Money and the New World Economy

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When it comes to discussing such a broad and highly speculative subject as the future of the international trade and payments system, I feel like the scholar who one day discovered that Christopher Columbus had set sail for America with four ships. Of course his astonished colleagues demanded an explanation for what had happened to the hitherto unknown fourth ship. The scholar replied that it had gone over the edge. In peering over the precipice at which the international economic system now lies, there is considerable danger of judging *how* the system is doing rather than *what* it is doing, or of projecting one's convictions about how it should operate in the future directly into a forecast. I shall try to avoid these traps.

The essence of the international economic system is more complex and abstruse than generally recognized. To businessmen it is a matter of investment and trade in products and services; for academics it is an historically rooted series of multilayered relationships involving social, political and economic forces and transactions; for labor leaders it involves jobs; and for politicians it is a policy area which may assume life-and-death proportions. In its broader interpretation it is part of the larger world political scene. Economics can serve both as the raw material for the political process or as an instrument for fulfilling political decisions. Effective summitry, for example, requires considerable economic harmony among the non-Communist countries. Narrowly interpreted, the international economic system is inextricably wedded to what are generally considered domestic economic and political problems. A country's foreign economic relations are vital to its standard of living, but they may also intrude on its chosen life-style.

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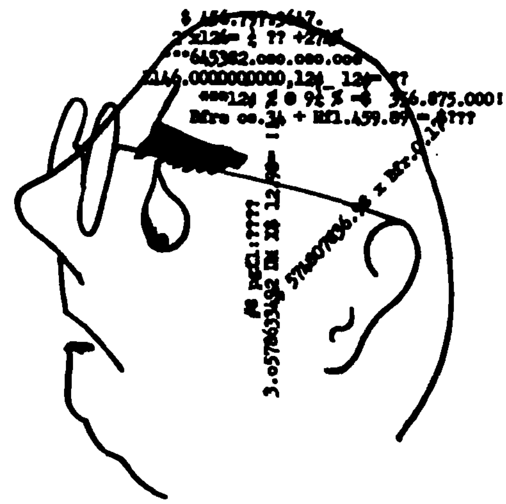
To forget that the world's economic system operates in a broader international political environment and, simultaneously, is closely tied to public policy debates going on in individual nation-states is to risk misunderstanding its true nature and importance. And to acknowledge the complexity of the system and the role of national governments as regulators of private transactions as well as participants in the market is to demand a closer look at alternative methods of managing the global economy. Unquestionably the most important function of the system is to exploit global resources to increase human welfare. How the benefits of international commerce are to be shared, however, is a hard, controversial question.

Indeed, when a nation enters into mutual tariff reductions it spurs export industries at the expense of its less efficient industries, which will suffer from import competition. The resultant redistribution of domestic real income will probably leave some members of the labor force worse off than before the increase in international trade.

Although governments agree in principle that the welfare of every national participant should be improved by the trading process, there is no universally accepted formula for how the gains are to be shared among nations. A parallel controversy at the domestic level, which may be just as acerbic as international trade negotiations, involves who will benefit from world commerce—producers, investors, consumers or government treasuries. In this case it is almost certain that not everyone will come out ahead, particularly in the short run.

The unprecedented and profound technological and communications revolutions of this century permitted—even forced—nations to increase their dependence on each other. In attempting to find sound economic alternatives to the gold standard or the chaos of the 1930's, the architects of Bretton Woods (1944) attempted to design an *institutional* frame-



work which would be responsive to this increasing *functional* interdependence, which would allow governments better to monitor and supervise the progress of the world economy. The policy planners envisaged an International Trade Organization which would concern itself with a broad range of economic activities, including relations with Communist countries. Although the organization was never born, considerable authority has been vested in the International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD) and the General Agreement on Tariffs and Trade (GATT). And to some degree these organizations have come to play an independent role in the determination of the system, albeit their actions are subject to agreement by national governments. Their impact, which stems both from the rules to which countries agree to adhere when they become members and from the independent operation of their nonnational bureaucracies can be seen in their contribution to trade liberalization, development (particularly the world of the International Development Association) and to the orderly and logical functioning of the international monetary system (particularly the IMF creation of Special Drawing Rights).

