic policy and particularly with monetary policy.

Of all macroeconomic cooperative enterprises, the summit meetings of heads of state and of governments are by far the most conspicuous. Of the Western-nation summit meetings that have taken place so far -- the ninth is just ahead -- some have arrived at specific cooperative commitments, some have stressed exchanges of views, some have been more tightly prenegotiated than others. The 1978 Bonn summit -- in which Germany and Japan traded obligations to accelerate growth against a commitment of the United States to deal with its oil problem and with domestic inflation -- is probably the best example of a successfully agreed specific macro initiative. Since some of the participants subsequently expressed unhappiness about the resulting alleged overexpansion, it is difficult to claim full success for the outcome.

Among the advantages claimed for the summit technique is that at top level some things can be agreed that cannot be negotiated at a lower level, although tight prenegotiation of summits seems to raise a question about this. The focusing of the attention of a chief executive on international economic matters, which cannot always be taken for granted, is another advantage. So is the strengthening of the internationally oriented part of the bureaucracy relative to their domestically oriented colleagues, at least in the view of the former. The public, too, is better informed as a result of intense summit media attention. Finally, there is the potential political benefit for incumbent heads of state or government.

On the other hand, summits have costs. Regular international contacts at diplomatic and bureaucratic levels are emptied out by the summit. The effort to get a conspicuous agreement may not always lead to the best results. High expectations may be disappointed, particularly if misunderstandings surface subsequently or agreed objectives are not achieved. On the part of American technicians,

there is often the concern, too, that the summit may provide undue prominence, if not actual success, for favorite foreign schemes such as a greater role for gold or for fixed exchange rates. This concern was particularly pronounced during the time when a number of the foreign heads of government were ex-ministers of finance.

International Monetary Fund

Below the summit level, broad discussions of macroeconomic policy take place at the IMF and the OECD. The IMF's worldwide membership is deeply divided by the continuing gap, in my view partly fictitious, between developed and developing countries. Practically all the recent borrowers from the IMF are developing countries. They are the demanders in most important matters concerning the IMF, as indicated by the monotonous insistence of the communiques of the Group of 24 (comprising a caucus of developing countries) on a variety of issues which the developed countries, forming a great majority of the voting strength, are reluctant to yield. As a result, a unified macroeconomic policy line is hard to find in the IMF's Interim Committee communiques, although nuances can be important.

Very different in this regard is the role of the IMF in dealing with individual countries. When a standby or Extended-Fund-Facility arrangement is negotiated, the IMF and the country agree on very definite policy lines. Here it is money that does the talking. In the IMF's annual Article IV consultations with individual countries, where no financial leverage is at work, the Fund's ability to influence policy is very much less.

Organization for Economic Cooperation and Development

The OECD can generate somewhat greater policy cohesiveness because its membership essentially consists of developed countries. It is in the OECD framework that the principle of the superiority of joint over individual-country action can most clearly find expression. "Locomotive," "convoy," and "concerted-action" concepts, therefore, play a role. The argument that if one country alone expands, it will soon run into exchange-rate depreciation and inflation, while if all expand together, balance-of-payments difficulties can be forestalled, often sounds persuasive. But since countries are constrained in different degree by inflation and balance-of-payments problems, differential roles for particular countries also sound plausible. The function of the OECD Secretariat, not always rewarding, is to discover such differential roles for countries that often have no taste for them.

The diversity of membership, even within this narrower group, introduces asymmetries. Smaller countries cannot have much influence on the course of the world economy. They seek to find out, however, what the larger countries, especially the United States, are planning to do and inform them of probable repercussions. The larger countries seek to explain and defend their policies.

In this process, the asymmetric role of the United States in the world economy becomes particularly apparent. On a world scale -- as contrasted with a European framework -- only the United States can exert enough influence on economic activity to be affected perceptibly by the repercussion of its own expansion or contraction. It is in the position of a large firm with market power in an industry consisting otherwise of more or less atomistic

competitors. Other countries, particularly small ones, cannot individually influence the course of world activity, even though usually they are much more dependent on it than is the United States. They are, therefore, somewhat in the position of free riders with respect to any proposed form of joint action, benefiting from it importantly but unable to make significant contributions.

