INTRODUCTION

DOLLARS, DEFICITS, AND TRADE

James A. Dorn

Where an open communication is preserved among nations, it is impossible but the domestic industry of every one must receive an increase from the improvements of the others. . . . Nature, by giving a diversity of geniuses, climates, and soils, to different nations, has secured their mutual intercourse and commerce, as long as they all remain industrious and civilized.

—David Hume

The Changing World Economy

The world economy has undergone significant changes since the collapse of Bretton Woods in August 1971. We are now living in a pure fiat money world, a world in which the purchasing power of national currencies depends primarily on the discretion of central bankers and ultimately on the politicians they serve. Other characteristics of the post-Bretton Woods landscape include floating exchange rates for the dollar and other key currencies; wide swings in the foreign exchange value of the dollar; persistent U.S. budget and trade deficits; growing economic interdependence among nations due in part to the information revolution and the globalization of financial markets; and a rebirth of protectionist policies, especially in the form of nontariff barriers, which distort the international price system.

The lack of any anchor for the dollar under the current international monetary system, or “nonsystem” as it is sometimes called, places heavy responsibility on the Federal Reserve to preserve the value of the dollar. Credible U.S. monetary policy, prudent fiscal policy, and a firm commitment to open markets are essential to international economic stability. The volatility and unpredictibility of both the

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domestic and foreign exchange value of the dollar are due in large part to the failure of U.S. policymakers to adhere to a long-run goal of price stability, to limit government spending and borrowing, and to abolish trade restrictions. While it is true that inflation has been reduced significantly since the early 1980s, there is still much uncertainty about the future price level in the absence of any constitutional limit on the monetary powers of government. Likewise, the large and persistent federal budget deficits and the rapid increase in federal debt appear to be built-in features of a political system characterized by virtually unlimited democracy and a redistributive state driven by "rent seekers" who cry out for protectionist measures in the name of the public good.

Yet, the fact remains that insofar as nations have maintained "open communication" (especially by maintaining open markets) and have remained "industrious and civilized" (especially by lowering marginal tax rates to encourage individuals to work, save, and invest, and by adhering to a rule of law protecting rights of persons and property), they have prospered. The rapid growth of Japan and the Pacific Rim countries, and the respectable growth of the United States, Great Britain, and Europe during much of the 1980s have resulted in large part from following the Humean recipe.

The future holds great potential for continued growth of the world economy, but the extent to which this potential is realized will depend on the success of the United States and other major democratic governments in strengthening their commitment to sound money, limited government, and freer markets. The ideal of Adam Smith ([1776] 1937, p. 651)—namely, a "system of natural liberty" wherein "every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men"—remains a useful blueprint for generating a stable world order.

The abandonment of the international monetary system based on the Bretton Woods agreement and the substitution of a system of managed floating for "fixed but adjustable" exchange rates paved the way for national economies to independently pursue their own monetary policies. Major industrial democracies, therefore, could choose to insulate their economies from the monetary disturbances previously transmitted under a fixed exchange regime. In practice, however, monetary independence proved difficult because of the policymakers' incentive to politicize the system of floating exchange rates. Nevertheless, until 1985, the United States largely refrained from interfering with the foreign exchange value of the dollar and
focused more on domestic targets than on rigging the exchange rate to achieve external balance.

With the possibility of increased monetary independence under floating, the integration of world financial markets, the growing importance of international trade as a component of the U.S. economy, and the corresponding importance of the foreign exchange market, it is essential to reconsider the framework for domestic monetary policy and the relation between domestic stability and exchange rate stability.

These and other issues were the focus of the Cato Institute's Sixth Annual Monetary Conference—Dollars, Deficits, and Trade: The Changing World Economy. By debating the role of the dollar, the shape of the international monetary system, the future of floating rates, the risks associated with alternative exchange rate regimes, the transmission of real and monetary shocks under fixed and floating rates, the seriousness of and the relation between the U.S. budget and trade deficits, and the role of policy coordination, the contributors to this volume help separate real from false problems and help design the framework for a more stable world economy. Moreover, by comparing the current international monetary arrangements to alternatives such as a gold standard, a commodity-basket standard, a single world fiat money geared to stabilize a broad-based price index of internationally traded goods, and a free-market currency, insights are gained that may permit the evolution of a sounder international monetary system.

This volume will also consider questions about the inflationary bias of the current national fiat money regimes; the role of the futures markets in helping individuals manage the risk inherent in floating rates; the risk of foreign exchange controls, capital controls, and trade barriers under pegged exchange rates; the ability of floating rates to insulate a national economy against monetary and real shocks from abroad; and the question of whether the European Monetary System (EMS) has achieved its goals of exchange rate stability, financial stability, and increased trade. Many questions remain, but the breadth of the papers—along with their timely nature and the many interesting questions they address—make this a useful volume for those interested in a thoughtful and provocative treatment of the key issues facing the world economy today.

