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**ECONOMIC AND MONETARY COOPERATION SEEN WITH AMERICAN EYES**

**Remarks by**

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

**at the**

**Nor-Shipping Exhibition**

**Oslo, Norway**

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It is a pleasure to speak at this panel on "Economic and Monetary Cooperation -- A Challenge for Growth and Stability," after listening to comments on this topic from Hermod Skanland, Wilfried Guth, and David Scholey. The United States sometimes is viewed as perhaps lacking somewhat in cooperative spirit. This is not something I should try to argue about -- to some extent it may be a matter of opinion and in the eye of the beholder. Instead, I would invite your attention to some fundamentals that shape the behavior of the United States as well as of other countries.

Fundamentally, countries act in their own interest as they see it. The discussion here today has made clear once more that it is in the interest of all countries to cooperate. But each country is different, and each country has a different interest in cooperation. The United States has a special interest that derives mainly from its large size. The influence of the American economy on the rest of the world is strong enough to generate a significant feedback upon the United States itself. In its own self-interest, therefore, the United States should pay close attention to how it

affects the state of the world, because that state will react back upon the United States. A recession in the United States can substantially reduce world economic activity. This can feed back upon matters of interest to the United States, such as on its exports, on prices, interest rates and exchange rates. A strong expansion in the United States has repercussions abroad that generally reflect back advantageously upon the United States.

For small countries, the case is different. A small country is strongly influenced by what goes on in the rest of the world, usually more than a large country. But a single small country cannot, by its own actions, influence the state of the world very much. Recession or boom in a small country has no worldwide repercussions, and accordingly no feedback on the country. The country can act without having to be concerned about such feedbacks.

Some countries occupy a middle ground. Especially in a close regional trading system such as the European Community, developments in one of the larger countries can affect the others sufficiently to generate significant feedbacks. But worldwide repercussions are likely to be smaller, and the need to be concerned about feedbacks accordingly less.

I would not argue that these are conscious maxims that countries apply in their policy making, and especially I would not assert it of the United States. Nevertheless, rational policy decisions of any country, large or small, are likely to take into account all repercussions that can be foreseen, and to give them some weight in the decision process. The United States cannot, and does not, ignore the international consequences of its actions.

In the present state of the world conjuncture there is a widespread demand that the United States reduce its budget deficit. This wish, I might add, is shared widely within the United States, and progress is being made. The result should be a decline in U.S. interest rates, a gradual although not precisely predictable moderate decline of the dollar and a movement of the U.S. current-account deficit from its present height in excess of \$100 billion to a more sustainable level.

Looking toward the future, such developments are necessary to permit adequate investment and growth in the United States and to allow balanced trade in a world free from protectionist pressures. Looking at the past, however, it is quite evident that the world so far has predominantly benefitted from recent U.S. policies. In a generally stagnant world economy, it has been the surge in U.S. imports that has enabled other countries to enjoy export-led growth. At home, the United States has reduced unemployment close to the full employment level. It has brought down inflation to levels not far from those of the countries with the most successful anti-inflation policies. The United States hopes that the stimulus it has given to other economies will lead to a stronger thrust of domestically fueled growth that in turn will help to reduce the U.S. current-account deficit.

I would hardly argue that U.S. policies had been specifically designed to generate these impacts on the rest of the world, or their feedback upon the United States. But, intended or not, there has been a positive interaction between the locomotive role of the United States, the positive response of the rest of the world, and the benefits that the United States has drawn from

these world events. The events have reflected, in a broad sense, the relative roles of a very large economy and a group of smaller economies.

The United States frequently finds itself challenged with respect to its role, or nonrole, in exchange-market intervention. It is argued that intervention in the exchange markets must be coordinated in order to be effective. The United States has been responsive to this request only on occasion. In part, this reflects skepticism regarding the effectiveness of exchange-market intervention which indeed seems to be shared at least to a degree by other major countries. This attitude was confirmed by the results of the intervention study conducted following the Versailles Summit in 1982.

Beyond that, one must ask whether the demand for coordinated intervention really takes adequate account of the asymmetrical structure of the world economy. The fact is that the United States is very much larger than other economies and in addition is the country of the major reserve currency. One must ask why intervention, to the extent that it is effective at all, must be carried out by two countries, one of them the United States, instead of by just one. If the resources employed are the same whether intervention is done by one country or by two, it is not clear why effectiveness should be any different. To be sure, the market might be more impressed by coordinated action. It might assume that larger amounts will be employed than if one country acts alone. It may assume that the authorities have agreed on some level of exchange rates. It may suppose that fiscal and monetary policy actions will be taken to achieve those rates if intervention does not do the

job. But assumptions such as these are not necessarily implicit in the simple act of coordinated intervention. If the market were to observe that the amounts are no larger, that no target rates have been established, and that no additional policy actions are to be expected, its responses should reflect no more than the magnitude of the operation. It would rationally ignore whether one or more countries intervened, and whether they coordinated their operations or not. The mystique of "coordinated intervention" would fade away.

The concept of coordinated intervention does receive some support from the rules governing the European Monetary System (EMS). In the EMS, intervention must always take place when two exchange rates are at their limits. The intervention is done by the two countries whose currencies are involved, regardless of whether these economies are of approximately equal or very different weight. This arrangement has a long history, with its roots in the "snake" of the early 1970's. Even so, most observers would agree that the greater weight, particularly of the D-mark, represents an asymmetry that underlies a spurious appearance of symmetry in the intervention operations of the EMS. In general, the concept of coordinated intervention seems to be at odds with the natural asymmetry of the world economy.