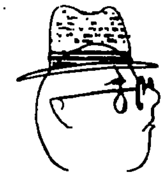
Parallel to the growth of functional and institutional economic interdependence is a change in the international psyche which makes nations increasingly aware and sensitive to each other. This is best illustrated by reference to the foreign exchange markets, where changes in sentiment have been the most important immediate cause for parity rate revisions. Indeed, who questions that, but for the fact that international currencies were not fixed in value at the time, the Watergate affair would have caused a foreign exchange crisis of monumental proportions?

The growth of economic interdependence has been accompanied by an emerging belief that national objectives are more likely to concern growing national wealth than territorial aggrandizement, i.e., that international confrontations are more likely to involve conflicting social and economic problems than military objectives. There are, of course, very different ways in which nations may respond to acknowledged problems.

1. A nation, great or small, may attempt to pursue its national interest as independently as possible. When countries are in general agreement on policy issues, however, there is a tendency to create international institutions in order to simplify the task. Unilateral action is most congenial to countries which feel threatened or are seeking extreme independence. For example, the competitive devaluations of the 1930's were a mechanism for achieving autarky through national behavior.

2. A strong nation may pursue hegemony. In the international economic system following the Second World War the United States followed such a course. But whereas the absolute power of the United States has continued to increase, its relative power has so declined that it is no longer able to play this role. And because no other power has acquired sufficient strength to replace the United States, hegemony is no longer a viable alternative for organizing the world economic system.

3. Organization by élites is another possibility. Elitism is a keystone for economic organization as currently instituted. For example, important functions are performed by limited membership organizations such as the OECD, by weighted voting in the IMF and IBRD, etc. But however much definitive and nonegalitarian procedures are needed to reach decisions in some difficult policy areas, and even though decisions taken by the élite may be enlightened and benevolent, this form of action is increasingly subject to criticism because of its undemocratic lineage. The ability of élite groups to make global policies is going to be further challenged by the changing character of the issues (e.g., environment, seabeds, etc.) which, because of their breadth, are going to



require more widespread cooperation among nations.

4. A systemic approach to the international economy is based on the premise that all nations have some stake in the issues; it may be dismissed as irrelevant moralism, however, unless it can take account of disparities in national power. A relevant example is the system of weighted voting used by the IMF. So long as the weights closely reflect the power of the membership the institution has a fair chance of smooth functioning. Should the stronger parties seek to treat the lighter weighted votes as zero-weighted, or should the numerous weaker voters combine on egalitarian principles rather than their collective voting strength, the system would be in trouble. The appeal of the systemic approach is that it emphasizes collective action in dealing with world problems that lie beyond the power of nations acting alone, and, because it recognizes that the overall interests of no two countries ever completely coincide, it permits shifting alliances in which nations may act as individuals or in blocs, depending on the issue. The rules-oriented, systemic approach seems ideally suited to a world of growing interdependence where national involvement in global problems is a feature of daily life. It is particularly attractive to countries such as Canada, which under alternative international regimes, are treated either as nonentities or, perhaps worse, are clubbed with (and by) their more elephantine neighbors.

To be effective the rules for international behavior must reflect a compromise among divergent national interests based on the following factors.

Power: As noted above, political and economic strength enhances a nation's ability to determine the system; there is a positive correlation between participation in the system and the ability to determine how it will be run.

Domestic legislation: There is a great variety of laws in every country concerning taxation, antitrust, health standards, etc. which have a direct impact on that country's participation in the global economy and which often cannot be changed willy-nilly to improve that country's ability to participate in the international system.

Nationalism: Countries do not always behave in ways which maximize their economic welfare. Questions of cultural integrity and national identity are of considerable importance, particularly among developing nations, which are more concerned with nation-building than the fine points of economic welfare.

Interdependence: It has already been noted that in 1973 countries are much more related to each others' economies than in the past. The cost of reversing the trend toward greater interdependence and switching to policies of autarky could be very dear. Even the United States, which is one of the most self-sufficient economies, would bear considerable costs if it were forced to do without imports.

Equity: The impact of moral issues on the international economic system is difficult to measure, but there is evidence that a concern to treat participants equitably does play a role and that a system which totally ignored these considerations of equity would be difficult to operate at the global level.

The spirit which guided the Bretton Woods agreements can be summarized in the idea of economic liberalism, the elements of which are expansion of economic contacts, widespread participation, equal treatment, reciprocity, equity and general recognition of the principle that there should be rules to which all participants adhere. In fact, the spirit of Bretton Woods was interpreted pragmatically so that when basic principles could not be universally applied, they were not altogether abandoned but were modified according to agreed-upon rules. Similarly, reciprocity was not strictly interpreted to mean that in every trade negotiation there must be a dollar-for-dollar or yen-for-yen exchange of tariff reductions, but rather that there be an overall pattern of new trade barriers which, in some larger sense, is as equitable or more equitable than the one it replaces.