Historically, this role has been recognized by the United States in accepting leadership, although, of course, it is much more pronounced in the defense area than in the economic. Over the years, the asymmetry has diminished as the weight of the United States in the world economy has shrunk. Meanwhile, however, the United States itself has become more open to foreign influences on its domestic level of activity. In other words, as our ability to influence world economic activity has diminished, our dependence upon it has increased. It cannot be argued, therefore, that a diminishing share in world activity and world trade has reduced the interest of the United States in exerting what beneficial influence it can.

There is some question about how effectively messages received at various levels of OECD meetings percolate into the consciousness of domestic Washington. Achieving a broader awareness of the conclusions reached at its meetings, in the macro policy area at least, remains a problem for the organization.

Bank for International Settlements

The BIS is the center of an even narrower group, comprising principally the G-10 and Switzerland as well as, more loosely attached, a number of smaller, mostly European countries. Participation is limited to

central banks. Partly for that reason, discussions at the BIS do not focus significantly on macro policy coordination, although monetary policies are discussed. Meetings also address central-bank functions other than monetary policy, including bank supervision and regulation, developments in the Euromarkets, payments systems, and the lender-of-last-resort role of central banks in an international context. Short-term liquidity assistance, such as was made available recently to several countries in payments difficulties, may be regarded as an extension of the lender-of-last-resort function from individual banks and markets to national economies and governments. Being of necessity very short-term, such assistance has provided a bridge to the availability of other funds from the IMF, national governments, and the private market, without preempting the political role of governments in the granting of such credits.

With regard to international cooperation in bank supervision, a "Concordat" has been developed under the auspices of the BIS that allocates responsibility for supervision of foreign branches, subsidiaries, and joint ventures between the respective host and parent supervisory authorities. It does not deal with the lender-of-last-resort function. As to the latter, similar questions arise regarding the allocation of responsibility between host and parent lender of last resort. By the nature of relationships in international banking, the principle of parental responsibility applies. Branches and subsidiaries of foreign parents must first look to these parents in case of liquidity needs, while the parents look to their own central banks. A role for the host country central bank is nevertheless maintained. To avoid the creation of moral hazards, the central banks at the BIS have not laid out

in advance detailed rules and procedures for the provision of temporary liquidity under circumstances that in any event cannot be foreseen. They have stated that means are available for that purpose and will be used if and when necessary.

The European Monetary System

The EMS represents perhaps the tightest grouping requiring the most intensive cooperation and, at least conceptually, firm coordination of macro policies. Complete success obviously has not been achieved. It is possible that in the absence of these unifying pressures, divergence of members' macro policies would have been even greater. More will be said below on the degree of success of the EMS in maintaining relative exchange-rate stability.

Developing-Country Groups

Various groups of developing countries, such as the G-24, the G-77, and the Nonaligned Movement make up the "south" side of the "North/South dialogue." That dialogue occurs in the United Nations, in UNCTAD, and, in muted form, in the international financial institutions. It is an unfortunate fact that the nature of the discourse does not generally reach the level of cooperation or even consultation, but often borders on confrontation. This problem, of course, goes far beyond the issues of cooperation in economic policy. It is a profoundly political condition. Given the rapid population growth of the developing world, and its growth in economic and other capabilities, this situation needs to be viewed with the greatest concern. One might expect that North/South polarization in the course of time would diminish thanks to the rapid growth of a group of newly industrializing countries. In fact, the developing countries seem to be held together by strong common interests,

including those of being heavy borrowers. No developing country, with the possible exception of Saudi Arabia in the area of international finance, so far has "graduated" and joined the ranks of the developed.

Monetary Policy

After this quick survey of a selected group of international institutions where cooperation on macroeconomic policies could be looked for, I now turn to a small number of areas of policy in which cooperation often is looked for. One of these is monetary policy. Cooperation in monetary policy is often urged as a means of achieving a coordinated change, usually downward, in interest rates. Countries acting in isolation, it is argued, run the risk of lower interest rates causing capital outflows, a decline in the currency, and a rise in inflation. Alternatively, under fixed exchange rates, a loss of reserves might lead to an exchange crisis. A concerted move would protect against such risks and would promote expansion all around.

