Transcription of actual remarks.

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AUTONOMY AND INTEGRATION IN A GLOBAL FRAMEWORK

Economic Policies for a Post Cold War Environment

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August is my favorite month of the year. That is because our President is on holiday, our Congress is in recess, and for the moment, at least, our liberties are secure. But I always look forward with some uneasiness to the arrival of September because the politicians will be returning to office, and one can never be sure what is going to happen.

August is a good time to hold the Alpbach Conference because, with elected leaders generally around the world on holiday, the nations' capitals are not generating any news so it's interesting to look at those issues that are in fact dominating the mass media. August gives you a chance to reflect on the major issues that are of a more fundamental nature than the pronouncements of politicians.

I think a very interesting history of the second half of the 20th century could be written by simply focusing on the top news stories during the time of the Alpbach Symposium. In recent years, for instance, there have been some very profound developments while you have been meeting here. Four years ago, you would have been focusing on the flood of European refugees coming out of Hungary and East Germany,

through Austria, into the West -- people voting with their feet about socialism and communism. In August of 1989, you could not have been sure what the implications were going to be, what the response of the Soviet Union might be, or how the Western countries would react.

Three years ago, you would have all been focused on the occupation of Kuwait by Saddam Hussein -- wondering about the implications of his dominating a large share of the Persian Gulf oil resources, and the possible response of the Western Allies.

Two years ago, you all would have been discussing the developments in the Soviet Union as a group of bungling thugs took Mikhail Gorbachev prisoner, while Boris Yeltsin stood on top of a tank defying the attempt coup. And, this year, we see that millions of young people around the world are drawn together in solidarity focused on the continuing crisis of allegations regarding Michael Jackson.

While this latter may sound as though it is not in the same category with prior years, it may be just as significant. If this is all that the world has to worry about at the moment, we're in pretty good shape. I can assure you that, at least for young people around the world, the break-up of the European Exchange Rate Mechanism, or the recent rise of the Yen, are not the dominant issues of 1993.

While listening to yesterday's discussion, I found the various interpretations of the meaning of autonomy and integration to be of

interest. To some it appears that autonomy means insulation from the policies of others. People talk about independent Central Banks, but it leaves me wondering -- independent to do what? -- independent from what? In the Federal Reserve System, it has become commonplace to say that our Central Bank is independent within the government, not independent of the government.

I was intrigued yesterday by one of the discussions about the economic integration of Europe requiring greater independence of the Central Bank, but then interdependence of the economies reduces the autonomy of the government. So, we have the paradox that greater independence or autonomy of the Central Bank is essential for integration which, in turn, reduces autonomy of, I suppose, other parts of the governments. What none of this discussion raises is the autonomy of individuals to make their own decisions.

Even though we talk about the Federal Reserve being independent, the Bundesbank, the Bank of New Zealand, or other Central Banks that are moving toward independence, it is independence only in a certain manner of speaking. In contrast to that notion, increasingly we are seeing that the globalization of financial markets means that even the monetary policy actions of the United States are disciplined by the financial market vigilantes in the equity, debt and foreign exchange markets. One only has to look at 1987, when 28 stock markets around the

world crashed, to realize that the economic policies of the major industrialized market economies are not at all independent of each other.

Once upon a time, it was said that when the United States sneezes, Europe catches pneumonia. But, that's no longer true. Now, the first thing that we want to know in the U.S., early in the day, is what happened earlier the same day in Tokyo and then later in Frankfurt, Paris, London, Rome and other major financial centers in Europe before moving on to New York. The interdependence of financial markets means that some of the so-called independence does not exist.

When the word integration appears as a topic of discussion, from a U.S. perspective the first thing one thinks about is racial issues. Since at least the 1960s the word integration has always been juxtaposed against the word segregation -- meaning, racial divisions. That certainly is not what you're talking about here, but it has not been fully clear to me yet what it means on the program. So, I'm going to give you my view of what might be meant by some of these terms.

