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Policymaking in a Global Economy

Preston Martin
Vice Chairman
Board of Governors of the
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The goals and objectives of economic policy in the United States and in Switzerland have long been regarded as fundamentally different. It seems to the casual observer that the United States has followed a policy path pertinent to a large-scale economic entity -- ostensibly preoccupied with domestic concerns, but with continuous involvement with Canada and Latin America. The very success of the Swiss economy and of Swiss financial centers has implied to some resistance to change and a continuous involvement with other European economies. Such simplistic views must yield today to the realities of an increasingly interdependent global economy. In a functional sense, contemporary capital flows across national boundaries have made New York, London, Zurich, and even Tokyo into electronic neighbors. Zurich is looking outward more than ever, giving the lie to the old, old charges of parochialism.

The decades-long discussion of the coming of interdependence must now give way to discussion of the implication of interdependence for economic policy. Markets and economies are already intertwined like a string of DNA molecules -- thus the compelling need for cooperation between and among policy makers in the developed nations, whether the Croup of Five, or the Group of Ten including Switzerland, or a larger combination. We must plan together, consult, and confer, lest the evils of protectionism and other begger-thy-neighbor policies damage our institutions and turn global economic growth into global stagnation.

International trade has accelerated everywhere, but especially for the United States. Capital flows across national boundaries have grown geometrically. New financial instruments have been developed in both national and international markets, spurred by a variety of needs arising from the increased volatility of asset prices, the trend toward financial deregulation and diversity in most countries, and technological innovation that compels global linkages. As a result, each market participant in the Western world experiences the same economic shocks. The shared effects of oil shortages and inflation followed by an oil glut and disinflation are felt by firms and families in Europe and the United States, in Japan and the Pacific Rim, and certainly in less developed countries. Truly "all the world's a stage . . ", and we share a common economic destiny.

We also share a common responsibility. Each nation has a stake in the prosperity of all nations. Both larger countries like the United States and smaller but financially important countries like Switzerland must recognize that economic policy cooperation is essential in this interdependent world economy. I think this recognition has been impeded by widespread unrealistic expectations about what a flexible exchange rate system would achieve. The conventional, virtually received, wisdom was that floating exchange rates would insulate national economies from foreign disturbances and would allow governments to pursue policies chosen to accomplish domestic goals. Experience indicates, however, that the global integration of economic and financial markets has increased the interdependence of our economies and has enhanced the need for balance in the economic policies of the principal western societies,

regardless of whether we are operating under a fixed or a flexible exchange rate system.

The Bretton Woods system of fixed exchange rates worked reasonably well for almost two decades. The United States had emerged from WWII as the dominant economic power, and the dollar was as sound as the U.S. economy -- inflation remained low throughout most of the 1950s and early 1960s. The United States was then predominantly a closed economy, both in fact and in philosophy. A single computer filled a whole room, and communication was by telephone: technology was too rudimentary to permit true integration of financial markets. Exchange rate pressures chiefly reflected trade positions rather than capital flows, and intermittent realignments of parities were generally sufficient to maintain worldwide equilibrium. In this simple past period, it was natural, if not inevitable, that the dollar and gold would serve as the anchors for the international monetary system, as had sterling and gold in an earlier era. The United States was the archetypal reserve-holding country, and its role in the Bretton Woods system was a function of its dominance.

As the 20th anniversary of Bretton Woods approached, however, the weaknesses of the system became increasingly apparent. The capital controls used by many countries to stabilize their exchange rates were increasingly circumvented through innovative financial linkages: it was increasingly difficult to insulate domestic financial systems. Moreover, some in the United States began to understand that its "exorbitant privilege," as General DeGaulle called it, of financing balance of payments deficits in its own currency was an

invitation to ignore external imbalance as a constraint. Fiscal policy turned strongly expansionary as the Vietnam buildup, combined with Great Society programs, produced large budget deficits -- judged by the standards of the 1960s. The failure of monetary policy to offset the expansionary thrust of fiscal policy led to growing inflationary pressures.

The effects of increased U.S. inflation were felt throughout the world. Deterioration in the U.S. trade balance was accompanied by a drain on our gold stock and other official reserves. As importantly, private investors began to question the soundness of the dollar and increasingly invested elsewhere. Other industrial countries with lower inflation experienced capital inflows. To offset the potential effects on exchange rates of these capital inflows, these countries intervened in exchange markets to support the dollar, thereby tending to increase their domestic money supplies. Domestic monetary policy in many countries was thus frustrated by the need to maintain exchange rate parities. In this way, U.S. inflation was exported to the rest of the world through the conduit of fixed exchange rates.