These observations lead to some speculations concerning the future evolution of the international monetary system. We have come a long way from the old Bretton Woods system, which recognized the asymmetry among national economies and their currencies by putting the dollar in a special role. We have arrived at a condition where that asymmetry is not recognized. Under the Bretton Woods system, currencies other than the dollar were pegged to the

dollar. The dollar was pegged to gold. This system served well for a time but eventually broke down because gold convertibility of the dollar could not be maintained. Observers disagree concerning the relative causal roles in this breakdown of the limited supply of gold and of inflation in the United States. At the time, moreover, there was dissatisfaction with the asymmetrical aspects of the system. Countries other than the United States were able to change their exchange rates; the United States, in effect, could not. Other countries, therefore, could and did put the dollar in a position of overvaluation from which the United States could not extricate itself. On the other hand, countries other than the United States perceived the United States as enjoying an "unfair advantage" in being able to settle its deficits with its own currency, particularly after the United States had terminated gold convertibility in 1971.

Terminating the Bretton Woods system has not meant, however, an end to the asymmetries that underlay it, although the relative weight of the U.S. economy in the world (but probably not of the dollar) has secularly diminished. What does seem to have changed is the attitude of many countries with respect to features of the Bretton Woods system that were subjects of criticism in the 1960's and early 1970's. For one thing, the United States has shown itself extraordinarily tolerant of changes in its exchange rate, which has fluctuated widely. This change in attitude becomes apparent when one remembers the bitter struggles before and at the Smithsonian Agreement in 1971 over exchange-rate adjustments that today are routinely accepted within a month or even less. Recently, there has been little evidence of the concern

that the United States felt in those days that other countries might fix a low value for their currencies and gain a competitive advantage.

By the same token, other countries seem to have taken a more relaxed attitude toward the ability of the United States to finance its current-account deficit in its own currency. The development of international financial markets in which creditworthy countries can smoothly finance deficits has in considerable measure removed this invidious distinction. The concept of balance-of-payments discipline has largely given way to a recognition that it is internal discipline, over fiscal and monetary policy, that is required for stability. Fear of inflation has to some extent replaced fear of payments deficits as a policy motive.

Under these conditions, exchange-rate stability is perceived as being largely dependent on domestic stability in the major countries. Domestic stability involves primarily an absence of inflation. It also involves a reasonably stable rate of growth, with some allowance, of course, for moderate cyclical fluctuations. It also implies budgetary policies consistent with long-term stability, even though price stability can in the short run be achieved with different mixes of fiscal and monetary policies.

These are demanding conditions. One may doubt that they will be continuously achieved by most of the major countries. Exchange-rate stability based on domestic stability, therefore, is by no means assured. The very wide fluctuations recently experienced, to be sure, should be greatly narrowed if the domestic stability conditions are even approximately achieved.



At the same time, the possibility is open to individual countries, or groups of countries, to achieve exchange-rate stability by external rather than internal action. By directing their fiscal and monetary policies to the attainment of external stability rather than stable growth and stable prices, they can have whatever degree of exchange-rate stability with respect to the dollar or any other currency they desire. Some countries indeed are to some extent following this policy, for instance, Canada with respect to the dollar, as well as some, if not all, of the countries in the EMS, and some that are not EMS members, with respect to the D-mark.

A combination of intervention and of policy targeting on another currency would ensure exchange-rate stability. There would be no need for coordination of intervention, not indeed of anything else between the targeting and the targeted country. As noted above, exchange-market intervention can be conducted unilaterally -- it takes only one to tango. The condition of success is a monetary and fiscal policy that makes the targeted rate credible. As a practical matter, intervention can be conducted in its unsterilized form, allowing the full effect of creation or extinction of bank reserves to affect the money supply. This was the technique of the ancient gold standard and, to an extent, of the Bretton Woods system. This technique would work today as it did decades ago, for a country willing to subordinate domestic to external stability.

The cooperation to be offered by the United States in such a scheme would not have to take the form of reciprocal intervention, or even of policy coordination. It would have to consist of an assurance of policies dependably aimed at domestic stability, including price stability, reasonably stable growth over the cycle, and a sustainable budget position.

Countries seeking external stability would have to be able to rely on this degree of stability in the United States. The arrangement would reflect the inherently asymmetric structure of the world economy. It would imply, assuming enough countries to be willing to rely on U.S. stability, a division of labor, with other countries individually providing exchange-rate stability between their currencies and the dollar, and the United States providing an anchor of price stability and stable growth. In such a context, the International Monetary Fund could play an important role through its surveillance activities. This would enhance confidence of other countries that the United States would maintain its domestic stability.

It is to be noted that arrangements implicitly similar have broken down in the past. The Bretton Woods system was too rigid to bear the pressure that developed, and toward the end of the period -- after many years of success -- the United States failed to maintain the stability to which implicitly it was committed. But, we have seen that the alternative arrangements, or improvisations, now in place are not considered satisfactory either. There is great danger that if countries are not satisfied with the payments system, international trade will suffer. It is not inconceivable, therefore, that the evolution of the system may reverse the direction in which it has been going and move back toward greater exchange-rate stability based on a pragmatic acceptance of the structural asymmetry of the world.

I hope that these ideas will not be misinterpreted as a form of dollar chauvinism. The days when the role of the dollar gave the United States "an exorbitant advantage," as General de Gaulle said, came to an end with the development of international capital markets as a source of liquidity

for all creditworthy countries. The obligation of the United States in the framework I have described, to supply a base of stability, is a demanding one. Failure to meet that obligation would have worldwide repercussions that would feedback upon the United States. At the same time, the ability of other countries to choose their dollar exchange rate seems to me a major advantage for them. In short, the role of the N<sup>th</sup> country is no bed of roses. It is a role mandated, in some degree, by the arithmetical fact that among N countries there can only be N-1 exchange rates. It is in that sense that I would like to see these ideas examined.

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