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2This conference was held February 25–26, 1988, in Washington, D.C. The conference was supported by grants from the Lynde and Harry Bradley Foundation, the Chicago Mercantile Exchange, the John M. Olin Foundation, and Sears, Roebuck & Co.
The Dollar and Domestic Monetary Policy

The dollar's purchasing power largely depends on the course of domestic monetary policy. If money growth consistently outpaces the growth of real output, inflation will result. Short-run changes in the demand for money can alter this relation between money and prices, but historical evidence of the long-run relation is too strong to ignore. The framework within which domestic monetary policy is conducted is therefore of great importance for the future value of money. The conduct of domestic monetary policy is also critical for the foreign exchange value of the dollar under floating rates and for the smoothness of the adjustment process during which the foreign exchange value of the dollar is moving toward a new equilibrium exchange rate. In the absence of a predictable purchasing power for the dollar, its foreign exchange value will also be less predictable. The pursuit of stable money, therefore, will spill over onto the foreign exchange market under floating rates, so that increasing domestic price-level stability will tend to foster exchange rate stability as well. The papers by Manuel H. Johnson and Leland B. Yeager consider these and related issues.

A Framework for Monetary Policy

In his opening paper, Johnson points to the importance of central-bank credibility in a fiat money regime and argues that in establishing a framework for monetary policy it is essential to clearly state the long-run goals of monetary policy and how they can be achieved. For Johnson, a primary goal is to achieve price-level stability. This goal is important because price-level predictability is a necessary ingredient for a rational price system, in addition to competitive markets. In particular, without monetary disturbances and an unstable price level, competitive markets will be able to operate more efficiently and real economic growth will proceed more smoothly than in a world of erratic money and prices.

In Johnson's opinion, the volatile nature of monetary velocity in the 1980s has made it necessary for the Fed to shift from monetary aggregates to alternative indicators for conducting monetary policy. These indicators "should be accurately measurable and readily available," "should respond to changes in Federal Reserve policy," and "should be reliably related to the ultimate goals of monetary policy." Johnson therefore suggests looking to financial markets to help guide monetary policy. He recommends that the Fed rely on the yield

The foreign exchange value of the dollar under floating, of course, also depends on the monetary policies of foreign central banks.
INTRODUCTION

curve, the foreign exchange value of the dollar, and selected broad-based commodity price indices in formulating monetary policy. Changes in these indicators, he believes, would provide the Fed with clues as to whether monetary policy is overly restrictive or overly expansive. Thus, Johnson expects that when these indicators are used jointly they should help the Fed avoid serious policy errors and maintain long-run price stability.

Domestic Stability versus Exchange Rate Stability

If a choice has to be made between domestic stability and exchange rate stability, Yeager favors the former. Abandoning floating exchange rates would not solve the fundamental problem confronting every national economy, namely, the absurdity of a fiat money system in which the future purchasing power of money is unknown. Without solving this problem, it makes little sense, in Yeager's opinion, to focus on exchange rate stability. However, if national currencies can be reformed to achieve sound money, then floating exchange rates will be less volatile. Yeager therefore calls for fundamental monetary reform.

In reforming the monetary regime, Yeager would "give defined values to currencies," preferably in terms of a commodity basket rather than in terms of gold. If there were a credible commitment to maintain the long-run purchasing power of the monetary unit in terms of a representative basket of commodities, Yeager believes the well-known problem of lags associated with a price-level rule would be minimized. He also thinks that the use of monetary aggregates and policy indicators, such as those advocated by Johnson, would help avoid prolonged monetary disequilibrium and restore price-level stability without serious lags.

Moving from a government fiat money standard to a governmentally managed commodity-basket standard no doubt would provide a more stable anchor for the price level, but Yeager goes on to argue for the complete privatization of money. Once government fiat money is abolished, a new private unit of account could be defined in terms of a broadly selected bundle of commodities with a given total value. If the standard bundle were representative of a large enough number of goods and services, a relatively high degree of price stability could be achieved. Indeed, Yeager argues that the new monetary unit would be "endowed practically by definition with a stable purchasing power."

Under the monetary scheme Yeager envisions, private banknotes and deposits would serve as circulating media. The private suppliers would respond to changes in the demand for money without altering
the stable unit of account. Any deviation of the price level from that associated with the defined value of the unit of account would quickly be corrected by arbitrage. With the maintenance of monetary equilibrium and price stability, Yeager predicts that the private money arrangement would avoid the high costs of inflation and recession that have hampered government fiat money regimes. Moreover, once governments could no longer abuse and politicize national currencies, the foreign exchange value of the dollar would itself become more stable.

International Monetary Reform

The papers by Jacob A. Frenkel and Morris Goldstein, Richard N. Cooper, and Ronald I. McKinnon survey the current terrain of the international monetary system and consider how it might be improved. Leo Melamed discusses the globalization of finance since the advent of floating. He explains how the emergence of the International Monetary Market (IMM) has benefited the international community by enabling individuals to better manage the risk associated with fluctuating exchange rates through the use of futures contracts.

Developments and Prospects

In their wide-ranging paper, Frenkel and Goldstein review recent developments in the world economy and the key issues that must be addressed in any meaningful discussion of international monetary reform. Recent developments include the large U.S. current account deficits, increased official intervention in the foreign exchange markets, a substantial fall in the foreign exchange value of the dollar since 1985, and an increased recourse to policy coordination in international economic affairs.

