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EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

Remarks by

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

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Conference of the

"Zeitschrift fuer das Gesamte Kreditwesen"

Frankfurt, Germany

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The world business cycle is passing through a phase of great significance for the world economy and the functioning of the international monetary system. The growth rates of the U.S. economy on one side and most industrial countries on the other have been converging. Until not long ago, the United States was expanding at a rate above its long-run potential, while most other countries were expanding well below their potential . According to many projections, we are entering a phase in which the rate of growth of other industrial countries will, on average, exceed that of the United States.

What we are witnessing is a dissynchronized world business cycle, a condition, in other words, where national cycles are out of phase with each other. Much of the turmoil that we are observing in the world today can be traced to this dissynchronization.

Before examining what a dissynchronized business cycle has done to the world, however, we should remember the experience we had with the previous cycle, culminating in 1973-74, which was almost perfectly synchronized. All major countries, at that time, were moving in step and were then operating at peak capacity. Widespread shortages prevailed. There was no way in which excess demand in one economy could be compensated by excess supplies in another. Consequently, competing buyers drove up prices mercilessly all over the world. When the bubble burst, inventories were excessive, orders vanished, and, with the additional burden of a quadrupled price of oil, a severe recession became inevitable. It was then that the thought took hold that if the world economy were to continue to be cyclical, as it has been for 150 years or more, somewhat less synchronization would be helpful. Peaks and valleys would be smoothed out, shortages in one country could be overcome by excess supplies elsewhere, the danger of a severe recession greatly reduced.

That wish has been granted. Five years later, we find ourselves in a dissynchronized expansion. Are the results what we expected them to be? Let me begin with the good features, which do not seem to have attracted a great deal of attention. The United States, and most other industrial countries, are now almost four years beyond the trough of the recession as it was recorded in the United States in early 1975. Continued expansion is expected in the United States at about its long-run potential rate of 3 - 3-1/2 per cent. Other economies, after some slow starts and a few relapses, are now growing at somewhat faster rates. Given that historically the length of cyclical expansion, at least in the United States, has been 2-3 years, the longevity of the present expansion is a distinct achievement in no small measure probably attributable to the dissynchronized pattern of the present cycle.

The dissynchronized pattern, however, has not been particularly favorable to the functioning of the international monetary system. The reason is that dissynchronized behavior produced imbalances of trade which affected exchange rates. These, in turn, affected rates of inflation which reacted back on exchange rates. Moreover, as the cycle advanced, the approach to full employment generated inflationary pressures in some countries while excess capacity still was pushing down inflation elsewhere.

During the present cycle, it was the United States that was leading in cyclical phase. The United States, therefore, found its imports rising rapidly while its exports were lagging and a large current account deficit developed. Japan and Germany, expanding slowly, had the opposite experience. Some countries fell in between.

The ensuing divergent pattern of deficits and surpluses set in motion exchange rate movements which in turn began to influence price developments. The declining exchange rate contributed to inflation in the United States. Rising exchange rates in Germany, Japan, and Switzerland helped to reduce inflation there. The inflation differential further weakened the dollar while the currencies of countries in strong surplus strengthened.

Meanwhile, as the United States economy began to approach the full-employment zone, renewed price pressures began to make themselves felt. Previously, the United States had succeeded in bringing inflation down from a peak of around 12 per cent in 1974 to the 5 per cent zone shortly following the 1974-75 recession. More rapid expansion, however, and policies supporting this expansion, as well as the institutional peculiarities of U.S. collective bargaining, kept inflation from falling further. A declining dollar and mounting economic activity caused U.S. inflation to reaccelerate from the 5-6 per cent range after a period of perhaps two years during which it had remained relatively constant.

In the countries whose economies were lagging, an opposite pattern occurred. Maintenance of substantial slack helped to bring down inflation. Policies designed to accomplish this objective were supported, in the case of Germany, Japan, and Switzerland, by a rise in exchange rates. The latter, in turn, responded both to a movement toward current account surplus and to diminishing inflation. In this way, the leading industrial countries developed sharply contrasting patterns. Some countries fell in between, suffering both high inflation and slow growth. These eventually found themselves compelled to restrain their economies in order to remove current account deficits which threatened further exchange rate depreciation and inflation.

It is noteworthy that during this period of contrasting movements, some features of the separate economies involved came into good alignment, while others did not. In the major countries, interest rates came roughly into alignment with rates of inflation. Low-inflation countries had low interest rates, countries with higher inflation had higher rates. Particularly among the United States, Germany, Switzerland, and to some extent Japan, differences among rates of inflation were roughly equal to differences among interest rates. Real interest rates, that is, nominal interest rates adjusted for current inflation rates, were not very different among these countries. Where nominal interest rates were high, they nevertheless were, if not negative, at most barely positive in real terms.