I've subtitled my paper, Economic Forces and Political Institutions, and I need to spend a few minutes defining these terms. While I know that there have been many forces at work over the 20th century -- certainly political, social and religious forces have helped shape the course of events for these hundred years -- I'm going to focus only on those that I call "economic forces". These include technological changes

or innovations; productivity increases; lower information, transactions, transportation and communications costs; the phenomenon sometimes referred to as downsizing; and, of special note, as the century draws to a close, the true value added rising from knowledge-based industries as opposed to resource exploitation activities.

In the 19th century and at the beginning of the 20th century, we tended to measure the wealth of nations by tons of things and numbers of things. Basically, iron ore, coal, the numbers of logs cut, tons of wheat, and so on, all tended to be added up to make a statement about the so-called output or wealth of countries. But, that is no longer appropriate. Instead, in today's world those things produced by companies such as Microsoft, the world's leader in software, and other human capital-enhancing enterprises are more important in determining the relative well-being of nations. In fact, we see some of the most natural resources, or raw material, rich places in the world -- such as Brazil, Russia, and Africa -- are actually economic basketcases, while the natural resources poor places of the world sometimes are among the most prosperous.

Let me turn now to political institutions. I'm going to define two different types because of the different ways we use the word institutions. First, is organizations, such as ministries, bureaus, departments, agencies, and central banks -- as well as international

organizations, such as the IMF, the World Bank, and the Bank for International Settlements. Even the United Nations and NATO could be put into this type of grouping. The second way we use the word political institutions is rules -- meaning contracts, generally accepted accounting practice, labor laws, laws of incorporations, the judicial system and the enforcement of property rights. Rules also includes various types of economic controls, such as wage, price, credit, interest rate, exchange, and capital controls, or even margin requirements. One would also take into account such restrictions on the financial industries such as loan-loss reserves, capital adequacy standards, debt limitations, credit allocations, leverage ratios, and so on.

Some of both of these types of institutions -- the organizations that are created and the rules that are laid down -- are intended to improve the workings of markets. However, some of both types of institutions -- organizations and rules -- are also intended to inhibit or alter the working of markets because the benefits are perceived to be greater than the cost. That is the case when political social objectives seem to dominate economic efficiency. Such objectives as redistribution -- a political decision to give priority to sharing wealth, rather than creating wealth -- result in institutional arrangements that reduce the efficiency of markets.

I'm going to argue that some of what I call economic forces constitute an <u>irresistible force</u>, while some of the political institutions

tend, over time, to become immovable objects. Even those political institutions that are intended to improve the workings of markets and are designed to have a great deal of inherent flexibility or adaptability, tend to become immovable objects. A conjecture is that the degree to which political institutions tend to become immovable objects depends on the scope of government involvement in the economy. The size of government, measured in terms of government spending as a percent of GDP, may reflect the scope of government involvement in resource allocation and control, but it is not sufficient as a complete measure of intrusion of government in the economy.

In a pure market economy, there would be no institutions that we would call immovable objects. On the other hand, in a total command economy, all institutions would take on the characteristics of immovable objects. However, they would prove not to be immovable after all in the face of the irresistible economic forces in a global economy.

The architects of new rules or organizations usually understand the need to create institutions that are "living organisms" capable of adapting to changing conditions. This is true not only of constitutions for governing, but also of the various agencies of government with specific missions.

The Bretton Woods System established in the final days of World War II had built into it rules for adjustment. However, there was an

asymmetry in the way the rules worked that proved to be the rigidity that caused the system to break, rather than bend, in the face of specific economic forces.

Much of the history of the 20th century reflects what I think of as the "contest of ideas" -- democracy and capitalism on one hand locked in a struggled with dictatorship and socialism. Essentially, it was a contest for the minds of the people of the world as to the best ways to organize economic affairs and the best ways to organize political affairs.