The problem with formulating rules, particularly when they become embodied in institutions, is that nations are required to yield sovereignty. Although there may be a positive correlation between the amount of sovereignty a nation is willing to yield and the perceived benefits from doing so, it is for a government vital that the party to whom it yields its sovereignty can be trusted and that it can expect favorable attention to its grievances if its interests are hurt. The problem is complicated because it is not one of right versus wrong but right versus right. For example, the right of a country to levy quotas and high tariffs to protect a domestic industry which is dying as a result of import competition may be opposed to the right of a foreign producer to take advantage of unique economic conditions that allow him to produce efficiently for export.

Underlying the needs to find rules which maximize the benefits of global trade and investment, there are three major problems which must be resolved by the international monetary system: (1) It must provide adequate reserves and liquidity for the financing of commercial transactions and other needs as perceived by governments and private parties.[1] (2) It must create a situation of confidence in which the orderly production and consumption of goods and services are not interrupted by the speculative sideshows which have been known to occur in both financial and commodity markets. (3) It must provide an adjustment mechanism whereby, if a country's external balance (its balance of payments) is upset by price movements or growth substantially above or below that in other countries, it can return to external balance without undue sacrifice of domestic economic priorities.

These three objectives are closely interrelated. For example, with a payments mechanism based on freely floating exchange rates, the need for reserves would be substantially reduced insofar as nations would expect payments imbalances to be reversed by changes in comparative prices and, therefore, would not need to hold extensive reserves.

Greatest progress has been made toward the solution of the reserves and liquidity problem, which was severe for European countries in the early postwar period but has not been of major consequence since then. This success is due to the gamut of institutional arrangements used to nurse the world economy back to health; to the United States's redistribution of international monetary reserves that it had accumulated during the war; and, finally, to the statesmanlike response of nations to the growing inadequacy of gold as an international reserve. The latter response reduced the importance of gold in the system by the deliberate creation of a new international reserve asset, Special Drawing Rights (SDRs) in the IMF.

Confidence, which seems to be in unusually short supply at the present time, derives from the ability of domestic economies and, in a larger sense, the ability of the international economic system to meet the demands of its constituent members. Inflation, rapid change, gaps between rhetoric and fact and signs of basic payments disequilibrium are the factors most likely to erode confidence in the system. Confidence in the system can be enhanced by a variety of measures.

International economic problems can be depoliticized by predetermined rules and by impartial arbitration machinery. In addition, their political content may be reduced by subjecting them to a multilateral rather than binational conciliation process. The economic problems between the U.S. and Japan are a good example of how trade and payments difficulties between two countries—but related to other nations—have threatened to spill over into potentially abrasive political issues, such as return of Okinawa, Japanese rearmament, etc. Management of the U.S. payments deficit and the Japanese surplus through an international framework promises both more effective economics and less political friction. The paradox which hinders this approach is that when the equity of the system is called into question, political clout is needed to right the balance, but this is anything but depoliticization.

Confidence can be furthered by reducing uncertainty for traders and increasing risks for speculators. Also, by encouraging the existence of instruments whereby the potential costs of future exchange-rate changes can be largely offset, e.g., insurance schemes and a healthy forward currency market, the effects of uncertainty can be minimized. Finally, by adopting self-correcting mechanisms, such as flexible exchange rates, participants in world commerce are able to anticipate future changes, disagreements among governments are reduced, and there is likely to be less lag in the initiation of adjustment measures.

The restoration of balance-of-payments equilibrium by surplus and deficit countries is the most difficult of our three problems, principally because it requires governments to take actions which are almost invariably unpopular domestically and are sometimes even contrary to other national objectives. In the early sixties, for example, a payments deficit coincided with domestic unemployment in the United States. One cure recommended for what was recorded as a $3 billion balance-of-payments deficit was a domestic deflation which could have cost as much as $50 billion in lost gross national product. This Draconian remedy was seen as a nonchoice and rejected.