Exchange rates, on the other hand, behaved very differently. For the most part, their movement failed to reflect nominal interest rate differentials, frequently exceeding these differentials very substantially. Likewise, exchange rate changes were greater than needed to reflect the change in purchasing power. Over prolonged periods, exchange rates, especially for the dollar, the yen, and the Swiss franc, but only to a lesser degree for the DMark, very considerably under- and overshot exchange relations based on relative price movements.

For the behavior of exchange rates, and the associated behavior of current account deficits and surpluses, a variety of factors may be held responsible. One of them is the well-known J-curve phenomenon. An exchange rate movement that, over two or three years, may be expected to bring about greater balance in the current account, may in the short run produce the opposite effect, or perhaps a delayed effect. The volume of exports and imports does not respond instantaneously to changing prices and/or exchange rates. It takes some time before the more favorable exchange rate -- for the depreciating country -- and the less favorable rate -- for the appreciating country -- can have their full effect.

A similar J-curve phenomenon may occur in capital markets, although it has been less clearly demonstrated in that context. A rise in interest rates may be expected to attract capital to the country where it occurs. A rise in interest rates, or the expectation thereof, has an adverse effect upon long-term financial and real assets. Bonds, the stock market, and perhaps other assets tend to decline as interest rates rise. The capital losses that investors could sustain from such moves can far exceed any gains that would accrue to others from investing at the new rates. While asset markets seek to establish a new base, therefore, the effect of rising interest rates is not necessarily to attract capital to the countries where the rise occurs. If investors move abroad during this period, the exchange rate may suffer. Once an adjustment has taken place, of course, the widened interest differential may well produce a much enlarged inflow of capital with attendant consequences for the exchange rate.

All this demonstrates that in a dissynchronized expansion, considerable pressures are likely to converge upon the international monetary system. Exchange rates may undergo movements that do not necessarily correspond to their values in any long-run equilibrium. For that reason, it is perhaps not exclusively of historical interest to inquire how a dissynchronized business cycle would have fitted into the precepts of the old Bretton Woods system. That system was exposed to dissynchronized cycles only rarely and in moderate degree, such as in 1958-59 and the latter half of the 1960's. The prevailing view in those days was that "when the United States catches cold, the rest of the world catches pneumonia." This implied a cycle led by, and synchronized with, the United States cycle. Nevertheless, the Bretton Woods system had one clear standard that could have been applied to a dissynchronized cycle: Under the Bretton Woods code, only fundamental disequilibrium could justify and require an alteration in exchange rates. A cyclical disequilibrium, absent other sources of imbalance, was to be ridden out. The ensuing current account deficit was to be financed and dealt with by other adjustment measures, but not by exchange rate depreciation.

In recent years, market forces have told us that the Bretton Woods prescription would probably not have been adhered to had it still been in effect today. They have told us this by moving exchange rates around rather sharply. The world has fared better under floating rates because in all probability it has been spared a series of exchange rate crises that could have provoked counterproductive controls on capital movements. But the Bretton Woods precepts are not without their lesson. They remind us that there is a difference between a cyclical and a fundamental disequilibrium. That difference, of course, was never clearcut. No one would argue that the disequilibrium experienced by the world today is purely cyclical. For the United States, it is overlaid by the problem of oil imports. For Germany and Japan, it is overlaid by a variety of structural changes. Something similar could be said for numerous other countries.

But the cyclical component is important, and the Bretton Woods precept that cyclical movements should not give rise to permanent exchange rate changes should not be altogether forgotten. Nor does today's floating rate system, to which there appears to be no practical alternative, relieve us of the need to take adjustment action. "Adjustment" was one of the key words of the Bretton Woods system. Its successful implementation frequently eluded us, and the Bretton Woods system came to an end. But the need for adjustment has remained under the system of floating exchange rates.

Contrary to the views frequently expressed before floating began, floating exchange rates do not allow a country to adopt any kind of domestic policies that it chooses. A country that were to ignore the effect of its policies upon inflation and upon its exchange rate would quickly discover, from the behavior of both, the limits of its freedom of action.

The United States has been very conscious that the value of the dollar depends on its domestic policies and that the value of the dollar is enormously important for its domestic well-being and for its international economic and political relations. A number of actions attest to this.

