

# Comments

*Peter B. Kenen*

**L**et me start with a rather long quotation. I have taken a few liberties with it to disguise its source temporarily.

[E]conomic interdependence among industrial countries has increased sharply in the last several decades, and this increase is likely to continue unless it is deliberately checked. . . .

The vast accumulation of capital and the international transmission of knowledge have reduced inter-country variation in comparative cost structure. . . . This narrowing of cost differences has been complemented by the reduction of transportation and communication costs and, since 1949, by the policy-guided reduction in tariffs and other artificial barriers to trade. . . .

[T]he psychological and institutional barriers to international capital movements among industrial countries [also] have eroded rapidly. . . . Capital tends increasingly to move in great volume from country to country in search of small yield differentials.

This greater economic interdependence has three consequences for national economic policy. First, it increases the number of “disturbances” with which national policy-makers must cope. Changes in incomes, prices, costs, and interest rates abroad are more rapidly transmitted into changes in the demand for domestic output or funds than they used to be, and these changes in turn affect domestic income, employment, prices, [and] interest rates. . . .

Second, the enlarged interactions among national economies will generally slow the speed with which traditional measures of economic policy take effect on the level of domestic employment, output, and interest rates, for each move will “spill over” into other economies and will evoke policy reactions there which will often weaken the influence of the measures initially instituted. . . .

Third, competition by one nation with another in the use of national policies can leave the community of nations worse off than it need be. Regulatory action or taxation may be thwarted by the prompt movement of regulated businesses beyond the jurisdiction of the regulating nations or by the shifting of profits through intracorporate pricing. . . .

In sum, as national economies become more closely integrated, national

freedom to set national economic objectives and to pursue them effectively with national instruments of policy is increasingly circumscribed.

Who wrote this passage? When was it published? It comes from Richard Cooper, in the final chapter of his book *The Economics of Interdependence*, published in 1968.

I do not mean to chide Cooper for repeating himself. Some things have to be repeated, because economists can barely keep up with newly published work and cannot reach back to refresh their memories or, for that matter, to read what was written before they began to practice the trade. Furthermore, there are important differences between Cooper's earlier treatment of the subject and the excellent chapter he has written for this book. I will return to these differences shortly. First, two observations about his earlier treatment of the subject.

Cooper was right in predicting that integration would continue. In fact, it continues even now, and the deregulation of domestic financial markets that is going on today in several countries will probably carry the process further. During the past decade, however, there has probably been some significant *disintegration* of goods markets, as distinguished from financial markets, with the spreading use of quantitative trade barriers outside the GATT framework. Comparing the current situation with the one in 1968, I would guess that goods markets are less closely integrated, despite the Kennedy and Tokyo rounds of tariff cuts and the enlargement of the European Community. But integration has gone on in another direction. In his book, Cooper concentrated on relations among developed countries. In his chapter here, he calls attention to many ways in which their economies are now closely tied to those of the less-developed countries (LDCs): The increasing dependence of the United States on raw materials that come mainly from the LDCs, the impact of recession and austerity in the heavily indebted LDCs on the level of U.S. exports, and, most important right now, the complex set of relationships described as the debt problem.

In one important respect, economic thought has gone in an unexpected direction. Cooper wrote his book shortly before the breakdown of the Bretton Woods system, and he did not anticipate or advocate the shift to more flexible exchange rates that took place in its wake. That is one important contribution of his chapter. It examines the ways in which floating rates have altered the policy problem facing industrial countries, and I will say more about this issue. But something else is new. Cooper made a recommendation in 1968 that he has chosen to omit from his current chapter. He noted in 1968 that the increased interdependence forces policymakers to confront three alternatives:

1. to accept the integration and the consequential loss of national freedom, and to engage in the *joint* determination of economic objectives and policies;

2. to accept the integration but attempt to preserve as much national autonomy as possible by providing financial accommodation for prolonged payments deficits;
3. to reject the integration by deliberate imposition of barriers to the integrating forces, freedom of foreign trade and international capital movements.

In his view, governments were not ready in 1968 to adopt the first solution, partly because they confused formal sovereignty with real freedom of action, and they were not even ready for the second, because it involved substantial confidence on the part of each government in the ability of the other governments to manage their policies. The third option he viewed as possibly winning by default. He ended his book on the pessimistic note that “unhappily, the principal contender to controlled use of restrictions is uncontrolled use of restrictions,” which seemed to be the direction in which the world was moving late in the 1960s.

