The Fred Hirsch lecture
sponsored by the
Fred Hirsch Memorial Committee
at Warwick University
Coventry, England, on
Thursday, November 9, 1978

The Political Economy of the Dollar*

Paul A. Volcker
President, Federal Reserve Bank of
New York

In view of this occasion, I spent some time in recent weeks reading and rereading Fred Hirsch, and of course came away with a renewed feeling for the strength and breadth of his thinking. Surely few men have so successfully melded command of technical modern economics with insight into the political processes and social setting within which economic policy is framed.

In his last works, Fred battered at the doors of our professional insularities. To carry that work forward will require the effort of more than one man or one lifetime—certainly when that life was cut so short. As one who has practiced at the margin of economic analysis and the political processes for some years, I can only appreciate the privilege of initiating this lecture series in his honor.

For a good many years, the world of international monetary affairs was Fred's particular specialty. In an area where much commentary written only a few years ago seems stale and naive, his continue to stimulate.

Indeed, I was tempted to take as my text today one of Fred Hirsch's last dicta: "A controlled disintegration in the world economy is a legitimate objective for the 1980's . . . ." The phrase captures what seems to me the prevailing attitudes and practices of most governments in this decade, as they struggle with two central issues that bedevil so much of our negotiations and our actions, not just with respect to money, but over the full range of international economics.

We live in a world in which individuals and businessmen, as never before, have the capacity and the incentives to buy and sell, invest and travel, where they want and when they want—and they want to do so unencumbered by national boundaries. At the same time, modern democracies, at least as much as other forms of government, long for autonomy; they want to control their own destinies in ways responsive to the needs of an electorate often concerned less with national than with local or sectorial interests. Yet, theory and experience indicate we can't have it both ways, full integration and full autonomy.

A compromise needs to be struck, and the way we strike that compromise seems to me conditioned and vastly complicated by needed adjustments to another set of circumstances. The United States no longer stands astride the world as a kind of economic colossus as it did in the 1940's, nor, quite obviously, is its currency any longer unchallenged. Now, other centers of strength and power have arisen in the indus-

* Concurrently being published in the January 1979 issue of *The Banker* (London)
These remarks are in the nature of a personal reflection; they do not purport to reflect the official views of the Federal Reserve System or any United States administration

trialized world, and they will need to share in the leadership. Developing countries have a new economic importance and political consciousness of their own.

A world of more widely dispersed power may have some advantages. But ease of achieving consistent and coherent leadership in the collective international interest is not among them. Intellectually, it is easy to recognize our interdependence. But in practice the instinct is to exert our independence.

Perhaps in the circumstances, the objective of "controlled disintegration"—modest as it may seem to be—is indeed a legitimate goal. Yet the phrase leaves me uneasy.

I start from the premise that the underlying pressures toward integration and interdependence are growing stronger, not weaker. We cannot reverse or stop the advancing technology that brings us fast and cheap communication and transportation, or the spread of knowledge. Nor can we fail to recognize the sheer gains in economic welfare inherent from a relatively free flow of trade and investment in a world in which endowments of labor, capital, and scarce natural resources vary so widely.

No doubt, we can conceive of national economic policies, whether purposeful or accidental, powerful enough to repel the integrating forces. Indeed, in the monetary sphere itself, we seem to have gone some distance in that direction.

But let us be aware of the difficulty of controlling disintegration, once fairly started. Already there are temptations to take instability in exchange rates as justification for measures to control or subsidize trade; restraints on trade in turn invite emulation and retaliation. I doubt whether we can proceed very far down that slippery slope while retaining market mechanisms as the main guides to economic adjustments, or without disappointing minimal expectations of rising living standards (particularly among those "southern" nations only now entering into a "manufacturing age" which seek our markets). And in time, an increasing sense of commercial rivalry could cloud—or perhaps rather define—political relationships among nations.

I was tempted to take as my text . . . one of Fred Hirsch's last dicta: "A controlled disintegration in the world economy is a legitimate objective for the 1980's. . . . "

I do not suggest that we stand on a knife's edge, forced to choose between integration and autarchy. But I would much rather take as my rallying cry, as a focus for necessary negotiations, as an ideal from which to measure progress, the challenge of "managing integration" rather than disintegration.

I inescapably approach these problems from the context of American experience with the international monetary system, a system in which the dollar has long played a special—in fact an integrating—role. There are those, of course, who would reject the label "system" as descriptive of the current state of affairs. Certainly, it lacks the sense of agreed structure explicit in the Bretton Woods agreement (a structure, let us not forget, not always paralleled by the actual operation of the "Bretton Woods system"). Nor does the present system bear much resemblance to the theorizing about floating exchange rates, at least as propagated by the enthusiasts in the 1960's and early 1970's. Indeed, it may not be entirely appropriate to label the system by the single word "floating", as I shall for convenience, for it has hybrid elements, reflecting in part the absence of a strong consensus on the manner in which it should be managed.

But let us be aware of the difficulty of controlling disintegration, once fairly started. . . . I would much rather take as my rallying cry, as a focus for necessary negotiations, as an ideal from which to measure progress, the challenge of "managing integration" rather than disintegration.

The "free form" of the present system is hardly surprising, given the circumstances of its birth in early 1973. There was no agreed sense among governments then (and perhaps not even now) that floating provides a basis for a superior monetary system over time, although some officials of some governments had come to hold that view. In the framework of the reform discussions that were taking place before and after the decision to permit the dollar to float, floating exchange rates were eventually relegated to vaguely defined "special circumstances".