Similarly, the dangers inherent in seeking to solve imbalances by imposing restrictions on trade and investment are clear from the experience of the 1930's. Even assuming that a country could erect restrictions without rousing retaliation, this approach should be regarded as unacceptable because it undoes the rationalization of international resources brought about by the operation of relatively uninhibited trade. In recent years there has been considerable pressure on countries in balance-of-payments surplus to reduce their barriers to imports and capital outflows, an approach which has integrity but which is difficult to implement with any speed and cannot be regarded as a long-term adjustment mechanism insofar as the system could run out of barriers.

The adjustment mechanism of last resort, and the one to which increasing attention has been paid, is parity changes. The increased flexibility provided by the Bretton Woods system for making changes in exchange rates was not fully used by countries which were in "fundamental disequilibrium," particularly the surplus countries. As Lawrence Krause notes, there are three costs involved in a change in exchange rates: the effect on real resources as the devaluing country reduces its international purchasing power, the domestic dislocation as the real burdens of shifting costs and job displacement fall unequally within both deficit and surplus nations and the political burden which usually is an unwelcome consequence in both devaluing and revaluing countries.[2] Exchange rates are, therefore, a most curious phenomenon insofar as they reflect needed accommodation to imbalance and abet long-term goals, but are almost universally abhorred; development of a sugar coating for this unique and powerful medicine is a high-order political priority.

Because all policies for adjusting payments imbalances have been unpopular, and sometimes contrary to domestic requirements, fundamental disequilibriums have too often been allowed to develop until crises forced realignment of exchange rates. And then the changes were necessarily large, disturbing to ordinary commercial relationships and, out of ignorance, only approximations of what was needed. The striking contrast between the sensitivity of business to trade and investment opportunities and the insensitivity of governments to the evolving world economic situation is cause for concern, because our experience is that government regulation is necessary for near optimum functioning of the system. Furthermore, by excessive delay in acting on problems, governments may reduce the number and desirability of policy choices until the entire system is endangered. Let no one doubt, however, that speedy introduction of new policy is almost always controversial and is easier to advocate than to implement.

When the English word "crisis" is translated into Chinese, it is denoted by two characters which independently stand for the English words "danger" and "opportunity." To me the greatest dangers of the current international economic crisis flow from our possible failure to recognize the potential importance of the trade and investment system to the overall organization of a global society and, therefore, to the solution of our most overriding problems.

The extreme danger is that a series of confrontations on a variety of economic questions will lead to a degeneration of the élitist, supranational system which now exists. The result could be a return to the chaos of the 1930's or the establishment of a set of competitive economic blocs. Both solutions would imply a reduction in welfare below what would otherwise be obtainable. The opportunity presented by the present crisis lies in the hope that our approach will prove sensitive not only to the interrelationship of the monetary factors—liquidity, confidence and adjustment—but also to the relation of each of these to growing world trade and investment; that our approach will become more systemic and thereby accommodate increasing interdependence not just of Western economies but of the economies of Communist and less developed nations. In effect, the future of the world economic system will be determined by changes in its environment and the substance of its approach to specific problems of investment, trade and payments.

The growing interdependence we have noted can be projected into the future, but its character may change considerably. In many countries production associated with direct foreign investment has consistently grown faster than the production of purely domestic companies, a trend which cannot be perpetuated indefinitely and has already raised strong political objections. Because growing national wealth tends to shift demands from products to services, the relative importance of foreign investment to domestic investment may shrink. But the decline in the relative importance of international trade to international production may be more rapid, assuming, that is, that new barriers to global investment do not coincide with reductions in the barriers to international trade. An interesting exception to this general pattern is trade in food, which may show robust growth for some time to come. A caveat which follows from disaggregation is that as the rich increasingly divert their consumption from commodities to services, the potential rate of growth for poor country production and product imports is greater than for the wealthy.

The immediate future will be largely determined by government policies, the content of which is not yet known. Although the production and trade effects of international investment have received much attention in recent years,[8] and have been recognized as a major influence in the world economic system, most national governments have been more interested in encouraging the entry of multinational companies than in regulating their behavior. Because multinationals have so much to offer, however, their future appears as sound as the future of international trade; the principal question is how they will be regulated. The answers, which may range from adoption of technical rules such as more careful scrutiny of arms-length pricing to occasional expropriation, thus far do not threaten their future prosperity.