Under the old regime of fixed exchange rates, there were indeed some instances of interest-rate cooperation. Examples are the easy-money policy of the Federal Reserve after the return of sterling to gold in 1925, and the decision of the finance ministers of the United States, the United Kingdom, Germany, France, and Italy taken at Chequers in 1967 to work jointly for lower interest rates. Whatever the merits of these initiatives, under present-day conditions cooperation in moving interest rates up or down would be made especially difficult by two circumstances. One is the floating exchange rate system, the other the widespread practice of money-supply targeting. Both circumstances, of course, are in part the consequence of years of rapid inflation.

Under floating exchange rates, capital movements are influenced by real rather than nominal interest rates. Under fixed rates, so long as they are reliably supported, an investor in a low-interest-rate country is indifferent to the rate of inflation prevailing in a country with a high interest rate. If his anticipation of stable exchange rates is correct, he can profit from a differential in nominal interest rates and recover his principal without loss. Under floating rates, the same investor must make allowance for the "expected" depreciation of the high-interest-rate currency. In the absence of reliable predictors of exchange rates, he may well be guided by the inflation differential of the two currencies, which leads him to compare their respective real interest rates.

The real rate, however, is not controllable by the central bank except in the very short run. In the long run, it is determined by the demand for and supply of saving, with a very important determinant of the demand nowadays being the government deficit. In the short run, the central bank can influence nominal interest rates, and thereby real rates, to the extent that this does not lead to changes in inflation and inflation expectations. Since the latter nowadays change rapidly in response to monetary policy actions, the time horizon over which the central bank can afford to manipulate nominal interest rates is quite limited. Meanwhile the control of real rates, other than in a very short-run sense, is in the hands of the fiscal-policy authorities and not of the central bank.

Furthermore, the widespread practice of money-supply targeting makes nominal interest rates largely dependent on the market's reaction to a given money supply. This reduces the central bank's control over, as well

as possibly concern about, interest rates. In any event, given the differences in the targeted aggregates between countries, in the relationship between money targets and interest rates as between countries, and differences in velocity and its trends, coordination of targets (even if possible) would not mean coordination of interest rates.

Balance of Payments and Exchange Rates

Monetary-policy cooperation, in addition to being viewed as an instrument of domestic expansion and contraction, has also been viewed as a means of cooperatively adjusting balance-of-payments deficits and, possibly, of stabilizing exchange rates. The balance-of-payments adjustment in question, in the short run, can, of course, result only from capital flows. The current account changes only over time, in response to, among other things, exchange-rate movements.

This view of monetary policy reflects the classical Mundellian assignment of monetary policy to the control of the balance of payments, with fiscal policy assigned to promoting domestic full employment. This early Mundellian conception, however, fits less easily into a framework in which monetary policy has only limited and short-term control over interest rates, while the real interest rate is determined by fiscal policy through the budget deficit. In an extreme version of this framework, monetary policy is unable to affect any real variable, determining solely the rate of inflation, while fiscal policy, through government borrowing, determines the real interest rate, so that there is no fiscal/monetary mix capable of achieving simultaneously the two targets of full employment and payments equilibrium.

In this light, monetary policy cooperation could influence interest rates and exchange rates only temporarily and within a limited range. Moreover, the effort would seem to require giving up adherence to a money-supply target, which would threaten to raise inflationary expectations. Exchange-rate targeting and money-supply targeting are at odds.

Nevertheless, given the rather wide range in which many money-supply targets are expressed, it is at least conceivable that some compromise between money-supply targeting and exchange-rate targeting could be found. For instance, the German Bundesbank seems to have been able to reconcile reasonably successful pursuit of a money-supply target with the need to maintain the D-mark within the exchange-rate limits of the EMS. From time to time, to be sure, new exchange rates have had to be set within the EMS as the money-supply target and other policies have kept German inflation down and made existing exchange rates unsustainable. Perhaps the operation has been somewhat successful because the D-mark tends to dominate the EMS and has pulled some of the other currencies along. Additionally, relative success may have been due to the ability of the Bundesbank to maneuver within the range of its money-supply target, aiming at the lower or higher end as exchange-rate considerations made desirable.