In many respects, especially from a U.S. standpoint, there were two watershed decades of the century the 1930s and the 1980s. In the 1930s, during the world-wide economic depression, there was a massive increase in the intrusion of government in economic affairs. If governments did not outright nationalize and directly control resources in a command structure, then they set up regulatory agencies that were designed to decide what was to be produced, where it was produced, how much could be charged for products, how much could be paid to workers, or for other inputs to production, what interest rates could be charged, what interest rates could be paid, and so on.

The subsequent several decades after the 1930s were a period in which the role of the nation-state in economic affairs was large and tending to grow. Much of the underlying conceptual framework was based on what I think of as the "stagnation thesis" as set forth in

John Maynard Keynes in The General Theory in the 30s. That is, even economies that are based on private property and rely on market forces to allocate productive resources, tend to stagnate at less than full potential in the absence of governmental activities to cause growth. In other words, a view widely held through much of the 20th century, and maybe even continues to be held today by a lot of people, is that governments cause growth, and the so-called economic "policies" of government are appropriate for influencing economic activity.

The rival conjecture from the 1930s, which had little following for most of this century, was the "inherent resiliency proposition" of Friedrich A. von Hayek and other economists of the Austrian school. Their view was that an economy that relies on a price system to allocate resources in a market environment, relying on private property rights, tends to be inherently resilient -- that is, it naturally gravitates toward full utilization of its productive resources in absence of government pump priming. Whenever shocks of various types -- such as oil price increases, droughts, wars, or perverse government policies -- knock the economy down, there is a general tendency to start to grow again as the perverse effects of these negative shocks tend to dissipate.

Common threads of the contest of ideas in the 20th century have been: (1) That political and economic institutions tend to "ossify" or to "rigidify" over time, mainly because these institutions, especially

organizations created by people and operated by people, become resistant to changes of the status quo; (2) The fundamental economic forces -- technological innovation, falling information and transaction costs, increasing economies of scale and economies of scope of production, globalization of goods markets, financial markets, and asset markets -- all lead to what is called the "global village" or "borderless world". One recent book was titled the "Twilight of Sovereignty."

The main thesis is that while the naturally efficient marketplace for many goods and services at the beginning of the 20th century was a small town, village, or a province, increasingly, over the course of the century, the growth in the naturally efficient market expanded to the point that even large countries such as the United States find it increasingly difficult to regulate or control various products or services. That is because for many products and services the entire world has become the naturally efficient market, so the ability to regulate or control depends on the ability of the nation-states to collude in common regulation. The Basle Accord of 12 countries getting together to set capital standards for commercial banks is one example of this. Possibly the development of the European community is a similar effort.

The ultimate implication of the conflict between the irresistible forces that of an economic nature, confronting the political institutions that take on the characteristics of immovable objects, is that institutions

must change, or they will fail. In other words, there must be an effective political and economic regeneration in which various institutional arrangements, especially organizations, take on the characteristics of living organisms -- that is, they must be adaptable to a changing environment.

Joseph Schumpeter, another Austrian economist, said "the essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process . . . Capitalism, then, is by nature, a form or method, of economic change and not only never is, but never can be, stationary."

Schumpeter's observation about capitalism applies equally well to all of the institutions that define the parameters of our global economy. Propelled by technological change and chance economic events, these institutions undergo a continual process of change. Those qualities that enhance economic well-being tend to survive, and those that do not eventually disappear. People develop institutions -- laws, rules, conventions, and customs, to define and enforce property rights and, more generally, to reduce the costs of economic exchange. The various laws, rules, conventions, and customs that define money, protect its purchasing power, and govern its use, are example of such institutions.

Recent international monetary developments can be explained in terms of these general ideas about institutional transformation. What appears as conflicts between global monetary integration and regional

monetary autonomy are artificial, resulting largely from vested interests in maintaining local governmental monopolies over the issuance of the national media of exchange. History demonstrates, however, that national currencies inevitably compete in the international financial arena. Earlier in this century, the U.S. dollar gradually replaced the British pound as the dominant global reserve currency and as the primary unit of account for international transactions. Following Hayek, approaches to international monetary relations that foster competition among alternative currency units are more likely to enhance world welfare than systems like Bretton Woods that mandate change directed by supranational governmental bodies which will tend to rigidify or ossify over time.