Investment opportunities among the OECD countries are nowhere near exhausted, but they sometimes appear pale and unexciting in comparison with the possibilities in some developing and centrally planned economies. One exception is Japan, which is finally opening its doors to foreign investors. The second exception is the United States. A significant dose of exchange-rate depreciation during a period when its unit costs have been rising no faster than those of competitor nations has made the U.S. a much more enticing place for foreigners to invest, and the foreign capital has already begun to arrive.

The outlook for investment in Europe is clouded because exchange-rate appreciation and inflation have made it a relatively high-cost area. In addition, some investments of the past decade may have anticipated the growing size and cohesiveness of the European Community, a trend which, in the absence of new political understandings, will soon reach its outer limits. Among the developing countries new investments are likely to be widely dispersed, with the exception of a few poor nations which have little to offer international business (e.g., Burundi and Burma) and where barriers to investment are politically motivated (e.g., India) Paradoxically, Communist countries, including China, appear increasingly less concerned with ideology and are actively seeking foreign collaboration in what are usually considered sensitive industries.

The U.S. may be a relatively less significant overseas investor for a variety of reasons. Exchange-rate changes have provided an important advantage to domestic rather than foreign sourcing of global demand. And by raising the cost to the firm of investing abroad, they have reduced the ability of American corporations to buy up foreign companies, a change which was reinforced in the short run by the decline in the New York stock exchange. Japan gives promise of becoming the world's leading exporter of investment capital; the transformation of government and private focus from an international trade to a mixed world trade and investment strategy is readily apparent. And other countries are emerging as significant investors. These include the Europeans, the oil-producing nations and even some of the middle-income countries.

The design of a new world economic system will be further complicated by the intrusion of pressing new issues, as evidenced by the United Nations-sponsored Conference on the Environment which took place in Stockholm last year. The Club of Rome thesis—that problems of ecology, pollution, resource scarcity and population will bring about a collapse of the world economy—may be excessively pessimistic. But these issues are more than merely fashionable, and the problems they pose will eventually require costly solutions. What is more, there is no precedent to guide the system toward an answer to the question of how the cost of dealing with these issues will be shared among nations. The U.N. Conference on the Law of the Sea, meeting next spring, will provide an important test of the extent to which nations are now prepared to cooperate in the use of nonnational resources.

It is difficult to predict the extent to which a confrontation between the rich and the poor will emerge as a major problem. The success of OPEC (Organization of Petroleum Exporting Countries) arrangements for petroleum has been widely admired by developing countries, but thus far they have found no other major areas in which they can cooperate to bring about a redistribution of the world's wealth. Because they already obtain considerable benefits from the existing trade, investment and aid system, developing countries can ill afford to do battle with the rich on issues where the potential benefits are not large or where the rich appear unyielding. The attitude of the LDCs is indicated by the Communiqué of the Group of 24, issued on May 22. In it they declare that the poor nations will not cooperate in reform of the international monetary system unless a "link" is adopted giving them a greater share of future SDR distributions. But although nine of the nations belonging to the IMF Committee of 20, charged with finding a formula for the new payments system, are developing countries, I suspect that total intransigence on their part would lead either to indefinite delay in the reform, or to a proposal of the major trading countries which would be put to developing countries on a take-it-or-leave-it basis they could not afford to refuse.

This is not to say there will be no "link." The elimination of global poverty will remain a high priority on the world's agenda; it is an issue the developing countries will raise in a wide variety of bilateral and multilateral contexts. And, in view of the growing wealth the developed countries could share and the growing ability of the developing countries to play a mischievous role, it might be enlightened self-interest for the United States to adopt a more forthcoming policy.

When, beginning on August 15, 1971, the United States unilaterally launched the world on its current efforts to reform the international economic system, it formulated the problem in terms of close interrelationships among trade, investment, development and the international monetary system, It remains to be seen whether this was a tactic designed to maximize international support for its program or the reflection of a confirmed belief that it is not possible to tackle one set of problems without dealing with the others. Events since then suggest that the concern for interrelationships was genuine and that the apparent U.S. backing away from this approach may be because it was rejected by other countries.

The future for international trade is currently clouded by the struggle between the gathering forces of protection and their free-trading opposition. The outcome of the battle is far from obvious. The hopeful signs are the essentially liberal U.S. trade package presented to the Congress this spring by President Nixon, growing European Community dissatisfaction with the cost of its Common Agricultural Policy (CAP), growing dissatisfaction of some countries (particularly African) with the system of reverse preference and the imaginative Japanese example of exporting lower technology jobs in order to give Japan the opportunity to upgrade its economy without bankrupting its trade partners. On the negative side are the autarkic trends observable in the Burke-Hartke Bill and the reluctance of many countries to seek reductions in tariff and nontariff trade barriers.