Frenkel and Goldstein associate four basic issues with these developments: (1) whether fiscal policy can be disciplined by the choice of the exchange rate regime; (2) the extent to which monetary independence is reduced by moving away from floating exchange rates and the costs involved; (3) the best means for determining equilibrium exchange rates; and (4) the characteristics of a sound international monetary order.

In discussing the relation between fiscal policy and the exchange rate regime, the authors find little evidence that the choice of the

\(^4\)For an elaboration of the private money and payments system, see Greenfield and Yeager (1983).
regime significantly influences the size of the budget deficit. The authors imply that a better understanding of how to discipline the fiscal authorities is necessary before considering any reform of the exchange rate regime.

On the question of monetary independence, Frenkel and Goldstein note that the relevant issue is the cost in terms of alternative policy options forgone when moving to fixed exchange rates. The question that policymakers will have to address is whether the cost of sacrificing monetary independence is worth the benefit of achieving more stable exchange rates.

With respect to whether the government or the market is better able to determine equilibrium exchange rates, the authors are skeptical that official intervention is likely to hit upon the market-clearing exchange rate. The proclivity of governments to err in determining equilibrium exchange rates makes official estimates subject to frequent revision. Official intervention typically adds "noise" to foreign exchange markets and provides opportunities for destabilizing speculation. In comparison, competitive foreign exchange markets utilize existing information about myriad forces affecting exchange rates. This information, in turn, enables individuals to adjust their plans in a rapid and consistent fashion without incurring the costs of government intervention. As Gottfried Haberler notes in his comment on the Frenkel and Goldstein paper: "The fact is that we, economists as well as ministers of finance and central bankers, do not know what the equilibrium rates are." Even so, there seems to be an unending stream of official advice and arguments for greater intervention in the hope that governments may still be able to outguess the foreign exchange market. The problem is that by interfering with the free-market process, official intervention makes the foreign exchange market less, not more, efficient as a mechanism for disseminating relevant information and coordinating individual plans.

Finally, in considering the international monetary system, the authors address the question of whether a smoothly operating system requires rules, leaders, and explicit anchors. They note that although the current floating rate regime has no well-defined rules like the

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5 Niskanen (1988, p. 177), for example, reports that no predictable relation has been found between exchange rates and budget deficits from either time-series or cross-country studies.

6 For a useful discussion of this tradeoff, or what has become known as the "Doctrine of Alternative Stability," see Yeager (1976, pp. 651–53).

7 F. A. Hayek's argument about the market as a mechanism for utilizing the decentralized knowledge that is only available to individuals "on the spot" is as relevant for the foreign exchange market as it is for other markets. See Hayek (1945).
An International Fiat Money

Richard Cooper provides a careful survey of various commodity-reserve proposals and examines the performance of the gold standard. Based on his observations, he rejects the commodity-based approach to international monetary reform in favor of an international fiat money. By instituting a single monetary unit for the major industrial democracies, Cooper hopes to circumvent the problem of exchange rate uncertainty. The backbone of his proposal is to establish an International Central Bank (ICB) that would be instructed to achieve price-level stability and maintain the purchasing power of the international fiat money.

The question that arises with respect to Cooper’s proposal is whether the ICB has any incentive to consistently follow a price-level rule and maintain a long-run noninflationary growth of the world money supply. The long experience of the Federal Reserve and other central banks operating under national fiat money regimes certainly does not warrant much optimism in this regard. Nevertheless, even if the ICB were merely to “muddle through” without any specific operating rule, Cooper still thinks his international fiat money would be superior to the present system and other alternatives—though he clearly prefers the ICB to be bound by a price rule.

Lawrence H. White and Paul Craig Roberts question Cooper’s enthusiasm for an international fiat money. They argue that handing over monetary policy to a group of world central bankers may simply make the world economy more, not less, unstable by further politicizing money. For this reason, White (like Yeager) prefers to abandon government fiat money altogether and ultimately privatize money.8

8In his comment, White makes an important distinction between proposals for govern-
INTRODUCTION

An International Gold Standard without Gold

An alternative proposal is presented by McKinnon who favors returning to a fixed exchange rate regime but abandoning gold as an anchor for national price levels. As a substitute for gold, he would have the monetary authorities of the leading industrial democracies jointly manage their respective monetary bases (fiat monies) in order to stabilize a price index of internationally traded commodities. He believes that his “international gold standard without gold” will ensure exchange rate stability but avoid the bouts of inflation and deflation that characterized the historical gold standard.

McKinnon’s scheme, however, raises the same question as Co oper’s, namely, whether any government fiat money can avoid being politicized over the long run. It also raises two additional issues: whether the monetary authorities will succumb to controls over trade and capital when facing a balance-of-payments problem under a fixed exchange rate regime, and whether (as Robert E. Kelcher mentions in his comment) the exchange rate itself will be used as a policy tool so that the stability inherent in fixed rates becomes more rhetoric than reality.

The International Monetary Market

Leo Melamed reminds us that the Bretton Woods system broke down, as Milton Friedman had predicted, because it failed to recognize the inconsistency of fixed exchange rates, independent monetary policy, and freedom from controls over international trade and capital movements. Governments, however, have learned little, according to Melamed, for they continue to desire all three objectives. Thus, the regime of flexible exchange rates, reluctantly ushered in after the closing of the U.S. gold window in August 1971, remains a dirty or managed float.