Nowhere was this loss of domestic policy autonomy more apparent than in Switzerland. In part because Switzerland was an open, financially oriented economy, the Swiss National Bank (SNB) was severely constrained in its anti-inflation policy during the 1960s and early 1970s because of the need to support the dollar. By 1972, a massive amount of capital was flowing into Switzerland. As the SNB intervened in exchange markets to prevent appreciation of the franc, the Swiss money stock and inflation rate soared. Two official revaluations of the franc were to very limited avail, so there was little

choice but to let the Swiss franc float. Given this experience, it is not surprising that Swiss authorities were in the forefront of advocating the move to a generalized floating exchange rate system.

The theoretical basis for floating exchange rates had been developed during the 1960s by economists in both Europe and the United States. Models were developed showing that a flexible exchange rate system theoretically would remove the balance of payments constraint on domestic policies, especially for small open economies. Removing the distortions of official capital flows would allow domestic monetary policy to operate autonomously in pursuing domestic price stability. Advocates argued that floating rates would insulate an economy from foreign shocks and would promote liberal trade and financial systems by eliminating the need for capital controls and trade barriers to ensure external balance. Finally, it was argued that a continuous adjustment of exchange rates to changes in market forces would prevent the intermittent, discrete changes in parities that led to market uncertainty. The Canadian experience of the 1960s was cited as evidence that small, gradual changes in exchange rates would be sufficient to maintain external balance.

Experience in the real world during the recent floating rate period has differed in several respects from the theoretical scenario summarized above. Of course, not all of the developments during the past decade can be directly attributed to the floating rate system. Some economic developments were due to exogenous factors that affected exchange rates. Others were due to the failure of most countries to allow their exchange rates to float freely.

The most important exogenous events were the massive increases in the price of oil in the mid-1970s and then again in the late 1970s and early 1980s. The large worldwide change in relative prices that resulted was necessarily reflected in a realignment of real exchange rates. The oil shocks surely would have contributed to an acceleration of inflation and slowing of economic growth under any exchange rate system, though the transmission process would have been very different under a fixed than under a flexible rate system. Blaming all of the dislocations in the world economy resulting from the oil shocks of the last 15 years on the floating exchange rate system thus resembles beheading the bearer of bad news. Indeed, a reasonable case can be made that the adaptability afforded by flexible exchange rates eased the burden of adjustment to OPEC price shocks as well as to other factors affecting real exchange rates -- such as changes in productivity trends and labor force growth across countries.

Another reason for unrealized expectations during the flexible exchange rate period is that most countries have not allowed their exchange rates to float freely. Relatively fixed parities are maintained within the EMS, and several European countries -- including Switzerland -- that are not formally members of the EMS nonetheless try to limit fluctuations of their exchange rates against the Deutschemark and other EMS currencies. Similarly, some industrial countries, including Canada, and many developing countries try to keep their exchange rates relatively stable against the U.S. dollar. To some extent, these blocks of relatively fixed parities that float against each other may reflect legitimate desires to facilitate regional trade or to prevent

a vicious circle -- with inflation leading to currency depreciation, which causes more inflation. Nevertheless, unwillingness to allow exchange rates to adjust has contributed to persistent trade imbalances. Moreover, use of monetary policy to prevent exchange rate movements limits its effectiveness in achieving domestic price stability.

Switzerland has been fortunate that the SNB has a track record of accomplishing its medium-term objective of price stability. This record allowed the SNB to smooth fluctuations in the exchange value of the franc without exacerbating inflation expectations. Although temporary abandonment of monetary targets by the SNB in the late 1970s in order to hold down appreciation of the franc was accompanied by a brief surge of monetary growth and inflation, there was little evidence of a resulting increase in inflation expectations. For example, long-term interest rates declined even as inflation spurted upward. Investors' confidence in the resolve of the SNB to prevent a permanent acceleration of inflation was subsequently justified by a successful return to monetary targets, which have been expressed since 1980 in terms of the monetary base. Indeed, the Swiss inflation record in the 1980s has been among the best in the world. Unfortunately, the experience in Switzerland is the exception rather than the rule. More typical are chronic trade imbalances and adverse effects on inflation expectations when monetary policy is used to limit or prevent exchange rate changes.

Having said that the problems experienced during the floating exchange rate period cannot all be blamed on the system itself, it must be admitted that flexible exchange rates have not fulfilled the optimistic expectations of early

advocates. For countries like Switzerland that must take world inflation and interest rates as given, the biggest disappointment may be that floating exchange rates do not adequately insulate their economies from foreign disturbances. Conversely, countries like the United States have found that flexible exchange rates do not relieve them of responsibility for the worldwide effects of their macroeconomic policies. Moreover, exchange rate changes have sometimes been abrupt and exaggerated rather than gradual, as had been anticipated.