This is regrettable because there is a tendency for government to give in to local interest groups and backslide on trade matters unless they are dealing with important liberalization initiatives. The trade negotiations are of particular importance insofar as the parties are increasingly aware of the extent to which changes in trade barriers are related to other aspects of the international economic system and also because of the need to deal with nontariff barriers, itself a reflection of the success of past negotiations which have drastically reduced tariffs as barriers to world trade.

Agreement on monetary reform was not forthcoming in September at the Nairobi meeting of the IMF, although there was need for governments to indicate at that time that progress was being made. Just how the current experience with floating exchange rates will affect the final decisions of the Committee of 20 in their recommendations for restructuring the international payments system remains to be seen, but it is inevitable that the adjustment mechanism will always comprise some combination of domestic inflation and deflation, trade and payments liberalization and restriction and exchange-rate movements.

What makes sense for the future, as it did for the recent past, is that the primary burden for adjustment be placed on exchange-rate changes. Belatedly, the trauma of large, crisis-induced parity revisions has been universally recognized as inevitable under a fixed parity system, as they are injurious to global commerce. Most governments are opposed to freely floating rates. One halfway house, frequent and small changes in parities which would permit significant variation in exchange rates in the course of time, has been considered as an alternative; and, indeed, examination of the world's monetary experience during the past quarter century suggests that there is much merit in trying such a procedure.

Compared to the need to overcome parochial national barriers to agreement on an adjustment mechanism that works smoothly, other issues in monetary reform are of secondary importance. We have already established that governments can agree to create "paper gold" (SDRs) to serve as international reserves. Thus the speed with which metallic gold declines as a significant part of international reserves is a question of diminishing importance. The only obvious way in which gold could reassert its importance in the system would be through a failure by governments to agree on a solution for the basic payments problem. Whether the dollar will continue to serve as the principal medium for international payments and how the large overhang of dollars now held by foreign central banks is to be treated are questions of secondary interest and are not central to the future of the system.

The question of confidence has already been discussed and related to action on a new payments mechanism. International exchange rates may now be fairly realistic, although this is difficult to judge after there has been so much churning of the markets. It is fair to suspect that the U.S. dollar is slightly undervalued and needs to remain in this position for some time before U.S. exporters and import-substituters are energized to make the investments that will eventually eliminate the U.S. payments deficit. Indeed, if the current rates prevail for very long, there is a danger of the world's being swamped by an enormous U.S. trade surplus.

Minor but, until recently, relatively unthinkable changes in the system—such as the widening of exchange-rate margins that govern when central banks are required by IMF rules to interfere in the market—also have a role to serve in raising confidence in the payments system and discouraging speculation. Confidence can be enhanced by the appearance of a cooperative attitude among governments, but it is also a function of domestic fiscal and monetary virtue. The most critical factor will always be the degree to which national governments practice effective demand and price control, in the absence of which there are bound to be opportunities for destabilizing speculation.

If there is any common thread running through the preceding analysis, it is that we are dealing with a multiplicity of related activities which can be comprehended only when they are seen as a system. And, on the assumption that international commerce is valuable, the logical answer to a systemic problem is a structure of rules and institutions by which participants give up some prerogatives to obtain larger benefits. In international commerce there is a natural tendency for nations to cling to tolerable but second-best practices, such as bilateral balancing of trade. Like Philoctetes they dare not give up their present problems for fear of the greater suffering that may result from a new initiative. But because the willingness to overcome this timidity has been amply demonstrated by the experience of the past twenty-five years and has been well rewarded, it does not seem romantic to hope that whatever technical changes are made in the international trade and payments system, the liberal spirit of Bretton Woods will continue to be the future's dominant theme.

NOTES

1. See Fritz Machlup, *International Monetary Systems and the Free Market Economy*, reprint in International Finance No. 3 (Princeton, N.J., 1966).

2. *Sequel to Bretton Woods* (Washington, D.C., 1971).

3. See, for example, Judd Polk, Irene Meister and Lawrence A. Veit, *U.S. Production Abroad and the Balance of Payments* (New York, 1966), and Raymond Vernon, *Sovereignty at Bay* (New York, 1971).