In his paper, Melamed, like Haberler, explains why we should not abandon floating exchange rates. The difficulty of international policy coordination, the globalization of financial markets, the information revolution, and the need for flexibility all support the case for floating, argues Melamed. He sees no sense in trying to place a straightjacket on exchange rates and the information they convey by reinstating the rigidity of a Bretton Woods—type system. Although the adjustable

mentally directed commodity standards, as discussed in Cooper’s paper, and proposals for denationalizing money. The latter are characterized by commodity standards that emerge and operate via voluntary choice—in the absence of any monetary authority or monopoly central bank.

See Yeager (1976, p. 652).

9For a detailed treatment of the case for floating, see Melamed (1988).
peg system under Bretton Woods worked reasonably well in the immediate postwar years, it could not weather the inflation and oil price shocks of the 1970s.

The International Monetary Market has proven beneficial, observes Melamed, because it has allowed individuals to offset some of the risk associated with floating rates. In turn, improved risk-management strategies have helped facilitate international trade and investment. The fact that the IMM arose spontaneously via the entrepreneurial foresight of Melamed places it in stark contrast to the governmentally determined Bretton Woods system. By placing their own money at stake, those who began to trade futures contracts in foreign currencies had a strong incentive to have the new market work and to serve the ever-growing demands of an interdependent world economy. This resiliency, argues Melamed, is the IMM's strongest asset.

Exchange Rate Regimes: Rules and Consequences

The papers by Thomas D. Willett, Martin J. Bailey and George S. Tavlas, Michael D. Bordo and Anna J. Schwartz, and Michele Fratianni provide a detailed investigation of the nature of alternative exchange rate regimes. In doing so, they offer a broad perspective of the arguments for and against floating.

Key Exchange Rate Regimes: A Constitutional Perspective

In his perceptive paper, Willett provides an overview of key exchange rate regimes from a constitutional perspective. He does not attempt to review the extensive theoretical literature on alternative exchange rate regimes. Rather, his objective is to offer a conceptual framework for analyzing exchange rate regimes in terms of whether they are constrained or unconstrained, and whether the constraints are imposed at the domestic or international level. From his viewpoint, the most fundamental issue in analyzing the consequences of alternative exchange rate systems is whether national monetary and fiscal policies are disciplined by effective rules that lend stability to both the domestic economy and exchange rates.

Willett cautions against "the severe danger of analyzing exchange rate issues in isolation." Political factors and economic factors are both obviously important in evaluating alternative exchange rate regimes. One must ask how constrained and unconstrained domestic monetary and fiscal policies will affect different exchange rate regimes and how the choice of regime will subsequently influence domestic policy choices.
INTRODUCTION

Three key issues come to mind when looking through Willett's constitutional political economy window: (1) What is the best way to discipline domestic monetary and fiscal policy—by international policy coordination or by national constitutional limitations on the economic powers of government? (2) Which of these two approaches is more likely to be politically feasible and how can the new set of rules be implemented and maintained? (3) Within the set of feasible alternatives, which is most likely to generate long-run economic stability?

Given the proclivity of all governments to abuse their power, moving political authority to an international body may create more problems than it solves. Moreover, national governments are unlikely to give up their sovereign powers to an international organization. Considerations of simplicity and enforceability, therefore, may require turning to internal constraints to limit the monetary, spending, and borrowing powers of national governments. If successful, the greater domestic stability will also ensure greater exchange rate stability under floating, argues Willett.

For Willett, then, there is a strong case for focusing on "fundamental institutional reforms to help promote long-run economic and financial stability, including exchange rate stability." In his view, the key industrial democracies should first get their own financial houses in order by constraining monetary and fiscal authorities before looking for a more stable exchange rate regime. Floating exchange rates may place some pressure on national governments to correct inappropriate monetary and fiscal policies by openly disclosing policy errors in the foreign exchange markets. This indirect discipline, however, is insufficient in Willett's view and must be supplemented by domestic measures designed to bring about greater financial stability.

U.S. Trade and Investment under Floating Rates

The effect of floating exchange rates on international trade and investment is an important issue. The post-Bretton Woods system of managed floating has been characterized by wide swings in nominal and real exchange rates. Opponents of floating argue that the greater variability of exchange rates under floating, as compared to fixed rates, reduces the volume of trade and investment. Bailey and Tavlas investigate this issue in detail and find that neither theory nor evidence can definitely support any significant effect of floating exchange rates on trade or investment.

In the theoretical section of their paper, the authors offer important insights into the determinants of exchange rate variability (both short-run volatility and long-run misalignment) and the consequences for
The unpredictable nature of many of the factors that account for exchange rate movements helps explain the variability of exchange rates—and the greater the unpredictability, the more volatile a floating regime will be. The question that Bailey and Tavlas seek to answer is, “To the extent that the size and variance of movements in exchange rates have been unpredictable, have they also been harmful?” The results of their study imply that the post-1973 floating rate regime has not had any serious effects on U.S. trade or direct investment.