First, the United States has brought its cyclical expansion to a soft landing at a rate of growth consistent with its long-term growth potential. This was accomplished by a reduction in the budget deficit which in 1976 stood at $66 billion. Early this year, the budget deficit for fiscal year 1979, which began October 1, 1978, was still projected at $60 billion. Now the deficit for fiscal year 1979 is expected to be less than $40 billion. It is recognized that such a deficit is still too large for a fully employed economy, and a reduction to $30 billion is expected for 1980.

Second, the Federal Reserve has tightened monetary policy, by seeking to limit the growth of the monetary aggregates. While the target for M_1 (currency and demand deposits) of 4 - 6-1/2 per cent has been overshot by approximately 1.5 percentage points, it should be recognized that the M_1 target was extremely modest, considering that nominal GNP was expected to rise at a rate of 11 per cent. The Federal Reserve is aware of the need for adequate monetary restraint. Recent increases in the discount rate, the latest by a full percentage point to an unprecedented level of 9-1/2 per cent, as well as in the Federal funds rate, which is the principal focus of impact of Federal Reserve policy, attest to this. So does the increase in reserve requirements on large time deposits by almost $3 billion; the successful achievement of our targets for M_2 (M_1 plus bank time and savings deposits other than large negotiable CD's) and M_3 (M_2 plus deposits in thrift institutions) also is evidence of a policy of restraint.

Third, the United States has instituted a program of wage and price restraint. While the program is voluntary, it does not lack means of enforcement, through the procurement mechanism and through the action of regulatory agencies that set prices for certain regulated industries. The use of the tax system to encourage wage restraint, through a real wage insurance, is also being proposed by President Carter.

Fourth, the United States has finally enacted energy legislation. A great effort in intensifying conservation of energy and developing substitute sources for oil and gas is still ahead of us. Nevertheless, it should be noted that increases in the price of energy have been proportionately no less than in most other industrial countries. They have gone less far only because they started from a generally much lower level. The response of U.S. consumers and particularly of U.S. industry to higher energy costs has been about the same as abroad.

Fifth, the United States has also instituted an export promotion program. The United States is a relative latecomer to export promotion. That practice has been employed far more energetically for a long time by some of its competitor countries, including some that today are concerned about their own large surpluses and about the U.S. deficit. These concerns could be eased if more effective agreements could be arrived at to restrain competition in export promotion. The United States has been trying to promote such agreements.

Finally, to support its policies, especially the President's wage and price program, the United States also has strengthened its capacity for intervention in the exchange markets by putting in place a package of $30 billion of foreign exchange resources, including sale of SDR, drawings on the International Monetary Fund, sale of foreign currency obligations by the Treasury, and enlargement of swap facilities on the part of the Federal Reserve. An increase in gold sales beginning December was also announced. The United States expressed its determination to intervene, in cooperation with the governments and central banks of Germany and Japan and the Swiss National Bank, in a forceful and coordinated manner in the amounts required to correct the situation in the exchange markets.

Under the impact of these policies and developments, the U.S. current account deficit today gives promise of substantial reduction over time. Econometricians have estimated that the full effect of the cyclical gap between the United States and the rest of the world accounts for something like $10-20 billion. That is to say, if the entire world were to move to full employment, the U.S. current account, which amounted to about $20 billion over the last 12 months, would be reduced by that order of magnitude. It has also been estimated that every percentage point of depreciation of the dollar, after adjustment for inflation, i.e., in real terms, should reduce the deficit by $750 million to $1 billion over a period of two years. The dollar has depreciated, in real terms, about 12-15 per cent over the last 18 months which again would imply a substantial reduction in the deficit. An improvement of 30-40 per cent is a reasonable expectation.

These developments should help the international monetary system to regain a much greater measure of stability than it has recently shown. Universally it is recognized that the stability of the system can only be attained by greater stability of the fundamentals. Actions in that direction are now under way in all countries.

In addition, evolution is progressing along two lines. Within Europe, action is afoot to create an area of monetary stability among countries willing to achieve a sufficient convergence of their policies to be able to sustain among themselves a system of fixed though adjustable exchange rates. Within the membership of the International Monetary Fund, arrangements have been put in place for surveillance of members' policies with respect to exchange rates and with respect to domestic policies affecting the exchange rate system. The European effort, if designed properly, can make an important contribution not only toward the stability among the countries concerned but also toward the strengthening and stability of the international monetary system and to the central role of the IMF within that system.

These developments characterize the present state of evolution of the international monetary system. The system cannot be static, and gradual change must be expected. The system must be capable of dealing with both synchronized and dissynchronized cyclical developments. It will best be able to accomplish this task, the advantages and difficulties of which I have tried to set forth here, if evolution proceeds in an environment of international cooperation and freedom of movement for goods and capital.