No doubt, the events of early 1973 could be considered one such "special circumstance"—it reflected an inability to conceive of any other practical way of proceeding at the time. That conclusion was widely shared despite (or perhaps because of) sharp differences about the desired future evolution of the system. But that was not a setting which encouraged governments to give priority to efforts at "systemization", in the sense of developing agreed codes of conduct within a framework of floating rates.

In the event, floating has of course turned out to be more than a temporary escape valve. Conventional thinking—influenced by the evidence of economic instability all around us—has changed to the point that it finds it difficult to conceive of any general return to officially sanctioned and defended exchange rates. But more than passive acceptance of the *status quo* is involved. After the end of the reform discussions, successive American administrations aggressively espoused the floating rate doctrine on its own merits. They had strong support from economists—liberal and conservative alike—within and outside official circles. Mainly schooled in and preoccupied with the economics of a closed (or nearly closed) economy, the economists tended to see floating primarily as a way of freeing macro policy from the awkward external constraints of the balance of payments. At the same time, they theorized that, in practice, floating rates could provide as much, or even more, stability than was evident in the latter days of Bretton Woods. The point had obvious appeal to political leaders with a full plate of domestic problems, particularly if they did not fully appreciate the warnings of those economists who emphasized the importance of price stability at home to the orderly functioning of the system. Some key Congressional figures, important because they held a virtual veto power over legislation that would be necessary to implement a new monetary system, became particularly ardent supporters. And important elements of the financial and business community, fearing that the defense of any set of fixed rates would lead to controls on capital or even on trade, provided powerful support. Similar thinking was evident in some other important governments; the allure of autonomy was strong.

The idea of floating as a fully respectable and more or less permanent part of monetary arrangements now has its institutional manifestation in the new Article IV of the IMF Agreement. But that Amendment does not provide much in the way of substantive guidance about how the system should operate, beyond rather broad strictures to "behave thyself".

There have been attempts, first in the reform discussions and later within the IMF, to specify codes of conduct for the new system, at least in the area of defining rules to govern intervention practices. But these efforts have not gone far enough to have had much influence on actual behavior. Present arrangements are also, if not quite silent, then reticent on such matters as the size and composition of reserves, the appropriate or inappropriate use of controls, and the like. There is, indeed, acceptance in principle (or perhaps I should say in writing) of the need for international surveillance. But the actual practice, except when countries find it necessary to borrow in the higher credit tranches of the IMF, is undeveloped. In fact, an IMF council of representative national finance ministers, which was intended to provide adequate political authority to the surveillance process, has not even come into formal existence despite years of discussion and authorization in the new articles.

As all reform discussions have made clear, these are matters fraught with technical difficulties. But large as those technical difficulties are, they cannot in my mind fully account for the lack of progress in providing a more precise framework for the operation of the present system. Nor can we claim that the operation of the system has been so effective as to render the question irrelevant. Present arrangements have plainly not afforded the sense of stability or speed of adjustment one would instinctively associate with a well-functioning international monetary system. That is as true today, more than five years after its origin, more than three years after the major recession, and at a time when the extraordinary OPEC surpluses have largely been absorbed, as it was in the turbulent "learning" period.

The happy days of Bretton Woods, often viewed today with nostalgia, were a special case, workable because of a particular economic and political setting . . . . the inherent contradictions in the system were too great. With the benefit of hindsight, it would seem that an erosion of the United States competitive position was implicit in the postwar arrangements.

It would surely be wrong to point to international monetary arrangements as the principal source of instability at a time when many national economies have been marked by home-grown inflation, when growth trends have diverged so widely, and when the world economy has had to try to adjust both to the oil shock and the dislocation of the dollar. But it seems to me equally wrong to evade the question as to whether the management—or lack of management—of the system has not to some degree contributed to the instability or, to put it another way, has failed to provide timely incentives for better economic performance. It does not seem to me an adequate answer to the question to suggest that the system would be more stable if only national economies were stable. Of course, that is true. But, as with chickens and eggs, how does the benign process start?

The contrast between the troublesome performance of present arrangements—at least as measured by the extreme volatility of exchange rates and the slowness of current account adjustment—and rather passive acceptance is striking. It seems to me to reveal much about the problems and preferences of governments in operating a monetary system. Management of an international system requires that certain rules and decisions be agreed among a number of countries, and those participating must have a sense of obligation to conduct their affairs within that framework.

The most sensitive of the rules and decisions involved the exchange rate itself. There is a becoming professional modesty amongst economists about their ability to approximate equilibrium exchange rates. The views of different countries, looking at the same exchange rates from different perspectives, usually differ. There is no objective way to settle the question. Yet no country today can feel indifferent to the decision. There are direct effects on industrial activity and structure. Support of an exchange rate structure may entail financial costs and impinge upon domestic policy whether as a result of intervention or because explicit adjustments in monetary or other policies will become necessary. And when financial markets are so open and fluid as in today's world, the potential costs and pressures seem even greater than in the past.

In these circumstances, it is tempting to look to the market itself as an impartial arbiter. If the result is instability, then the potential costs in terms of integration may become relatively high. But balancing the requirements of a stable international system against the desirability of retaining freedom of action for national policy, a number of countries, including the United States, opted for the latter.

Others—most particularly smaller countries with open economies—may and do feel differently. To a considerable extent, their choices are limited by those of others, and they have a clear interest in binding these larger trading partners to codes of conduct. But they have not generally wanted to be bound by rules restricting their own options still further.

