

Comments

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Jacob Frenkel has provided an extensive survey of the literature relevant to his title, and an illuminating analysis. I agree with most of Frenkel's commentary, and will add some of my own.

Frenkel begins with an assessment of the assignment problem and Mundell's solution to it. The Mundell solution seems to me to be very artificial. If separate monetary and fiscal authorities agreed on the economic model and on policy objectives, it would not make sense for them to accept separate assignments for achieving policy objectives. It would make more sense to assume that each authority sets its own policy instruments at the levels required for internal and external balance under the assumption that the other policy authority behaves in the same manner. The two policy authorities, sharing the same model and same objectives, would act as if they were departments of a single policy authority.

The problem is different if one authority—Authority *F*, say—is unable or unwilling to act to achieve equilibrium. In such a case the other authority—Authority *M*—would no longer act under the assumption that Authority *F* would set its policy instruments appropriately. Authority *M* would instead optimize subject to the policies followed by Authority *F*. It would not be sensible for Authority *M* to blindly pursue the assignment given to it knowing that the other authority was not going to act appropriately.

This reasoning might be applied to today's conditions by asking what the Federal Reserve should do given that the fiscal authority—the Congress and administration taken together—is unable to reduce the budget deficit. Put another way, the question is how the Federal Reserve might act differently if the budget deficit were smaller. Defining monetary policy in terms of money growth, it does not seem to me that the Federal Reserve should permit monetary policy to be determined by the level of the budget deficit. There is no significant trade-off between monetary and fiscal policy, so changing money growth as the budget deficit changes only risks compounding one set of policy errors with another. Using money growth to finance the large budget deficit risks accelerating inflation and rising interest rates. Inflation may reduce

the real value of the dollar, but benefits flowing to U.S. export industries and import-competing industries hardly seem worth the cost that generalized inflation will bring. One of these costs is that rising nominal interest rates are likely to bankrupt many of our weakened financial intermediaries.

Leakages and Competitive Opportunities

Let me turn to a more general discussion of the constraints that openness imposes on adjustments in U.S. economic policies. These constraints are sometimes analyzed in terms of “leakages” abroad of the effects of changes in domestic policies. The very term suggests the usual central planner’s complaint that the competitive marketplace is inhibiting the effectiveness of the planner’s policies.

Openness, however, offers opportunities as well as constraints. Let me illustrate with two regional examples from within the United States. The first example is the New Hampshire liquor monopoly. This state liquor monopoly is highly aggressive. Its prices are low, its stores large, well-stocked, and conveniently located on major highways near the state borders. The state monopoly profits mightily from drawing customers from other states with higher prices. In the absence of “foreign” customers, the optimal policy of the state monopoly would have been quite different. With closed borders the profit-maximizing price would be high instead of low, and the New Hampshire taxpayer-consumer worse off.

A second example concerns the industrial development policies of the Sunbelt states. These states pursue local fiscal policies that maintain attractive tax and regulatory environments for the purpose of luring industry from other states. Many of these policies have been successful in promoting economic development.

In both of these examples, openness provides an opportunity to aggressively competitive states but a constraint to states attempting to pursue policies injurious to the interests of mobile resources. I conclude that the literature on macro policy constraints imposed by openness must come primarily from economists from the Snowbelt states, or at least economists with Snowbelt mentalities.

These examples, when transferred from the interregional to the international realm, seem to have more to do with microeconomic than macroeconomic policies. Perhaps the problem is less a matter of constraints introduced by openness than it is of a general conflict between microeconomic efficiency and macroeconomic policy. Many of the leakages in the open economy models are nothing more than manifestations of incentive effects so long ignored in Keynesian approaches to macroeconomic policy. The Keynesian planner finds it very inconvenient when investment flows to less-taxed opportunities such as consumer durables domestically or capital assets abroad.

Competitive Monetary Policies

With respect to monetary policy, the constraint involves the possibility of flows out of a country's currency, and assets denominated in its currency, into assets denominated in foreign currencies. This possibility, though, is the other side of an opportunity to attract foreign capital. A country can profit greatly from net foreign investment and from serving as an international financial intermediary.

To maintain a demand for its currency, a country must maintain price stability, political stability, and markets free of capital controls and regulatory impediments. These conditions are all desirable on domestic grounds. If maintaining these conditions attracts capital from abroad, it is because financial stability is an economic good in short supply around the world.

Most economists favor free trade on the grounds of both static efficiency and the dynamic effects competition has in breaking down the entrenched positions of lazy monopolies. Competition is good for both the "invader" and the "defender" firms. The same principle applies to "invader" countries that are successful in creating financial stability at the "expense" of capital flows out of "defender" countries.

Some observers argue that the international role of the dollar relaxes a constraint on U.S. monetary policy. That view does not seem to me correct. The United States profits from financial intermediation, but U.S. monetary policy is subject to competition from monetary policies abroad. Other countries also produce financial stability, and the funds that have come to the United States can readily leave for foreign shores should U.S. economic conditions deteriorate. Many countries have tried to avoid becoming reserve currency countries because of perceived constraints from capital "sloshing" around internationally.

Effect of the Exchange Rate System on Policy Constraints

Frenkel argues, and I am inclined to agree, that policy constraints and opportunities are not greatly affected by the exchange rate system. The fixed exchange rate system tends to constrain money creation, but there is always the opportunity to respond by imposing capital and trade controls as the United States did in the 1960s. The fixed rate system itself cannot impose discipline that the political system refuses to accept.

But the irrelevance of the exchange rate system is primarily a long-run proposition. In the long run, countries must adjust one way or another to changes in relative prices. The exchange rate system affects the characteristics of the short-run adjustment process. Frenkel spends little time speculating on what these characteristics might be.

I suspect that the difference between fixed and flexible exchange rate dynamics in the short run may have something to do with the distinction drawn by Arthur Okun between the “fix-price” and the “flex-price” sectors of the economy. Flex-price sectors are characterized by auction markets and atomistic traders. Fix-price sectors are characterized by relatively discrete price adjustments in markets with relatively few traders.

The flexible exchange rate market is itself a superb example of a flex-price sector. But this flex-price sector may turn certain other sectors that would otherwise operate on fix-price principles into sectors that must operate on flex-price principles. Because people do not understand why some markets function as auction markets, or a close approximation, while others are organized very differently, one should be slow to jump to any conclusions as to whether broadening the flex-price part of the economy is or is not a favorable development.

Finally, Frenkel’s chapter and my comments have both concentrated on policy constraints and opportunities from openness under the assumption that the objective function contains only U.S. objectives. But foreign objectives belong in the objective function of the United States. The United States has an intense practical interest, not just an altruistic one, in political stability and economic progress abroad. The real constraint on U.S. economic policy has nothing to do with the ratios of imports and exports to GNP, but rather with the fact that the world is in many respects a nasty and brutish place. The United States is in a deadly serious competition that it will not win if all it does is maximize an objective function containing as arguments U.S. per capita real income and the inflation rate.