Once we allow for the politicization of exchange rates under a Bretton Woods-type system and the possibility of trade and capital controls, the risk normally associated with freely determined exchange rates appears less problematic.\(^\text{11}\) And once it is recognized that exchange rates are asset prices, which change rapidly to reflect actual or expected changes in real and monetary forces, the variability of flexible exchange rates will depend in part on the policy environment. Sound monetary and fiscal policies, the protection of property rights, a commitment to open markets, and the enforcement of an international rule of law will all help reduce the variability of exchange rates by lowering institutional uncertainty and increasing predictability. These and other considerations lead Bailey and Tavlas to the conclusion that, in theory, it is difficult to determine the precise impact of exchange rate variability on trade and investment.

In the absence of either hard theoretical support or empirical evidence that, on net, floating rates harm trade and investment relative to fixed rates (or, more correctly, relative to the fixed but adjustable rate system that characterized the Bretton Woods system), one will have to incorporate considerations of constitutional political economy (as suggested by Willett) when choosing among alternative exchange rate regimes.

**Transmission of Real and Monetary Disturbances under Fixed and Floating Rates**

Michael Bordo and Anna Schwartz examine the various channels through which real and monetary disturbances are transmitted under

\(^{11}\)For a fuller discussion of the impact of alternative exchange rate regimes on trade and investment, see Yeager (1976, ch. 13).

All exchange rate regimes entail risk and uncertainty of one kind or another. The contention that floating has led to greater variability of prices and output than under the Bretton Woods system of pegged rates, for example, cannot be supported from existing data (see Economic Report 1989, p. 118). Moreover, Niskanen (1988, p. 180) makes the important point that “a move toward a more stable exchange rate system [engineered by government controls], as with domestic price or interest rate controls, would reduce uncertainty about exchange rates only by increasing uncertainty about government policy—at best a Faustian bargain.”
fixed and floating exchange rates. In their analysis, they further distinguish between exchange rate regimes operating in an open and closed world economy. With these distinctions in mind, Michael Darby (in his comment on the authors' paper) recommends a four-way classification of exchange rate regimes: "fixed open," "fixed closed," "floating open," and "floating closed." Bordo and Schwartz consider the transmission of real and monetary disturbances for each of these regimes in theory and practice.

The traditional approach to analyzing real and monetary disturbances under fixed open and floating open exchange regimes is contrasted with the Keynesian approach to transmission in a closed world economy. The latter approach was devised to help explain the interwar years while the traditional approach applied to the pre-1914 gold standard. The Keynesian model was further developed to apply to the post-1973 floating rate system.

For a system of fixed exchange rates in an open world economy, the traditional approach to transmission relied on the balance-of-payments adjustment mechanism. Monetary and real disturbances in one country spread to other countries linked to the gold standard. Balance-of-payments disequilibria were corrected by the Humean price-specie-flow mechanism, by direct changes in expenditures and incomes, and by arbitrage and capital flows. Thus, the adjustment process under the gold standard required sacrificing autonomy over domestic stability in order to maintain balance in international payments. In an open world economy with floating rates, the transmission of real and monetary disturbances is mitigated by having the foreign exchange market absorb most of the shocks, as reflected in movements in the foreign exchange rate. Thus, domestic stability can be pursued with monetary and fiscal policy while external balance is brought about through adjustments in the exchange rate.

Unlike the traditional approach in which the theory of transmission is fairly clear-cut, the Keynesian approach to transmission in a closed world economy has generated a host of ever more complex models. Indeed, as Bordo and Schwartz note, the growing complexity of these models has made it difficult, in theory, to predict the outcome of the international transmission process.

After a close examination of the traditional and Keynesian approaches to transmission, the authors consider the policy implications of the two approaches with regard to the role of government intervention. The traditional approach, of course, sees no role for intervention in either the fixed rate regime or the floating rate regime. The purpose of the gold standard is to discipline national governments, while
under floating rates domestic policy is largely insulated from balance-of-payments considerations. Under the Keynesian approach, however, it is taken for granted that government will play a role in the transmission process.

Within the Keynesian framework, arguments based on negative externalities and game theory imply that a more efficient adjustment to monetary and real shocks under fixed rates is possible with policy coordination. Similar arguments have been used by Keynesians to justify intervention in a regime of floating rates. But as Bordo and Schwartz emphasize, such arguments really miss the mark since "intervention under floating rates shifts adjustment away from the exchange rate back to the real economy, abandoning the benefits of floating." Moreover, with respect to policy coordination in general, the authors correctly note, "If there are negative spillover effects, the likely reason is that domestic policies from which they originate are misguided."

In sum, Bordo and Schwartz's reaction to the Keynesian proposal for intervention via policy coordination as an efficient means to better the international monetary system is that such a proposal "is visionary." In theory, it is possible to generate beneficial outcomes from policy coordination. But in practice, argue Bordo and Schwartz, such an approach is likely to fail because its theoretical framework ignores "the vested interest of politicians in safeguarding their home country sovereignty."