The nice question to which I want to return is whether these choices and compromises have, in fact, been appropriately struck—and whether the promise of autonomy, even for the United States, is not more than present arrangements can deliver.

The compromise appeared in a vastly different light at Bretton Woods. The world of Bretton Woods was, of course, a lopsided world. There was the United States emerging from World War II with unrivaled economic, financial, and political might; across the oceans were devastated and divided nations. Looking back at the disturbed interwar period, farsighted leaders of both the strong and the weak could appreciate the enormous potential for their own economies in an open, nondiscriminatory world paving the way to growth of trade and international investment. A par value system, with exchange rates ordinarily confined in narrow limits, bolstered by international credit facilities and at least the formal obligation for international monitoring and approval of exchange rate changes, seemed the logical monetary component of such a world.

There were, to be sure, strong reservations on the European side to participating so fully in an open world order, given their economic vulnerability. But the economic reservations were overcome by arrangements

A nation, most of all a great world power, does not want to be hampered in its domestic policies, or in its international security or political objectives, by external economic constraints, and specifically by the need to guard against a breakdown of the monetary system.

not an inherent part of the formal structure and symmetry of Bretton Woods, but which plainly recognized the asymmetry of the world as it was. The United States, in effect, held an umbrella over the system. It accepted a long transition period toward convertibility and open markets for weaker countries. A few years after Bretton Woods, exchange rates were fixed at levels that, in purchasing power terms, vastly overvalued the dollar. The Marshall Plan provided the spark and part of the substance for European recovery. And, in the background, the willingness of the United States to assume the major costs of the common defense—and the palpable need for a strong common defense—helped provide the incentive and will for cooperation.

The results turned out to be broadly consistent with the economic and political interests of the United States and its trading partners alike. Leading from a position of strength, the exchange rate relationship was hardly a burden for the United States. Rather, for a long time, it would enjoy the benefits of cheap imports, while its exports (largely of goods that could not yet be produced in volume elsewhere) benefited from increased buying power abroad. External defense and economic assistance did pose budgetary costs for the United States, but there was no "transfer" problem. With the international value of the dollar unquestioned, the use of the dollar as a reserve currency provided a ready means for satisfying demand for increased reserves of others without straining those of the United States. It also helped provide the flexibility to meet shifting international economic, defense, or political commitments of the United States—and to permit free outward capital flows—without much concern about an external constraint.

Other countries found they could increasingly compete effectively while rapidly rebuilding their economies—export-led growth became the norm for some. While there came to be political qualms, American investment speeded the growth process, helping particularly to bring modern technology and production methods. There was a broad coincidence of political objectives and low defense costs. Most leading countries were able to maintain exchange rates for long periods. The relatively stable level of prices within the United States made the dollar an acceptable unit of value. Both trade and capital flows flourished.

What was not so widely appreciated was that these happy circumstances depended on premises that were not sustainable in the new world the monetary arrangements themselves helped bring out. Viewed in that light, the happy days of Bretton Woods, often viewed today with nostalgia, were a special case, workable because of a particular economic and political setting.

It was symptomatic that hardly were the last books on the "dollar shortage" published than new authors set to work on the "dollar crisis". Triffin, as early as 1959, only a year after the restoration of European currency convertibility, produced the classic description of the ultimate fallacy of operating a system on the basis of increasing use of a convertible reserve currency. The "Triffin dilemma" inspired a long collective effort to reinforce the system by creation of a new international reserve asset. But, as that effort proceeded and before it would be crowned with full success, the persistence of the involuntary payments deficit of the United States raised still more difficult dilemmas in the management of the adjustment process in a fixed rate system, especially when the adjustment directly involved the United States and the dollar itself.

For years, exchange rate adjustment as a means of approaching the dollar problem could barely be mentioned—much less seriously considered—in polite official circles. The instinct was strong, and with justification, that a change initiated by the United States in its own exchange rate was bound to be profoundly disturbing in a system in which the dollar had not only become the leading reserve medium, but a trading vehicle and unit of account for almost all the Western world.

Appreciation of other leading currencies never seemed (to me at least) to provide an answer. It was expecting too much to think then, before inflationary concerns had become so great a consideration in exchange rate policy, that individual countries would voluntarily take the political and economic risks of seeming to write off export jobs and profits so long as they had another alternative. Even as occasional appreciations did appear in the latter days of Bretton Woods, in response to strong market pressures, they inspired a certain ambivalence; the potential small relief to the United States balance-of-payments position from limited and scattered appreciations had to be balanced against the psychological undermining of confidence in the United States dollar, risking an unraveling of its fixed position. Actually, of course, devaluations by foreign countries remained more common long after the United States payments position came under pressure, persistently working against the efforts of the United States to deal with its adjustment problem.

The origins of the dollar as a reserve currency antedate Bretton Woods; the design for the postwar monetary system did not contemplate a striking new departure in that respect. Markets, not governmental intentions, make and sustain an international currency; the increasing role flowed quite naturally from the political stability of the United States, its relatively stable economic performance, the sheer size of the economy, and its open financial markets. But it is also true that the international use of the dollar was freely accepted by the United States and supported formally by the policy of gold convertibility. As time passed, it came to be seen as a convenient and even essential means for operating a monetary system that was broadly in accord with United States economic and political interests.