Today's abruptness of exchange rate movements in part reflects discrete changes in economic fundamentals. The simple theory underlying the belief that exchange rate changes would be smooth under a floating risk system applies best to situations of differential trend rates of monetary growth and inflation. A permanently maintained growth of money in one country that led to an inflation rate persistently above that of its trading partners could theoretically be reflected in a steady rate of depreciation in the exchange value of the currency. In the real world, of course, trend inflation rates change over time, as we have seen in recent years when accelerating inflation has been replaced by disinflation. Furthermore, fluctuations around trend rates are often substantial.

Moreover, fiscal policies have come to play an important role in most developed countries, although perhaps less so in Switzerland. Fiscal policy changes, especially when working at cross purposes with fiscal policies in other countries, can lead to substantial and persistent changes in exchange rates. Indeed, divergence of fiscal policies has, in my opinion, been a major

factor accounting for exchange rate misalignment and the associated trade imbalances in the last few years -- as explosion of government budget deficits in the United States collided with restrictive fiscal policies in Japan and much of Europe. The resulting trade imbalances contributed to massive capital flows to the United States from Europe, Japan, and elsewhere.

Though changes in inflation rates and in fiscal policies have surely contributed to exchange rate volatility, they have not been the only factors. There is ample evidence that exchange rates frequently "overshoot" their long-run equilibrium values. The extraordinary heights reached by the U.S. dollar early last year, for example, were far out of line with levels that could be explained by underlying fundamentals.

Such overshooting can be explained in part by the effects of volatile expectations. Changes in macroeconomic policies and other fundamentals have an amplified effect on exchange rates to the extent those changes are anticipated in advance. After all, if a trader or an arbitrageur can predict that the exchange value of the Swiss franc is going to increase more than enough to offset the interest rate differential on dollar and franc assets, he has a strong incentive to buy francs well before he or his client intends to use them. Because the treasurers of multinational corporations and the investment experts of pension funds, insurance companies, and mutual funds all try to predict the direction of exchange rate movements, anticipation of future policy changes can have an immediate effect on exchange rates. Credible actions pointing toward some actual control of future U.S. budget deficits, for example, could have an immediate and substantial effect on the exchange value

of the dollar. Many traders and investors throughout the world may rush to convert part of their dollar holdings into other currencies. Knowing this, the major banks in New York, Zurich, and elsewhere are likely to change their quotes on the dollar even before any transactions occur. This is the historical process whereby a change in expectations about the future course of macroeconomic policies is reflected immediately in foreign exchange markets. Yesterday an agent waited for signals from a sailing ship rounding the headlands. Today a hundred thousand computer monitors flash the data in microseconds.

Moreover, because domestic price levels respond slowly to emerging economic realities, even more of the burden of adjusting to policy changes falls on exchange rates and other asset prices. So even a modest change in economic fundamentals can cause large variation in exchange rates, often exceeding what will ultimately prove to be sustainable.

This problem is intensified for the U.S. dollar and the Swiss franc by their important roles in international financial transactions. Telecommunications hardware and software is in place for most of the twenty-four hour market. The dollar and to a much lesser extent the franc are used as official reserve currencies, and more importantly, both currencies are considered safe havens for large institutional investors throughout the world. With the coming of around-the-clock trading in world financial markets, the volume of financial transactions between countries has come to swamp the volume of international trade. Foreign currency is no longer used primarily as a medium of exchange to finance exports and imports; it is used predominantly in

financial transactions. Accordingly, the demand for dollars, francs, and other major currencies surges whenever portfolio preferences change anywhere in the world. Although the effects of such disturbances are not permanent, they dominate exchange rate movements long enough to distort trading patterns.

Describing the problems experienced during the floating exchange rate period is much easier than coming up with solutions to those problems, however. One proposal is to return to a fixed exchange rate system. Some go so far as to advocate a full-blown gold standard. But where is the political will to submit domestic economic policies to the rigidities of such standards? Moreover, just as the advocates of a flexible rate system initially oversold its virtues, advocates of a fixed rate system often exaggerate the extent to which it would solve our economic problems.

Moving to a fixed rate system will not, for example, reverse the global integration of New York, Zurich, London, and Tokyo capital markets that has contributed to exchange rate overshooting. Pegging exchange rates would not, therefore, eliminate the pressures arising from changes in expectations and their effects on demand for currencies. Instead, these pressures would be manifested in other ways. If exchange rates are not allowed to change and so dissipate the pressures causing large changes in exchange rates, those pressures would become more apparent in domestic financial markets. Substituting interest rate overshooting for exchange rate overshooting would merely shift the burden of adjustment from tradeable goods sectors to such interest sensitive sectors as housing. It can even be argued that having flexible exchange rates as shock absorbers has reduced the burden in the United

States and elsewhere of the fiscal imbalances and differential rates of disinflation in recent years.