From a historical perspective, the authors point out that during the classical gold standard prior to 1914, national governments largely adhered to the "rules of the game" and maintained convertibility. The fixed open model was therefore appropriate. However, after 1914, with the demise of classical liberal attitudes, intervention became commonplace. The interventionist attitude was evident under the gold exchange standard of the interwar period, as well as during the Bretton Woods system, and it has clearly been the case under floating since 1973.

In examining the historical record, Bordo and Schwartz provide empirical evidence supporting the traditional approach to the transmission of monetary and real disturbances. They recognize that under the gold standard, business cycles were frequently transmitted from one country to another. And they draw on balance-of-payments adjustments during the U.S. greenback episode (1862–78) to provide evidence supporting the traditional approach under open floating. As predicted, during the period in which the dollar floated, the U.S. economy was insulated from monetary and real shocks originating abroad. Further evidence of the transmission of business cycles under
fixed exchange rates is found in the interwar experience with the gold exchange standard and under the Bretton Woods system. However, since the U.S. dollar floated in 1973, the authors find no clear evidence bearing on the transmission process. They venture that the interdependence that has been found to exist under the present system is not necessarily at odds with the traditional theory, since that theory applies to a freely floating exchange regime rather than to managed floating. In fact, they argue that “much of the interdependence may be a consequence of policy management and U.S. policy instability.”

An important lesson that Bordo and Schwarz draw from their study of the transmission of real and monetary disturbances under alternative exchange regimes is that “a stable international order is achievable with a floating rate system that provides independence to pursue stable domestic policies consistent with that preference. For international economic stability, policy coordination is neither necessary nor attainable.” The question still remains, however, about how best to discipline domestic policymakers to achieve the stability that is theoretically achievable.

**The European Monetary System: An Appraisal**

Michele Fratianni argues that the EMS (initiated in 1979) has not been the failure many had predicted, nor has it been an unqualified success. On the positive side, the EMS has reduced exchange rate volatility under an adjustable peg system and has used the credibility of the Bundesbank to discipline the French and Italian central banks. The EMS has also provided for greater European financial integration and lessened the extent of exchange controls by France and Italy. As a result, the French franc and Italian lira have both appreciated in real terms against the Deutsche mark and other EMS currencies. However, on the negative side, Fratianni points to the decline in trade within the EMS and to the fact that the reduction in inflation in France and Italy, while notable, has not been as significant as the disinflation experienced by non-EMS countries that have followed their own independent monetary policies under floating rates.

In Fratianni’s view, the main benefit of the EMS has been in using the reputation of the Bundesbank to lower the costs of disinflation policy in Italy and France, both of which have comparatively weak central banks. Insofar as the leadership role is more evenly distributed within the EMS, Fratianni warns that without enhanced reputations for the Italian and French central banks, democratization would defeat the very purpose of the EMS, namely, to establish a “zone of monetary stability.”
In his comment, Alan Walters is less sanguine about the benefits of the EMS, noting that the United Kingdom has made considerable progress against inflation and unemployment in the absence of EMS membership. More specifically, he believes that the EMS has politicized the exchange rate regime and made European financial stability largely dependent on German hegemony. He also sees the increased protectionism in Europe flowing in part from the EMS. As such, he holds that European monetary integration would be better served by an alternative institutional arrangement.

The Political Economy of Deficits and Trade

The growing volume of international trade and the corresponding increase in economic interdependence are characteristics of the world economy today. Yet national interests continue to prevail as special interests try to use the redistributive state to secure economic advantages for themselves at the expense of the larger society. Budget policy and international trade policy have both become so politicized that it is difficult for the nonspecialist to distinguish fact from fiction when listening to arguments for or against increased government spending and trade restrictions.

Are budget deficits and trade deficits detrimental to a citizen’s economic well-being? What, if any, is the relation between the budget and trade deficits? Are the budget and trade deficits only symptoms of more deep-seated problems that are being ignored by policymakers and the media? These and other issues are addressed in the final two papers in this volume by William A. Niskanen and A. James Meigs.

U.S. Budget Policy and the Trade Deficit

The relation between the U.S. budget deficit and the trade deficit is an uneasy one at best, argues Niskanen. In his view, there is insufficient evidence to support the hypothesis of a direct link between the two deficits. The past several years have witnessed high levels of both deficits. Economists have tried to explain these twin deficits by relying on an accounting identity and the so-called Feldstein chain linking increased trade deficits to increased budget deficits. But as Niskanen illustrates, the observed parallel movements in the two deficits prove nothing, since both the budget and trade deficits may be responding to outside forces. Moreover, based on available evidence, Niskanen warns that our theoretical understanding of the relation between the budget and trade deficits, while useful, is not sufficient to establish a firm basis for positing a statistically significant
direct relation between changes in the budget deficit and changes in the trade deficit.

The trade or foreign balance (exports minus imports) is identically equal to the difference between private saving and investment plus the government balance (the difference between government taxes and expenditures). This accounting identity implies that an increase in the government deficit will lead to an equal change in the trade deficit, if other things are constant. Niskanen, however, finds no compelling evidence to support this postulated relation. It appears that for the postwar era, changes in U.S. saving and investment largely offset changes in the government balance, so that the foreign balance was not significantly affected. Niskanen therefore argues that the rise in the U.S. trade deficit during the 1980s cannot be explained by the rise in federal government deficits.