As might be expected, sensitivity to protecting the stability and international role of the dollar was strongest among the Treasury and Federal Reserve officials directly involved in its management. Their instincts at the time of the first stirrings of the "gold problem" in the late 1950's were orthodox: concern about the dollar contributed to the relatively tight fiscal and monetary policies at the end of the 1950's. The recession that ensued—whatever the reasons for it—helped narrowly elect a new President, but it probably did not help the cause of orthodox measures to protect the balance of payments. The analogy of the "tail wagging the dog" seemed particularly apt for a continental economy with exports then a little more than 3 percent of the GNP.

We have learned that even large exchange rate changes have not been nearly as effective as hoped in achieving adjustment of long-standing imbalances in current account positions.

As it happened, President Kennedy, perhaps partly because he did not initially enjoy wide confidence in the business community, was himself instinctively apprehensive of the potential political and international effects of a dollar crisis (one of his biographers has reported that "he used to tell his advisers that the two things which scared him most were nuclear war and the balance-of-payments deficit"). But there also began to be, for the first time in the postwar period, a sense of dilemma between "getting the country moving again" and maintaining confidence in the dollar.

For years, the issue could be, and was, dealt with in a manner that did not seriously compromise domestic policy. The need to protect the dollar did influence macro-policy, but the influence was felt largely at the margins (as in the effort to "twist" short-term interest rates higher in the early 1960's) or to provide support for major and politically difficult policy steps that had a plain domestic justification, notably in the fight for a tax increase in 1968 when concern about the dollar became a clinching argument for a reluctant Congress. From the late 1950's onward, efforts were made to reduce the balance-of-payments effects of the overseas defense burden and economic assistance. More importantly, against American instinct and tradition, controls were placed on some capital transactions.

The effectiveness of these approaches was limited in part by the inherent limitations of such selective measures. But it also seemed to me that, as time passed, the will to retain or reinforce these measures dwindled as they more clearly cut into other perceived objectives domestically or internationally. It was symptomatic that, by 1968, the winning Presidential candidate pledged in his campaign to remove the capital controls—a pledge honored only after the floating system came into effect—despite the parlous state of the balance of payments and rumblings of uncertainty about the dollar. And, as business chafed under the restraints of balance-of-payments programs, so did others within the government who found room more limited for foreign policy initiatives that had balance-of-payments costs. The line was drawn quite clearly at security commitments; they would not be impaired.

The system held together for a decade and more after the first signs of weakness, despite the resistance to more fundamental adjustment measures. International cooperation flowered in the area of new financial mechanisms and improvisation to deal with potential points of breakdown—the swaps, Roosa bonds, and multicountry packages of short-term financial assistance to maintain the stability of one currency or another were born during that period. These complex mechanisms had limited economic costs or political risks and could be sustained and expanded over time. Probably more important, but less obvious, was the self-interest of other countries in maintaining a highly competitive external posture, and their perception of the long-term stability of the United States and its currency. United States growth and a credible defense posture were important to others than Americans, so there were strong incentives to avoid aggravating pressures on the dollar by refraining from gold conversion —and as the conversions were delayed it soon became evident that conversion on a large scale was no longer practically possible.

But in the end, the inherent contradictions in the system were too great. With the benefit of hindsight, it would seem that an erosion of the United States competitive position was implicit in the postwar arrangements. First Europe and later—with even greater momentum—Japan brought its industrial capacity and efficiency close to United States standards. It took some twenty years, but eventually the United States payments position was irreparably undermined. The full extent of the erosion never was reflected in price indices. But it happened and businessmen and unions knew it was happening. By the end of the 1960's protectionist instincts were aroused, particularly in the labor movement, directly threatening maintenance of a liberal world order. By that time, it began to look as if no feasible combination of macroeconomic or other policies would offer credible approaches to the underlying adjustment problem, even though cyclically tight money for a time strengthened the dollar.

The risks of initiating an exchange rate change for the dollar also seemed high, whether viewed from the standpoint of domestic politics or damage to the international system. There were strong doubts about the willingness of other countries to permit a sizable adjustment, however initiated. So there was no eagerness to precipitate exchange rate action before the need became crystal clear.

Finally, in August 1971, the United States did move decisively to promote the adjustments that seemed necessary. The precise timing was forced by the desire to retain some room for initiative in a situation where the pressures on the dollar were inexorably moving to the point at which inconvertibility would be forced upon us in any event. But the way was eased by the fact that decision provided an appropriate setting for a sudden shift in the administration's domestic policies that seemed urgent in its own right, for dealing constructively with protectionist pressures, and for pushing reforms of trading practices and a realignment of defense burdens that, to us at least, seemed necessary to restore and maintain the United States external position for the longer run.

It turned out to be a contentious period. The historians can debate whether it was unnecessarily contentious: Mr. Connally's manner may have grated some foreign (and a few domestic ears), but it was no mean feat to manage a devaluation of the proud dollar in a way that did not turn American opinion and policy inward.

The conclusion reached by some that the United States had shrugged off responsibilities for the dollar and for leadership in preserving an open world order does seem to me a misinterpretation of the facts. The effort to devalue the dollar externally was, you may recall, accompanied by a program to deal with inflation internally. The devaluation itself was the strongest argument we had to repel protectionism. The operating premise throughout was that a necessary realignment of exchange rates and other measures consistent with more open trade and open capital markets could accomplish the necessary balance-of-payments adjustment.