A preferable solution would be to reduce the need for shock absorbers of all kinds by reducing the shocks caused by unpredictable shifts in macroeconomic policies. There are simply no adequate substitutes for disciplined monetary and fiscal policy in providing an environment for world economic growth.

It has been claimed that returning to fixed exchange rates would impose such discipline. On a theoretical level, the claim seems compelling. The commitment to keep the exchange value of the currency constant, it is argued, would force central banks and governments to adopt policies that would keep domestic inflation and interest rates in line with those in other countries. Yet world experience in this regard is not encouraging. Under the Bretton Woods System, exchange rate parities were realigned on occasion to compensate for the cumulative effects of different inflation rates. To take a more recent example, inflation differentials have persisted within the EMS throughout its brief history, although those differentials have narrowed in the past few years.

Moreover, the mechanisms through which fixed exchange rates are presumed to enforce fiscal discipline are rather vague. How are political pressures to be galvanized to convince governments of the need to change their tax and spending decisions? What is the time frame over which political leaders would react to such pressures? And how would a fixed exchange rate system have prevented the divergence of fiscal policies in recent years among

the developed countries? Until such questions are answered, I remain skeptical about the ability of fixed exchange rates to enforce a harmonization of fiscal policies. Yet without such harmonization, a fixed rate system could again collapse because of the dominant influence in economic and financial markets of the government sectors in most industrial economies. In contrast, the government sectors were negligible during the heyday of the gold standard in the 19th century, and fiscal policy as such did not exist. In these circumstances, the specie flow mechanism led more or less automatically to changes in monetary and credit growth. But we live in a more complicated world today.

I have a final reservation about the feasibility of a fixed exchange rate system in current circumstances with the buildup of international claims over the past several years. Speculative attacks on the dollar forced a series of exchange market crises in the late 1960s, leading ultimately to the downfall of the Bretton Woods System. How much more vulnerable would a similar system be today -- with megaflows of capital, such volatile expectations, and private institutional resources so large relative to government holdings of international reserves? For these and other reasons, some internationally recognized experts consider a fixed exchange rate system unworkable in current circumstances.

How then can we achieve stability in the world economy and global financial system? The principal answer to me is through cooperative efforts to foster more balanced macroeconomic policies in the Group of 5 or the Group of 10, including Switzerland. In the United States, there is renewed optimism

about bringing down the budget deficits over a multiyear horizon. I can also report that the younger generation of U.S. political leaders is more aware of the international dimension to macroeconomic policies. In addition, I argue that there is a growing consensus that the Federal Reserve can contribute to economic growth nearer the U.S. potential without reigniting inflation. At the same time, cooperation in the domestic policy mix of the principal nations may be developing. To the extent this occurs, I have confidence that exchange rates would not only be more stable but also would return to levels that eliminate the competitive disadvantage faced by U.S. producers. In this way, the dangers from protectionism can be minimized. Thus, achieving more balanced macroeconomic policies is the major economic policy challenge for the remainder of this decade.

All of us -- whether in large countries or small -- are now part of an interdependent world economy. As such, we share responsibility for solving the common economic problems that bedevil us all. Along with this shared responsibility comes a shared opportunity -- to work together toward the common goal of adequate economic growth without inflation. Although our narrow national interests will not always coincide, we can learn to take a broader view of national interests. This broader view must recognize that sustainable prosperity in one country cannot long be achieved without prosperity in other countries.

In summary, today's global integration of economies and financial systems is not consistent with absolute autonomy of national economic policies. As Thomas Wolfe said, we "can't go home again." We cannot return to a world

without electronic linkages of financial markets day and night and without extensive world trade in both finished and intermediate goods. Nor would we want to. Global integration has improved the allocation of resources and has provided wider choices for both consumers and investors. Although the effects are troublesome and frustrating, enhanced world trade and capital mobility are irreversible trends with which macroeconomic policies must learn to cope.

It will not be easy. We in the United States must understand that we can accomplish our goals only if our policies are bold enough and reflect a major concern with their effects on others. We must cooperate, acknowledging the limitations to what macroeconomic policies can realistically achieve without causing distortions throughout the world economy. In the United States and elsewhere, we must learn to anticipate the global implications of macroeconomic policies. By so doing, we can achieve a balance of world economic policies that will allow us to enjoy the benefits of global integration while reducing some of the costs we have recently incurred.