If Cooper had written his book shortly after the breakdown of the Bretton Woods system and the shift to more flexible exchange rates, he might have been less pessimistic. Speaking for myself, because I cannot speak for him, I was prepared to believe that floating rates could rehabilitate national autonomy, not merely because central banks would be able to control national money supplies but also because the effects of monetary and fiscal policies would be bottled up to a greater extent, having more effect at home and less effect abroad. And many of us thought that floating rates would have important normative implications. Governments would not be constrained to pursue external balance, and there would be less need for them to concern themselves with the coordination of national policies, let alone the joint determination of policies, which was the first option on Cooper’s list in 1968. At the very least, some economists expected that floating exchange rates would reduce the temptation for governments to interfere with integration by the uncontrolled use of controls and would surely reduce governments’ need to interfere by the controlled use of controls.

In his chapter here, Cooper explains why those expectations were wrong. Formal models had not caught up with the process of integration; they did not pay enough attention to the consequences of capital mobility for the *modus operandi* of monetary and fiscal policies. To be sure, Mundell (1963) had brought some of those consequences to our attention, but economists were inclined to regard them as footnotes to standard exchange rate theory rather than basic revisions. They did not truly appreciate the chief consequence of capital mobility—that monetary and fiscal policies would function in large measure by attracting or repelling capital flows, which would in turn call forth balancing adjustments in trade flows, by way of the exchange rate, and that the adjustments in trade flows would have first-order effects on output and employment. They did not begin to understand that a floating exchange rate could lead a life of its own, nurtured by expectations about

future policies and other events, and that price flexibility in the market for foreign exchange could combine with price stickiness in the markets for goods and labor to generate large changes in real exchange rates, which could in turn affect output and employment more or less independently of current policies.

Economists have revised their views, and so have governments. Indeed, governments may have come full circle with the recent decision by the Group of Five (G-5), that is, France, Germany, Japan, the United Kingdom, and the United States, to concern themselves with the behavior of exchange rates, to intervene in foreign exchange markets, and, by implication, to assess the compatibility of their national policies by reference to their impact on capital movements and exchange rates. Economists may therefore confront today a set of options not too different from the set that Cooper set before them in 1968: (1) the close coordination of national policies, leading in the limiting case to the joint determination of those policies; (2) the partial financing of imbalances, by way of intervention; and (3) the controlled use of controls to reduce integration and restore national autonomy.

I may be reading too much into the G-5 decision. I hope not. But I would like to have Cooper's view. Let me ask him directly, then, what options are available? Is it still possible to contemplate a selective use of controls to separate national capital markets? Or have markets passed a point of no return? Would an attempt at selective disintegration induce enough avoidance and evasion to provoke an intensification and generalization of controls? Would the process of control get out of control? That is my fear and my reason for believing that Cooper's third option may not be available. In which case, of course, governments must decide how much coordination to combine with exchange rate management and the concomitant financing of imbalances, especially those that reflect large capital flows.

In most discussions of these issues, policy coordination is viewed as a precondition for exchange rate stabilization. But the recent report of the Group of Ten (that is, Belgium-Luxembourg, Canada, France, Germany, Italy, Japan, the Netherlands, Switzerland, the United Kingdom, and the United States) concedes that the "convergence" of national policies, whether expressed in terms of targets or instruments, may not be sufficient for stabilization, and my own current work has led me to believe that optimal exchange rate management should be viewed as a partial substitute for the coordination of domestic policies (see Kenen, 1985).

Cooper's chapter here raises many other issues. Let me mention four that call for further reflection.

Cooper notes that the correlation between U.S. and British interest rates has fallen sharply in recent years and that the average difference between them has risen. This was, he says, "a function wholly of differences in the currency of denomination," citing in evidence the persistently close correla-

tion between CD rates in the United States and Eurodollar rates in London. Does this really mean, however, that floating exchange rates have restored some monetary autonomy? The answer, I believe, depends on the way that interest rates affect the real side of the economy. If spending decisions by firms and households depend on the (real) domestic interest rate, Cooper is right. The variability of expectations about future exchange rates allows a central bank to influence expenditure by changing the size of the gap between domestic and foreign interest rates (by conducting itself in a way that affects exchange rate expectations or the size of the risk premium). If, instead, decisions by firms and households depend on the (real) domestic interest rate corrected for exchange rate expectations, more variability in that gap does not necessarily raise the influence of monetary policy on the domestic economy. I am inclined to agree with Cooper, who appears to believe that the *IS* curve should be drawn with reference to the (real) domestic interest rate, but economists must be very clear about this point.