The confusion about intentions stemmed in part from the fact that the United States did, for the first time in decades, move to exert strong influence on its own effective exchange rate—something that had not seemed practical under the Bretton Woods system. There was a sense that the United States no longer had the capacity, politically or economically, to accept the position of "nth" country in the monetary system, passively reconciling the balance-of-payments objectives of others. Put more concretely, the United States was reluctant to resume convertibility without a reasonable prospect for maintaining a strong enough balance-of-payments position to support that obligation. That in turn implied the need for a thoroughgoing reform of the monetary system that reflected the new balance of economic power.

If . . . markets come to believe exchange rate stability is not itself a significant policy objective, we should not be surprised that snowballing cumulative movements can develop that appear widely out of keeping with current balance-of-payments prospects or domestic price movements. At that point, freely floating exchange rates, instead of delivering on the promise of more autonomy for domestic monetary or other policies, can greatly complicate domestic economic management.

Presidents—American presidents—have not in my experience wanted to spend much time on the complexities of international finance. But the repeated charge to the negotiators seemed clear, and in a sense ominous: "I want a system that doesn't have all these crises!" The preoccupation was clear enough: a nation, most of all a great world power, does not want to be hampered in its domestic policies, or in its international security or political objectives, by external economic constraints, and specifically by the need to guard against a breakdown of the monetary system. In other words, we wanted an open system, but like others had a taste for autonomy too.

To me, the charge to find a crisis-free system could not be satisfied. The passage of time has not altered the judgment. In an open system, the external constraint is there. If ignored for long, a crisis will develop. But a crisis can also be therapeutic—it forces a response.

The first way station in the combined adjustment and reform effort was the Smithsonian Agreement. The problems in reaching that limited agreement provided ample warning of the inherent difficulty of reconciling the varied objectives of different countries when no single participant felt itself strong enough to, in effect, take the risks of underwriting the system.

In retrospect, it still seems a remarkable achievement for the industrialized countries to have agreed together on a new grid of exchange rates. But the agreement was flawed from the start. From an American perspective, the agreed exchange rates (and the barely discernible changes in trade barriers) fell well short of promising the adjustments in the United States balance of payments necessary to provide assurance that the new dollar could be maintained, a judgment that seems amply confirmed by subsequent developments. That ended any possibility of others persuading the United States at the time to assume a formal commitment on its part to sustain the new pattern. Convertibility would be left for subsequent negotiations, when its sustainability could be judged in the context of an entire new system.

As a result, neither the economic underpinnings nor the sense of mutual commitment to the Smithsonian arrangements proved strong enough to induce countries to take strong action to repel speculative attack. The British defected by summer 1972 with what appeared, by earlier standards in defending a fixed exchange rate, to be relatively little provocation. When an intra-European currency disturbance led to floating of the Swiss franc and to strong renewed pressures on the dollar in February of 1973, the moment was seized to arrange a further general and larger exchange rate realignment—not after months of difficult negotiation as in 1971 but in days.

Attitudes had plainly changed. In retrospect, some of the Smithsonian haggling over minute changes in exchange rates must have seemed ridiculous; the earlier changes had neither helped as much nor hurt as had been anticipated. To me at least, the new exchange rate pattern this time did seem economically appropriate and defensible. But by that time we had had too many changes in exchange rates too frequently to make any fixed rate easily credible. It had become evident, in the midst of the crisis, that official inhibitions on floating were fast diminishing. When the United States devalued, both Japan and Italy found it easier to respond by floating than by taking the political responsibility of fixing a new exchange rate. There was already a strong strand of opinion within the United States administration sympathetic to floating, and that opinion began to find some echoes elsewhere. As inflation gained momentum, some surplus countries, in particular, saw their efforts to restrain their money supply undercut by the defense of a fixed rate. Moreover, there was no urge to settle unresolved disputes about the form and nature of convertibility obligations in a new monetary system in the heat of crisis. So, when the new rates came under attack in the market, the alternative of permitting the dollar to float for an indefinite period no longer seemed so unthinkable a step. The industrial countries were tired of trying to make a fixed exchange rate system work, at least without reaching fundamental agreement about the manner in which such a system would work.

The American proposals that provided most of the focus for the on-going reform negotiations were designed to develop the logic of a par-value convertibility system suited to a more symmetrical world. Part of our preoccupation—and that of others—was to develop even-handed pressures on surplus and deficit countries for adjustment. Others were preoccupied with ensuring that the United States, as the most powerful country and the provider of the reserve currency, could not evade discipline. These concerns on both side for a fair sharing of responsibilities seemed to require more continuous, stronger, and more explicit international surveillance than that to which we or others had been accustomed. And even with significant new elements of exchange rate flexibility, there was an implication of the need for closer coordination of demand management, and particularly monetary policies.

The particular role of the dollar in a future system was a source of confusion in the discussion. To some, providing a reserve currency had aspects of what General de Gaulle had long before termed an "exhorbitant privilege" and, more technically, some were fearful that its use could delay the need for American adjustment. The United States looked at the other side of the coin; other countries could refuse adjustment by piling up dollars and thrust us back in the "nth" country position. In the last analysis, most other countries did not seem to want to give up all the flexibility in reserve management afforded by reserve currencies, nor did the United States want to lose all the element of elasticity provided by some use of the dollar. So, at times, it seemed possible that the basic positions were not so far apart. But the negotiators never fully resolved the more technical questions of how outstanding dollars would be consolidated—a matter of direct and visible financial consequences for participating countries—and the larger question was dropped with the reform effort.

