Research Department
Federal Reserve
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One World?

The world's finance ministers and central bankers dicussed a number of topics at the recent meetings of the World Bank and the International Monetary Fund, but one of the strongest themes was the call for the United States to adopt stimulative policies to pull the rest of the world out of recession. This discussion aptly illustrates the growing interdependence of the world economy. It has long been recognized that developments in the U.S. can affect other countries, but one of the most important lessons of the past several years has been the degree to which developments in the rest of the world can also affect the United States.

The 10-percent-plus U.S. inflation rate in 1973-74 was accentuated by a 25-percent rise in prices of world-traded goods. Since the underlying monetary expansion in the U.S. probably would have supported no more than about a 6-percent rate of inflation, a significant share of our actual inflation apparently was "imported". A rise in prices of world-traded goods during this period directly impacted on U.S. agriculture, raw-materials production and many industrial-goods sectors.

Developments in the rest of the world also added to the length and severity of the U.S. recession. First, world inflation reduced the real purchasing power of U.S. consumers more than would otherwise have been the case. Second, the slowing in world demand led to a slower growth of U.S. exports in real terms (though not in nominal terms). Both elements, but especially the former, contributed to a large decline in the real demand for goods and services in the U.S.

The same factors also worked in the other direction, helping to account for the recessions in other major industrial countries. Thus, the level of industrial production in Western Europe is far below a year ago—9 percent lower in West Germany and 7 percent lower in France—while the number of unemployed has doubled in a year's time.

Simultaneous world cycles

The simultaneous worldwide boom and bust since 1971 has added a new dimension to the economic scene. Until recently, each major industrial country marched to its own business-cycle drummer, thereby contributing to world economic stability. When one country was expanding another country was contracting, and as a result the demand on internationally-traded goods remained fairly stable, in line with the growing capacity to produce such goods. Prices of world-traded goods thus increased at a modest 1.3-percent average annual rate between 1962 and 1969.

Relative stability in the international sphere helped to soften business-cycle fluctuations in any one country. During the expansion phase of the cycle, a country

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could acquire imports at stable world prices, and therefore would suffer only from the price consequences of its own internal expansion. In the declining phase, a country's export demand typically would hold up because of expansion elsewhere, thus mitigating the effects of a softening domestic demand.

This relatively stable environment was thrown out of equilibrium by the shock associated with the breakdown in the international monetary system in the early 1970's. The accelerating U.S. inflation had already eroded private market confidence in the dollar as an international currency. This triggered a flight from the dollar which culminated in suspension of dollar convertibility into gold in August 1971. Then, by overstaying fixed exchange rates, foreign central banks purchased in excess of $68 billion in dollar-denominated assets in the two years ending March 1973.

The overall effect was equivalent to a simultaneous easing of monetary policy and acceleration of domestic money growth in all major industrial countries. The resulting worldwide business-cycle boom led directly to accelerating world inflation. However, the movement to flexible exchange rates in March 1973 permitted a sharp slowing in money growth, which then contributed to the current worldwide recession and the easing of inflation.

Repeat of boom and bust?

Perhaps the overriding question for the second half of the 1970's is whether the major industrial countries will continue on a largely synchronized and unstable path of boom and bust, or return to the less synchronized but far more stable business-cycle patterns which existed in the 1950's and 1960's. The possibility of another international monetary shock may be fairly remote. As long as the major industrial countries continue to maintain reasonably flexible exchange rates, with moderate exchange-market interventions, foreign central banks should be able to avoid massive flows of capital and internationally-induced expansions in domestic money.

However, the maintenance of flexible exchange rates is no guarantee against the repetition of another boom and bust. All foreign central banks are now faced with the same set of domestic economic problems: the worst recession in the postwar period, with a high rate of unemployment and a high but decelerating rate of inflation. If the major industrial countries respond to this common economic phenomenon with a common desire to recover as quickly as

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possible, we could see a common set of stimulative policies, resulting among other things in a simultaneous expansion in their domestic money stocks. This could lead to a repeat of the worldwide business-cycle boom in 1976-77 followed by a recession in 1978-79.

Such a scenario is analogous to the U.S. experience of the past decade. Prior to 1966 the U.S. enjoyed five years of growing prosperity and price stability. However, the shock of the Vietnam war, which was marked by Government deficit financing in a period of full employment and an acceleration in the U.S. money stock, disturbed this equilibrium and led to an accelerated inflation. The policy response from 1968 through early 1970 involved restrictive monetary and fiscal actions to counter the inflation. This led to a rise in unemployment and a subsequent reversal of policy, which in turn made the next round of inflation even more severe.

Interdependence

The U.S. is still suffering the consequences of the monetary and fiscal shock of 10 years ago because of the tendency for subsequent policy actions to amplify and reinforce that initial shock. If policy makers in other industrial countries were now to follow the same destabilizing reaction function, then a worldwide boom-and-bust scenario might well continue through the second half of the decade.

Probably the major threat of another worldwide boom and bust comes from sharply expansionary policies designed to generate an overly rapid recovery from the current recession. The U.S. plays the key role in this situation. First, the U.S. economy by itself represents almost 50 percent of the income of the industrial countries of the world. Thus, a slow but stable growth in this country would contribute to a moderate growth in the demand for internationally traded goods and would thereby ease the pressure on their prices. Second, a moderate U.S. recovery policy would strengthen the resolve of others not to follow excessively expansionary policies.

Nonetheless, our trading partners may continue to press for strongly expansionary policies on the part of the U.S. Most major industrial nations are looking towards an export-led recovery in their economies. They wish to avoid further deterioration in their own trade balances, in view of the adverse effects which higher oil prices have already imposed. Thus, they would like the U.S. to provide a strong market for their exports, through a more expansionary policy on our part.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/10/75	Change from 9/03/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	86,066	+ 1,044	+ 1,742	+ 2.07
Loans (gross, adjusted)—total	65,278	+ 1,217	– 1,777	– 2.65
Security loans	2,287	+ 1,315	+ 1,000	+ 77.70
Commercial and industrial	22,536	– 100	– 1,671	– 6.90
Real estate	19,560	+ 29	– 279	– 1.41
Consumer instalment	9,998	– 2	+ 350	+ 3.63
U.S. Treasury securities	8,138	– 153	+ 3,832	+ 88.99
Other securities	12,650	– 20	– 313	– 2.41
Deposits (less cash items)—total*	86,258	+ 915	+ 5,769	+ 7.17
Demand deposits (adjusted)	24,245	+ 658	+ 2,202	+ 9.99
U.S. Government deposits	358	+ 58	– 47	– 11.60
Time deposits—total*	59,877	+ 115	+ 3,742	+ 6.67
States and political subdivisions	5,832	– 33	– 98	– 1.65
Savings deposits	20,709	+ 9	+ 2,979	+ 16.80
Other time deposits‡	29,548	+ 129	+ 485	+ 1.67
Large negotiable CD's	15,714	+ 118	– 105	– 0.66

Weekly Averages of Daily Figures	Week ended 9/10/75	Week ended 9/03/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	– 53	67	– 6
Borrowings	29	12	249
Net free (+) / Net borrowed (–)	– 82	+ 55	– 255
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 1,486	+ 1,236	+ 1,308
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 915	+ 351	+ 695

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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