Finding no satisfactory evidence to support a positive relation between the government and trade deficits, implicit in the accounting identity, Niskanen next considers the “Feldstein chain” as a “plausible hypothesis.” Under this approach, economists have argued that “real budget deficits increase real interest rates, which increase the real exchange rate, which increases the real trade deficit.” Although Niskanen finds this line of argument reasonable, he cannot find any strong evidence to support each link in the Feldstein chain. As a result, he cautions against placing much weight on the argument as a whole.

In light of the inconclusive evidence for a stable positive relation between the budget and trade deficits, Niskanen approaches the twin deficit issue from a different angle. He notes that the twin deficits really point to a single problem: “The increase in private and government consumption, financed in part by borrowing abroad, will not provide a stream of returns to finance the increased debt.” The solution is to reduce the rate of private and government consumption relative to the growth of real output. Niskanen emphasizes that politicians must confront this issue head on and stop focusing their attention on the trade deficit, which is not the real problem.12

The present situation in which total U.S. debt is growing faster than real output is not sustainable, argues Niskanen. To face this problem squarely requires turning from the trade deficit to the federal budget deficit. In this respect, Niskanen recommends cutting the

12Niskanen remarks that the trade deficit has become a problem mainly because it has been used as a straw man by special interest groups seeking to protect their products and jobs from foreign competition, which many Americans have come to see as “unfair.” Meigs discusses this issue in more detail in his paper.
budget deficit in a way that is least harmful to continued economic growth, regardless of the impact on the trade deficit. His preference is to restrain government spending in the areas of defense, health care, and agriculture rather than to increase taxes. In his view, the main priority of U.S. policymakers should be to restore fiscal soundness and reduce the growth of total debt, rather than to sacrifice domestic stability for foreign balance.

Substituting False for Real Problems

For Meigs the twin deficits point to more serious problems that are often ignored in the heat of the debate over the budget and trade deficits. The continued growth of government spending, which draws resources away from the private sector, and the use of the trade deficit to motivate protectionist legislation are the real problems, according to Meigs. By focusing attention on the twin deficits as evils in and of themselves, the nation may lose sight of these real problems. In his paper, Meigs thoroughly explores the implications of substituting the false problems associated with the twin deficits for the real problems of excessive government spending and protectionism.

Meigs takes a public choice approach to analyzing the persistence of government growth and the rise in U.S. protectionism. The logic is simple: Public officials gain by conferring large benefits on special interest groups with political clout while spreading the costs over the general public or pushing the costs into the future by borrowing. In principle, Meigs prefers a balanced budget, but only if the balance is brought about by reducing the size of government. He strongly opposes tax increases because he believes that they would simply be used to create new spending programs and allow government to continue on its high-growth path while discouraging individual initiative. The present budget deficit, according to Meigs, places a constraint on further increases in government spending, and in this sense is to be preferred over higher taxes. Furthermore, Meigs does not see that the budget deficit has been harmful to economic growth or that it has led to inflation and high interest rates. Yet, Meigs does not address the issue of whether the deficit imposes an ethical cost on a free society by sanctioning the taking of property from future generations without their consent in order to finance current government expenditures. This ethical issue is at the heart of the proposed constitutional amendment to balance the federal budget, a proposal Meigs would undoubtedly support.13

13On the ethical issue behind the budget deficit, see Niskanen (1988, pp. 112–13).
INTRODUCTION

With respect to trying to cure the trade deficit by protectionist measures or by intervening in the foreign exchange market, Meigs explains that these so-called cures would only make matters worse. Recalling the work of Jan Tumlir, Meigs emphasizes the danger that nontariff trade restraints pose for the international price system and how quantity restrictions impede the efficient allocation of resources among nations. Introducing such “noise” into the international price system necessarily reduces the wealth of nations.

There is no moral dilemma inherent in the trade deficit as long as it reflects the voluntary actions of private individuals. If foreigners wish to sell more goods and services to Americans than they buy and invest the difference in the United States, why should such privately motivated actions harm the U.S. economy? Meigs shows that they do not and, in the process, dispels many of the myths behind the protectionist mentality. The fact is that during most of the 1980s U.S. output and employment both increased at healthy rates even though the current account deficit reached record levels—which lends support to Meigs’s contention that the trade deficit is largely a false problem.

The reversal in 1985 of the Reagan administration’s initial decision to refrain from intervening in the foreign exchange market and the increased willingness of the United States since then to intervene concerns Meigs. Foreign exchange intervention is detrimental in the long run because it increases uncertainty and masks real changes in relative prices, contends Meigs. Trade patterns will therefore be distorted away from what real market forces would otherwise have dictated. And insofar as monetary policy is held hostage to exchange rate policy, the attainment of both domestic stability and exchange rate stability (in the sense of lower variability of floating rates) will elude policymakers.

Real progress in resolving the critical issues underlying the twin deficits will be made only by reducing the growth of government spending, instituting a more neutral tax system, maintaining a sound monetary policy to achieve long-run price stability, protecting private property, keeping markets open to competition, and enacting a balanced budget amendment. For Meigs these are the steps that must be taken to cure the cancer that is slowly eroding our economic and personal liberties; superficial concerns with the twin deficits will not carry the day.