Which brings me to my second point, one concerning the demand for money and thus the *LM* curve. Cooper is right to say that the increased openness of the U.S. economy casts doubt on the validity of the standard demand-for-money function. But he may give too much away when he says that “the only argument in the equation that is not brought into question by greater openness is the interest rate.” While I agree with Cooper about the *IS* curve, I am less sure about the *LM* curve. The foreign interest rate and exchange rate expectations may affect the demand for money. I am not impressed by simple currency-substitution models and the statistical evidence that has been adduced to support them. And I have trouble with the notion of “indirect currency substitution” that McKinnon (1984) uses to replace those simple models. Nevertheless, I continue to be intrigued by a remarkable coincidence. The famous mystery of the missing money cropped up just when the world was moving toward exchange rate flexibility. This may, of course, be the impact of a common cause; the acceleration of inflation in the early 1970s could have destabilized the demand for money while also being one reason why governments sought more monetary autonomy by letting their currencies float. But I am not satisfied by this explanation.<sup>1</sup>

My third point pertains to the endnote in Cooper’s chapter that deals with the impact of fiscal expansion on the behavior of a floating exchange rate and calls attention to an anomaly. Although fiscal expansion by the United States causes the dollar to appreciate, fiscal expansions by other countries seem to cause their currencies to depreciate.<sup>2</sup> I can think of several complicated explanations, one of them related to my next and final point, that the role of the dollar as an international currency may have macroeconomic implications distinct from those typically assigned to the large size of the U.S. economy. But there may be a simple explanation. The builders of large multi-country models are very careful to impose consistency on the behavior of

trade flows; exports from *A* to *B* are always made to equal imports by *B* from *A*. They may not be as careful, however, about imposing consistency on the behavior of capital flows, and their models may behave asymmetrically when the real world does not.

Finally, I call your attention to a single sentence in Cooper's chapter: "The United States is so large a part of the world economy, and the dollar is so widely used, that the United States can influence world monetary conditions to the point of determining them." I have written similar sentences from time to time. Each time, however, I have an uneasy moment, because I would have trouble explaining the point at length. I know that the use of the dollar as an international currency has something to do with the influence of U.S. monetary policy, which cannot be due entirely to the size of the U.S. economy, even when size is measured in terms of asset markets as well as goods markets. But I cannot describe precisely the contribution made by the transnational use of the dollar, let alone measure it, and most theoretical models are unhelpful. They virtually preclude a transnational role for a national currency, because they net out all "inside" debts and claims; they focus primarily on changes in supplies of government debt; and the whole Eurocurrency market is made to implode, along with all other forms of intermediation. The same thing is done in most empirical work. Krugman (1984) has shown why foreign exchange markets will want to employ a single vehicle currency. He has dealt with some other aspects of the problem as well, but that sort of analysis has to be carried further before it can shed light on the broad issue. The whole subject calls for much more work.

## Notes

1. Note in passing one more problem. Cooper asks whether the demand for money should be treated as a function of output or expenditure—a question that does not arise in a closed economy but can be important in an open economy. Let me ask another question. If the demand for money should depend on output, should it then depend on gross output, including its import content, or on net output (value added)? If the latter, there arises an interesting problem that has not received much attention. Consider an economy that produces and exports a single commodity *x*, with price  $p_x$ , but imports an input *y*, with price  $p_y$ . For simplicity of exposition, suppose that velocity is fixed at  $v$  and that the input requirement is fixed at  $k$  units of *y* per unit of *x*. Then the demand for money is

$$M = v(p_x \cdot x - p_y \cdot y) = v[p_x \cdot x(1 - kp)], \quad (1.1)$$

where  $p = p_y/p_x$ . An improvement in the terms of trade (a fall in  $p$ ) has an odd effect. It raises the demand for money and will thus depress  $p_x$  or  $x$  unless the central bank raises the supply of money. Putting the point intuitively, a fall in the price of oil should reduce aggregate demand in an oil-importing country by way of its effect on the

demand for money, even though it stimulates aggregate demand by way of its income effect.

2. Incidentally, Cooper asserts in that note that fiscal expansion *must* cause the domestic currency to appreciate in portfolio-balance models. That may be true in the particular model he cites, but it is not true in all such models. In Allen and Kenen (1980), the exchange rate can go either way under the influence of an ongoing budget deficit, depending in part on the degree of capital mobility; when the budget deficit is ended and the economy allowed to reach its new stationary state, the value of the domestic currency will be lower, not higher, than in the initial stationary state. (This last result is, of course, consistent with the underlying logic of the portfolio-balance approach; an increase in the supply of dollar bonds causes the dollar to depreciate eventually.)

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