The vision of a highly structured new monetary system that emerged from that debate may rest on the library shelf, but three observations drawn from that debate and subsequent events still seem relevant. First, in the last analysis, the practical politician, already struggling with intractable domestic problems and pressures and looking toward a murky future, does not want to be bound by more rules and obligations than absolutely necessary—and the more precise and complicated the rules, the more difficult to reach agreement. Large and small countries alike resisted the requirements for heavy and explicit surveillance from without and for policy coordination—all under the oversight of a rather anonymous supranational body that, in the eyes of domestic legislators, would lack political weight or even legitimacy. In concept, the need for these disciplines could be recognized. In practice, the way the rules would be defined was crucially important to all, but views about just which rules were important did not easily coincide.

I do not depart from the strong consensus that we have, on a worldwide scale, no other practical choice than to work ahead within the broad framework of a floating system—and that system offers the most promising framework for "managing integration" as far ahead as we can now see.

My second observation is that the reluctance to develop a highly structured system does not mean the underlying issues will not return. Indeed, I believe they are returning, for they are inherent in the management of any international monetary system.

Third, the difficulties of writing a rule book for a highly structured system, combined with simple observation of the divergences of policy and performance in the real world, suggested that floating could be—indeed would have to be—more than a safety valve. If imperfect, it need not be the disaster that so many looking back at the 1930's feared.

By and large, that has been the way it has worked out. From the standpoint of integration, growth in trade has slowed, but not necessarily more than could be explained by the slower growth in worldwide GNP. Amid all the turbulence in exchange markets, financial markets have successfully recycled massive amounts of funds from OPEC and other surplus areas to points of need in the developing world and elsewhere. The general trend of exchange rates has been broadly in the direction of changes in purchasing power parities—in other words, real changes in exchange rates have been generally smaller than the nominal. And the real exchange rate changes have themselves generally been in a direction suggested by structural or cyclical payments imbalances.

Quite obviously, the industrial world has had more inflation and less growth over recent years than that to which it had grown accustomed. But those problems clearly had their roots in earlier developments, and it seems to me a fruitless exercise to try to compare what has happened with what might have happened under some quite different system.

But I do think we can say, with some confidence, that, whatever the net balance of pros and cons, experience had begun to reveal some potential difficulties more reminiscent of the flavor of the 1930's than much of the theorizing.

For one thing, we have learned that even large exchange rate changes have not been nearly as effective as hoped in achieving adjustment of long-standing imbalances in current account positions. Where clear improvements have been made, they can be traced mainly to changes in relative demand pressures, or to structural changes such as North Sea oil. I do not doubt that trade and current account positions will in time shift in response to real exchange rate changes, but I believe we are learning that the process takes a number of years—possibly even a decade—to work its way fully through the economic structure.

At the same time, there is little evidence that floating exchange rates have substantially dampened the tendency for changes in business activity in one country to affect the trade of others. Changes in income continue to dominate current account balances in the short run. The shifts in current account positions may exert a pronounced influence on exchange rates, but the exchange rate movements will not, in turn, have much impact on cyclical imbalances. Indeed, for extended periods, J-curve effects may be perverse.

Above all, we have seen again and again what some had forgotten—in these circumstances, exchange rates can be dominated by expectations of what they will be tomorrow, or next month, or next year. And, those expectations will be volatile when divergencies in national policies seem pronounced, or when those policies are subject to great uncertainty. If in these circumstances markets come to believe exchange rate stability is not itself a significant policy objective, we should not be surprised that snowballing cumulative movements can develop that appear widely out of keeping with current balance-of-payments prospects or domestic price movements.

At that point, freely floating exchange rates, instead of delivering on the promise of more autonomy for domestic monetary or other policies, can greatly complicate domestic economic management. Strongly depreciating currencies will not only reflect but exaggerate inflationary forces; in an inflationary world, appreciations may assist efforts to stabilize the domestic price level, but they will undercut efforts to deal with the other side of the "stagflation" dilemma. As uncertainty infects domestic as well as international financial markets, business decisions to invest slow down.

But it is not only domestic economic management that is affected when swings in exchange rates lose touch with underlying price and interest rate relationships. When patterns of trade or capital become influenced by monetary fluctuations rather than lasting comparative advantage, the underlying rationale of a liberal trade and investment order is undercut. The point is not merely theoretical. The instinctive political reaction in the face of seemingly capricious impacts on one industry or another is to protect or subsidize domestic industry, or to impede the flow of capital.

We have had plain enough warning of the fact that international money, any more than domestic, will not manage itself. It will deliver neither the promised autonomy nor integration if we fail to deal with some of those issues that were unresolved in earlier efforts at more structured reform.

Major nations have wisely and repeatedly pledged themselves during this disturbed period to maintain open markets. By and large, they have resisted the pressures to turn inward. But we cannot be blind to the evidence that, under strong pressure from monetary instability as from other forces, the fabric of discipline is fraying at the edges.

I do not depart from the strong consensus that we have, on a worldwide scale, no other practical choice than to work ahead within the broad framework of a floating system—and that system offers the most promising framework for "managing integration" as far ahead as we can now see. It seems to me particularly suited to a world in which the major adjustments, in trading patterns and in political thinking and organization, required by the dispersion of economic and political power have not yet been completed.

But, at the same time, we have had plain enough warning of the fact that international money, any more than domestic, will not manage itself. It will deliver neither the promised autonomy nor integration if we fail to deal with some of those issues that were unresolved in earlier efforts at more structured reform.