It is not at all clear, therefore, whether a similar reconciliation of an exchange-rate and a money-supply target would be possible for other large countries, were they to join an exchange-band arrangement similar to the EMS. A currency like the dollar, for instance, might in that entirely hypothetical case play the same role that the D-mark plays now. It might pull the whole group along. In that case, the ability of countries like Germany to achieve both money-supply and exchange-rate targets might diminish.

Intervention

Central-bank cooperation also is often proposed in the case of exchange-market intervention. It is argued that in the absence of cooperation, especially by the United States, intervention lacks in effectiveness. In this light, the recent U.S. attitude of minimal intervention appears lacking in cooperativeness.

I believe that this is a twofold misconception. First, intervention by two central banks is not essential to the maintenance of one exchange rate. Second, the attitude of the United States as an "nth country" deserves to be evaluated somewhat differently.

Intervention by more than one central bank is not essential in order to effectuate a certain increase in the supply of one or the other country's securities in the market. The central bank of any non-dollar currency can buy and sell its currency against dollars all around the world. As far as volume of intervention is concerned, it makes no difference whether this volume is done by one central bank, or shared between the foreign central bank and the U.S. monetary authorities.

The call for cooperative intervention must, therefore, be justified on broader grounds. It must be argued that the foreign central bank does not want to assume the full burden of the exchange risk involved in altering its reserve position, or that its reserves are inadequate, or that it believes the market will be given a more definite impression that both foreign and U.S. authorities want the rate to move in some particular direction. The recently published report of the International Working Group on Exchange Market Intervention reported that some countries judged coordinated intervention by two (or more) central banks to have been more effective than intervention by a single central bank. However, the conditions for successful coordination, were said to be exacting. It should be noted that, insofar

as the perceived greater effectiveness of coordinated intervention derives from an interpretation by the market that the U.S. authorities have a rate objective, that interpretation might be misleading.

There are, to be sure, some real advantages to be derived from cooperative intervention that do not follow from unilateral intervention. One of these is the possibility of controlling the volume of official international reserves created or extinguished in the process. International reserve creation and extinction depends on whether the central bank of the strong currency acquires reserves by buying the weak currency or the central bank of the weak currency extinguishes reserves by selling the strong. The volume of sterilization of the money supply created by intervention, for instance, to support the dollar is reduced for the foreign country, if the United States shares in intervention unless U.S. intervention is financed by drawing on a foreign-currency swap.

It can be argued also, on behalf of a more balanced evaluation of U.S. cooperativeness, that willingness to assume the role of nth country is, in itself, an act of cooperation. It leaves determination of the exchange rate, to the extent that intervention can affect the rate, in the hands of the intervening authority. It may further be argued that U.S. intervention activity, if any, might have to be very limited because many foreign countries have shown themselves reluctant to permit large accumulations of debit balances in their currencies on the part of the U.S. monetary authorities.

EMS Intervention

In raising questions about the usefulness of monetary-policy cooperation in exchange intervention, it is necessary, nevertheless, to note a degree of success, albeit limited, achieved by intervention in the EMS. In a world in which exchange-rate movements have become extremely large, movements within the EMS have remained small relative to fluctuations of

outside currencies. While outside currencies have over- and undershot purchasing-power-parity levels by wide margins, relative purchasing-power parity has been very roughly maintained in the EMS. And while outside currencies have often experienced sharp reversals, movements within the EMS have generally been in the direction of better adjustment, and without reversals except for some recent small revaluations of previously devalued currencies.

It is obvious that recent wide swings in non-EMS currencies, against each other and against the EMS, have reflected in large part capital flows. But in order to have a lasting effect on net capital flows, an exchange rate must remain for some time at a level that changes the current account. It is only then that net capital flows would change. Short-term rate movements that are quickly reversed do not change the current account. They simply serve to constrain net capital flows to the amount determined by the existing current-account balance, except for the effects of intervention. This seems an expensive and inconvenient way of constraining capital flows, without in the least implying that direct controls could be a viable alternative.