15Although U.S. imports increased from 1982 to 1987 by over 65 percent, employment rose by 13 percent and real output increased by more than 21 percent (Economic Report 1989, p. 166).
Toward a Stable International Order

The economic disorder that so often characterizes the major industrial democracies can be traced in large part to the absence of any solid constitutional anchors for domestic monetary policy, fiscal policy, and trade policy. Unstable and inflationary monetary policy, the growth of government, and the proclivity for trade restrictions (including export subsidies and so-called voluntary export restraints) have impaired the international price system and led to the erosion of the international economic order (see Tumlir 1984).

The deterioration of the rule of law, the lax enforcement of the nondiscrimination principle in international trade, and the general unpredictability of government economic policy have made private decision making more costly. At bottom, then, a major source of international disorder stems from the uncertainty generated by unstable and inconsistent government policies. The lack of discipline in the conduct of monetary and fiscal policy, and an unwillingness to let the free market operate without government interference are traits of the modern democratic state. Government failure not market failure appears to be the basic source of international economic disorder. Without changing this fundamental flaw by constitutional reform at the national level, there is little reason to be optimistic about the success of international policy coordination or global approaches to reform.

In considering the path toward greater international economic order, the presumption should be in favor of freedom rather than additional government controls or what Roland Vaubel (1986, p. 53) has called “naive internationalism,” that is, an internationalism that “welcomes international agreements for their own sake—regardless of what is being agreed upon.” In Vaubel’s opinion, this type of international policy coordination is dangerous because there is “a systematic built-in tendency toward collusion at the expense of the citizens.” Moreover, there is the possibility that such an approach to international organization “crowds out unambiguously desirable forms of international cooperation: agreements to remove non-market obstacles to market interdependence in the field of international trade and capital movements.” Thus, Vaubel (p. 41) notes that, as

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16 On the importance of applying the nondiscrimination principle to trade policy, see Tumlir (1985, pp. 70–71).

17 According to Tumlir (1985, p. 71), “An economist contemplating the present state of the mixed economies of the West cannot escape the impression that, while market failure is occasionally discernable, government failure is glaring and massive.”
commonly practiced, international cooperation among sovereign governments generates its own brand of "negative externalities."

While international coordination designed to increase the role of government is likely to be detrimental to domestic stability and a spontaneous market order, there is room for what Vaubel (p. 41) calls "decentralized policy making." According to Vaubel, this type of policy making can be socially useful because it "generates more knowledge" than forced international policy coordination. It does so "because it reduces world business cycle risk through diversification and uses policy competition as a discovery procedure." A decentralized approach driven by the self-interest of nations to search for ways to stabilize their own domestic economies, therefore, will appear as a positive externality for the world economy. This is a surer way to international order than working through predominately international organizations taking a so-called negotiations approach to reduce uncertainty and disorder in the world economy.

In the spirit of Vaubel's decentralized approach to international coordination, Karl Brunner (1987, p. 50) has called for a "club of financial stability." If the major industrial democracies could agree to practice monetary and fiscal discipline and also provide for the free movement of capital and goods, then domestic stability could be achieved along with greater exchange rate stability under a regime of floating rates. Brunner would have the United States play a key leadership role and other members of the club could choose to peg their currencies to the dollar. Of course, certain countries do peg their currencies to the dollar. But his arrangement only ensures that the foreign exchange value of their currencies will be stable if the dollar is stable; it does not ensure that such coordination will protect the purchasing power of their currencies or ensure their own domestic stability. Experience has shown that under the current illiberal attitudes that prevail in other nations as well as in the U.S. Congress there is not much chance for creating a "club of financial stability." Moreover, Congress has little incentive to act responsibly on key policy issues or to move far from the status quo in searching for fundamental reform of monetary and fiscal institutions that better serve domestic stability and world economic order. Brunner therefore remains skeptical but continues to hope for real reform.

Jan Tumlir (1983, p. 36) wrote: "It will not be possible to determine a realistic set of exchange rates until price levels in at least a few of the core economies are stabilized and a greater degree of freedom for competition to shape relative prices is re-established." His message is central to this volume. But as noted above, much work remains to be done in getting the message across to an entrenched Congress
whose ears are attuned mostly to special interest groups rather than to economic logic and the general consumer. Perhaps the best we can hope for is that each country look to its own state of economic and constitutional disorder and slowly attempt to restore what F. A. Hayek (1960) has called the “constitution of liberty.” To do so, however, also requires that individuals begin to acquire what James Buchanan (1977, p. 298) has referred to as a “constitutional attitude,” that is, “an appreciation and understanding of the difference between choosing basic rules and acting within those rules.”

In the process of restoring constitutional principles, it will be well to recall the policy advice of Adam Smith ([1776] 1937, p. xliii), whose vision helped pave the way for economic freedom and prosperity:

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things. All governments which thwart this natural course, which force things into another channel or which endeavour to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical.

The challenge facing the United States and other countries is to revive the Smithian vision and then to maintain it for the betterment of the international order.

References


INTRODUCTION