In quite different ways, the monetary initiatives under way in both Europe and the United States reflect

We cannot identify with any conviction or agree upon an "equilibrium rate". But it should be possible over time to reach a broad consensus about levels of a few key exchange rates that are *not* acceptable— that are plainly disruptive of mutual objectives.

a new appreciation of the dangers. A European Monetary System and the forceful program to stabilize the dollar at home and abroad can help point to solutions. I would like to suggest, in a very general way, how we might build on those initiatives in several areas.

The exchange rate is the most visible and sensitive manifestation of an international monetary system— and exchange rates inherently involve the interests of more than one country. A floating rate offers two enormous advantages in a world of uncertainty, and where more than one sovereignty is involved; it requires neither explicit international agreement nor a closely defined commitment to defend. For larger countries, these advantages are likely to remain decisive. But they do not negate the fact that, at some point, left to themselves the swings in market rates can become so large as to damage the growth and stability of countries with both depreciating and appreciating currencies.

We cannot identify with any conviction or agree upon an "equilibrium rate". But it should be possible over time to reach a broad consensus about levels of a few key exchange rates that are *not* acceptable— that are plainly disruptive of mutual objectives. I refrain entirely from the semantics of target or reference rates, which imply more confidence about identifying a central tendency or a narrower range of fluctuation than is warranted today, and a formality of obligation that is beyond our reach.

What I have in mind is more in the nature of quiet mutual contingency planning. Clearer understanding of a few leading nations among themselves about what extremes of fluctuation are mutually tolerable, and which should be strongly resisted, would seem to me to enhance the prospect for effective domestic policy-making, as well as lay a base for more stability in international markets. After all, we have the example before us of even the largest country, the United States, finding that it had to care when it found its domestic policy undercut by extreme exchange rate movements—a lesson long ago learned in the United Kingdom. At the same time, a sense that extreme fluctuations will be resisted and reversed could help stabilize market expectations, and thus reduce the risk of those extreme fluctuations developing in the first place.

I do not suggest that merely stating the objective will produce the result, or that there should be any public commitment to particular rates. It will be action that counts. In that connection, intervention alone seems to me a relatively weak reed upon which to lean; it will be effective over time only if more fundamental policies support the objective. Prolonged and massive intervention itself, of course, has implications for domestic monetary policies. But, in the end, if we are serious, domestic policy measures will need to be brought more consciously into action. The lesson of experience is that those instruments will, sooner or later, need to be used with force when markets become disruptive. At that point, the risks to the domestic economy may be greater than if more marginal changes were made earlier, before market uncertainty becomes so great and expectations perverse.

In an American political context, it has been a difficult matter to bring these considerations of exchange market stability to bear on a Congress or even an executive preoccupied with the domestic economy. In retrospect, the case can be made that, more often than not, a more forceful response to pressures on the dollar would have ultimately been helpful in promoting domestic as well as international stability. Experience in late 1972 and early 1973—when policy was slow to recognize the impending inflationary explosion—is one case in point. A floating system, unlike a convertibility system, does not flash its warning signals in a way that more or less demands a prompt policy response, but we need to learn that the warning is there nonetheless.

There seem to me implications for the way we organize ourselves for economic policy decisions. I alluded to the tendency in the United States to think of domestic and international economic policy as distinct, and the latter as the tail on the dog. The analogy is less apt as time passes, and the United States economy has become so much more exposed to external developments. Yet, partly by the accident of personalities, partly by explicit organization, the responsibilities for, and direct exposure to, the international side of the equation have sometimes been lodged with those most influential in domestic policies and sometimes not. Historically, the main preoccupation of Presidents themselves in the international arena has understandably been with security and political matters; the international dimensions of economic policy have not had the priority many foreign leaders attach to it. The situation is further complicated by the dispersion of responsibilities in the committee system in the Congress, where there are no mechanisms for looking at international economic policy as a whole, or for regularly blending oversight and legislative responsibility with those for domestic policy.

It is a matter of emphasis and continuity to which there are no simple organizational answers. Efforts to deal with the situation in both the Congress and in the earlier administrations of which I was a part were inevitably impeded by efforts to protect the bureaucratic "turf" and institutional jealousies. Even within the independent Federal Reserve, the right balance is hard to keep.

No doubt comparable problems exist in other large governments. But my experience strongly suggests that our mix of policies will be more effective as those responsible for the external side are also in the mainstream of domestic policymaking.

Obviously, the characteristics of economies differ in their exposure to foreign trade. A looseness of exchange rate relationships tolerable for some countries with relatively small external sectors may not be so desirable for others which feel more exposed. One approach toward reconciling those different needs is inherent in the current effort toward a European Monetary System. Clearly, that effort has more than economic dimensions—it is a part of the larger European ideal and a matter for European decision.

As Fred Hirsch emphasized some years ago, the transition toward a European system could pose difficult problems. I hope we will all be alert to dealing with the complications that the transitional period could present for international cooperation on a wider scale, to protecting the legitimate role of the IMF, and to the implications of decisions within Europe for the monetary systems as a whole. But I see no inherent conflict with the needs of the international system once the new regional system is fully effective. One important group of countries will have achieved conditions of monetary stability for the greater part of their trade. In economic relations with the rest of the world, Europe would be in much the same position as the United States and Japan with respect to trade and external influence. In those circumstances, with Europe speaking with one voice, a harmonious approach toward the international system could be easier than before.

There does seem to me a latent danger—no part of the intention of present European leaders—implicit in the development. Regional monetary unity implies a greater degree of visible loss of autonomy for member countries; yet national economic problems will remain. The temptation could arise to solve some of these regional adjustment problems within Europe by direct subsidies to producers, by protection against the outside world, or by other means damaging to the trading opportunities of others.