The countries of the EMS have spared themselves these difficulties. They have done so by engaging in believable intervention. Their intervention is credible, within reason, so long as the market believes that the existing rates will hold. The market will believe this so long as it also believes that the authorities are prepared to take the necessary monetary, fiscal and other actions to backstop these rates. Because the authorities have shown only quite limited willingness to take such action, existing fixed rates have become implausible from time to time and have had to be changed.

While the EMS currencies have not enjoyed the complete stability that some expected of the system, they have had the relative stability of a moderately predictable jumping peg, with respect to each other. Contrasted with the wide moves against outside currencies and among those outside currencies, there may have been benefits from this form of "stability."

It may be noted that cooperative intervention is involved in maintaining this relative exchange-rate stability. Both the authorities of the low currency and of the high currency must intervene. This means that, if they do not sterilize, the money supply in the low currency contracts and that in the high currency expands. In other words, the burden of sterilization is shared, each side being free to sterilize its share in the operation. As an example of monetary-policy cooperation, this is at least a partial success story and, unfortunately, one of the not many that I have been able to refer to in this paper.

Current-Account Coordination

It was noted earlier that there are some forms of international cooperation that, for institutional reasons, must arrive at an agreement, such as the annual budgets of international institutions. There are other relationships where, with or without cooperation, a joint result is bound to be reached, owing to the nature of economic interdependence or even double-entry bookkeeping. One such field is the exchange rate. If one country decides to establish a fixed rate between its currency and some other country's, that determines the bilateral exchange rate for both countries if the first takes the actions necessary to establish and maintain such a peg. Another

instance where the decision of one or more countries determines the outcome for others is the current account. If some countries successfully aim at current-account surpluses, others necessarily will have deficits. Thus exchange rates and current accounts become natural objectives for coordination. Since exchange rates have already been commented on earlier, this paper will close with a few comments on current-account coordination.

Under the fixed exchange rate system, most industrial countries ordinarily seemed to prefer a moderate current-account surplus so as to accumulate reserves or finance the export of capital. In some cases, a mercantilist bias may have contributed to this attitude. But in a world where many developing countries were structural importers of capital, with consequent current-account deficits, surpluses could well be appropriate for most industrial countries. The United States, during good part of the 1960's, had current-account surpluses which, however, were not sufficient to cover its capital exports and so led to reserve losses.

Under the floating system, exchange rates have been so variable that persistent current-account positions were unlikely to emerge. Moreover, during much of the floating-rate period, the large and varying OPEC surpluses imposed deficits on the oil-importing countries as a group. Considerable debate ensued at the time as to how these deficits should be allocated within that group, especially as between developing and industrial countries. Relative need for capital imports contrasted with the ability to finance them played a role in these discussions. The outcome, however, was left to market forces responding to national economic policies. No efforts were made, nor means developed, to reach a cooperative solution.

Today the large U.S. budget deficit exerts an impact on the U.S. current account. Strong Treasury borrowing tends to attract funds to the United States. The resulting high level of the dollar helps generate a current-account deficit and thus a net capital inflow into the United States which contributes to financing the budget deficit. Other countries accordingly find their own current accounts in surplus or at least their deficits reduced. In this broad area, international cooperation is still at a very early stage.

Concluding Remarks

The foregoing survey of institutional cooperation indicates that growing world interdependence is not yet matched by growing ability or willingness to cooperate in dealing with the results of interdependence. In some instances, such as the exchange-rate field, the response to growing interdependence rather seems to have been a more defensive attitude, seeking protection through floating. Nevertheless, there is a certain logic in the course of events that enhances the pressure for cooperation. As international economic relationships gain weight, the level of cooperative response is likely to rise. The present rather low level of response which becomes apparent from this survey is not due to a lack of instruments, but of will. The existing structure of institutions is quite capable of sustaining a higher level of international cooperation.

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