Unlike most people, economists think of money as merely an institutional convenience for greatly reducing the costs of transacting. Overall, a stable monetary unit allows greater specialization in production and wider choices in trade, thus, enhancing the associated economic benefits.

Building on these ideas, many economists and political scientists contend that extending the geographical area in which a common monetary unit is used would confer significant gains on the residents of that area. Monetary integration can take two institutional forms: The first is complete monetary union with a common currency and a single

Central Bank. This is already the case among the 50 United States and among the 10 provinces of Canada. And, it is the ultimate objective of the European Monetary Union.

A second and weaker form of monetary integration is fixed-exchange rates, such as experienced under the gold standard or the Bretton Woods System, as well, of course, as under the European Exchange Rate Mechanism. The conditions under which the second form is viable needs to be addressed.

Although a system of fixed-exchange rates could confer significant benefits on participants in terms of reduced transaction costs, it also imposes specific costs in terms of international cooperation and macroeconomic policy coordination. The external value of a national currency ultimately reflects the relative internal purchasing power of that currency. So, to maintain an exchange-rate, participants must coordinate their monetary policies to generate the same inflation rates. Monetary sovereignty is incompatible with fixed-exchange rates. This is why inflation convergence is so crucial.

Under certain circumstances, however, the costs of integrating monetary policies across countries can exceed the benefits of having a common currency. Countries are most likely to form a monetary union with other countries that share common economic conditions. To understand the macroeconomic sources of the conflict, consider the

history of the Bretton Woods System.

The Allies established Bretton Woods in 1944 to promote rapid recovery among war-torn economies. Close cooperation was seen as necessary to avoid the competitive devaluations and trade restrictions of the 1930s, which many economists believe contributed to the severity of the Great Depression.

In the late 1940s, Germany and Japan for instance, had a common unit of account, or standard of value -- it was called the United States dollar. However, they gave it a different name. In Germany, one quarter of the U.S. dollar was called a Deutsche mark and in Japan, one three hundred and sixtieth of a dollar was called a Yen. The point is that the standard of value or unit of account was not the same as the media of exchange. The latter are created or issued by governmental authorities, but the former is the crucial dimension of a currency. There never has been a Phoenix-like currency that arose from nowhere, unlinked to anything of accepted value.

The Bretton Woods System required all participating countries to define a parity for their currency against the dollar and to maintain the resulting fixed-dollar exchange rate. The United States, as the "anchor", or "key", currency, defined and maintained a dollar peg to a fixed quantity of gold. The dollar then functioned as a stable unit of account for the entire Bretton Woods System. The rules of the game required all

countries to adopt a monetary policy similar to that of the United States. In other words, the Bretton Woods System implied reduced monetary autonomy for participating countries.

My review of macroeconomic factors suggests that monetary integration is more likely to be successful if: (1) All regions in a monetary union have similar preferences for inflation, reflecting similar theoretical or conceptual views of monetary policy, and (2) All regions within a monetary union experience similar macroeconomic conditions.

While common responses to macroeconomic shocks are a desirable condition to enhance the likely success of monetary integration, they are not necessary. Regions of the United States often experience different macroeconomic conditions, especially responses to shocks such as energy-price changes, defense spending increases or decreases, and so on. What is crucial is that other avenues for adjustment between regions are available, so that exchange rate changes are not the issue. In the 1980s, we had what was called a bi-coastal economy, referring to boom conditions in California and New England while we had depressed conditions through much of the middle part of the country. Now, in the early 1990s, we once again have a bi-coastal economy with the opposite implications. Namely, we have severely depressed economic conditions in California and a continuing recession in New England, while the Rocky Mountains and the midwest are by comparison considerably stronger. If

it were not for the political integration and the associated high degree of resource mobility (investible capital resources as well as labor resources) then it would be more tempting for various regions within the United States to contemplate devaluation of their currencies in today's environment. The severe three-year old recession in California might lead some to believe that devaluing the California dollar vs. the Ohio dollar, or the Rocky Mountain dollar would be an attractive option. But, because of the political unity and resource mobility, this option is not under consideration.