In the last analysis, the United States, Europe, and Japan have similar endowments of skills, technology, and industrial plant—our comparative advantages *vis-à-vis* each other are not immense. (Ironically, where they are greatest, in agriculture, some of the largest barriers to trade exist.) At the same time, we are each heavily interdependent with the third world. In theory, a process of disintegration within the *industrial* world could probably go a long way without intolerable damage to our economic welfare. But it is hard to visualize that process without it also leading to intense national competition for the markets and materials of developing countries. It would not be a pretty picture.

In considering the sources of the recent monetary disturbances, I recognize the point has been made that the very large proportion of dollars in official and nonofficial balances held for international purposes is partly a vestige of the old system, and a desire to diversify can potentially become an independent influence on the stability of current arrangements. However, the forces that motivate decisions to diversify by a foreign dollar holder are, in the last analysis, no different than those bearing on the decisions of those holding the vastly larger stock of dollars in the United States. And, experience suggests that, as the dollar strengthens, concern about diversification dwindles.

In retrospect, the case can be made that, more often than not, a more forceful response to pressures on the dollar would have ultimately been helpful in promoting domestic as well as international stability. . . . A floating system, unlike a convertibility system, does not flash its warning signals in a way that more or less demands a prompt policy response, but we need to learn that the warning is there nonetheless.

For those reasons, emphasis on the "dollar overhang" as a special problem has often seemed to me misplaced, for it could easily divert attention from the need for more fundamental measures to maintain confidence in the dollar generally. The vigorous domestic and international measures in support of the dollar recently announced by the United States, including some sales of United States Government obligations denominated in foreign currencies abroad, can relieve pressures from the direction of diversification, as others. But, if the problem is indeed more structural, it does not seem to me one for United States concern or action alone; if so, the preferred option for the United States would in all likelihood be the opportunity to earn back any excess dollars through a current surplus. There is something unedifying, moreover, about some central banks taking full advantage of the flexibility afforded by present arrangements to place their funds where and when they choose, while complaining at the same time about instability in the system.

In a floating system, some of the particular concerns in a convertibility system about controlling the volume and composition of international reserves appear in a different light and may reasonably have lower priority. But that should not mean that, with the collective instruments at hand, progress could not be made under international auspices toward achieving an appropriate balance between the supply of dollars and its desired use in official reserves.

All of this raises questions of governance—if the system is to be managed, who will do it and how. The obvious institutional focus is the IMF, and it plainly has a full plate of work ahead. I have long felt that, if that work was to proceed with full effectiveness, the effort of the international bureaucracy—however able, and it is very able—needs to be reinforced by more active regular participation by politically responsible officials of member governments. That is, of course, the rationale of the council authorized by the new articles. To a degree, the function has been performed on an interim basis by the advisory council. But it would seem to me useful, more than symbolically, for that body to assume now full legitimacy by transforming itself formally into the council, and renewing the sense of commitment to develop its surveillance function.

As a practical matter, that body will be too cumbersome and too far removed to deal adequately with some of the continuing issues of exchange rate and economic policy management that arise among the leading industrial countries, nor could it really hope to have the kind of political authority in those countries necessary to make the process work most effectively. That gap can be filled, it seems to me, only by more or less continuous consultation among the "trilateral" countries: Japan, Europe, and the United States. And the consultation must extend to the highest level. The recent practice of "economic summitry" points that way.

The value over time will not, I suspect, lie primarily in particular decisions reached at particular times; in fact, one of the potential problems with summitry is that, when world leaders meet together on a special occasion, there is an artificial pressure to respond to public expectations by dramatic new initiatives, even when the most sensible and realizable objectives may be more modest. Instead, the most important result can be in the less public process of exposure to each other's problems and viewpoints, working against the natural bias to focus primarily on the internal consequences of economic policy. There is a chance to develop common objectives that can also be practically fitted into the domestic context; sometimes, the setting of the summit can help provide the necessary impetus at home for appropriate domestic action. And, as mutual understanding is enhanced at the top, the response to particular problems as they arise from time to time can be facilitated and speeded at lower levels.

This may seem a modest program. All of it grows directly out of the logic of recent practices, market developments, and governmental decisions. But if commitments to the approach were meaningful—if those recent initiatives are interpreted not just as isolated events but as frank recognition of the fact that the recurring issues of monetary stability cannot be shrugged away—then I feel confident that, in the end, the floating system will come much closer to the ideal of reconciling our domestic and international objectives.

This turbulent period started with two dollar devaluations. I thought then, and think now, they were necessary to lay the base for needed adjustments in the world economy.

But they also, perhaps inevitably, helped upset expectations and loosen disciplines. We have not yet been able to restore a firm sense of stability.

Today, a stronger and stable dollar is plainly in the interest of the United States and the world. These recent months have, if nothing else, been instructive to all—a sliding dollar undercutting our own anti-inflationary effort, generating uncertainty at home and abroad, hurting growth. There has been a sense of drift, of a lack of control or direction in the monetary system infecting and reinforcing other sources of economic instability.

Now, we can see the beginnings of a new base. It cannot rest on the actions of the United States alone—for we are no longer the dominant power of Bretton Woods. But our strength can be joined with others to provide fresh impetus and a renewed sense of commitment to a stable international order. And as we do, an objective of "managing integration" may not sound so utopian after all.