The recent history of our global monetary systems suggests that attempts to impose monetary integration by a fixed-exchange rate on a broad scale are not likely to succeed. In part, as I've argued, this results because regions of the world that experience disparate economic conditions and low resource mobility can adjust to economic shocks more efficiently by allowing their exchange rates to change. Furthermore, monetary integration cannot proceed in a credible manner, even among regions in which it is feasible, unless governments first adopt domestic institutions that credibly insure their comment to maintain domestic price stability.

History teaches us that institutions, including those that determine the use of national currencies, inevitably compete. Through competition, efficient wealth enhancing institutional forms tend to emerge. In the

interest of fostering greater international stability and integration, we should encourage such institutional competition. This requires, above all else, the free movement of resources through the elimination of artificial restraints on the movement of capital, goods, services, and labor. This could include the removal of either national legal tenure laws so that individuals could be assured of enforcement of contracts written in any currency. More likely, we could urge that the various parliaments legislate "specific performance" so that the courts will enforce contracts denominated any currency units. This would enhance the rule of law across borders of nation-states.

Individuals would then hold their assets in currency units that are most stable in terms of their expected long-term purchasing power. A free flow of resources would foster a convergence of institutional forms across participating governments as they compete for these resources by providing stable economic and political environments. Governments that fail to provide such an environment will lose resources as markets vote on policies. The resulting convergence of monetary and fiscal regimes will achieve the highest sustainable degree of monetary stability.

When some observers look at the centrifugal and centripetal forces at work in various regions of the world, there seems to be a conflict. That is, when one looks at the efforts under way to achieve European community objectives -- economic integration, and, maybe ultimately

political integration among twelve or more European nations -- in contrast with the political and economic disintegration of the former Soviet Union, it might appear that these trends are going in opposite directions. I do not think that that is the case. The common element in both developments is that, in the case of Europe, the move toward political and economic integration involves a very large number of specific steps to reduce the role of the participating nation-states in the economic affairs. In other words, it consists of specific actions to improve the workings of the markets <u>within</u> <u>Europe</u> -- to strengthen property rights within Europe and to eliminate a whole host of rules, regulations, barriers, and obstacles to the free mobility of goods, labor, and capital.

In the former Soviet Union, we see that political and economic <u>dis</u>integration is a process of tearing down the highly centralized command and control socialist economy. It is a process of searching for ways to make markets flourish in the 15 or so republics of the former Soviet Union, as well as in the eastern European countries of the former COMICON. So, the move towards economic/political <u>in</u>tegration in Europe and <u>dis</u>integration in the former Soviet bloc both involve the tearing down of previously erected political institutional arrangements that interfered with the workings of markets.

In this final decade of the 20th century, it seems that the clearest

trend around the world is to reduce the role of the nation-state in economic affairs. Deregulation and denationalization/privatization and tax reduction and tax reform, are all part of a process of "economic regeneration" -- to once again restore the wealth creating capability of markets. Resources, especially investment capital, move quickly to those regions that are making the most progress such as today in Mexico, Argentina, or the Czech republic -- while resources move away from those regions making little or no progress. This competition of political institutions -- both of the organization type and the rules type -- is a part of what I view as a very healthy process of reinstituting 19th century economic liberalization. The end result of it will be a much freer, as well as a much more prosperous world. The ultimate autonomy is not that of nation-states, that of individuals. The goal of "economic integration" should be to create institutions in which individuals are "free to choose."