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No. 121, June 1977

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SUSTAINING THE INTERNATIONAL  
ECONOMIC SYSTEM: ISSUES  
FOR U.S. POLICY

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MARINA v. N. WHITMAN



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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PETER B. KENEN, *Director*  
*International Finance Section*

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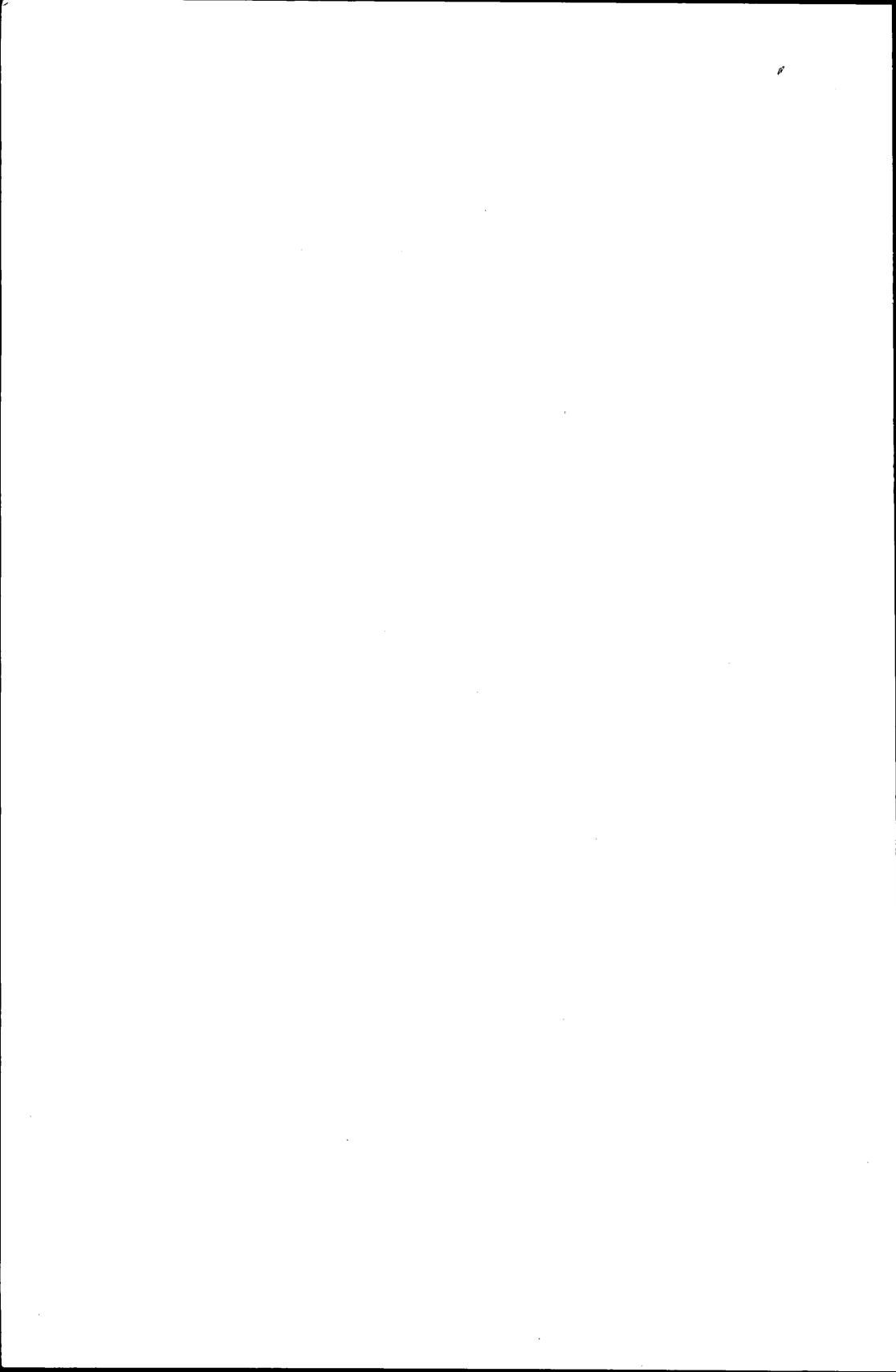
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# Sustaining the International Economic System: Issues for U.S. Policy

## **Introduction: General Themes**

In discussing the viability of the international economic system and the role of the United States in that system, it is tempting to organize the analysis into traditional categories: international trade, investment, the monetary system, relations with developing countries, and so forth. But this would risk ignoring or underemphasizing the strong interconnections among these categories and major issues and challenges that appear to concern all of them. And today, with virtually all aspects of the system in transition, under serious challenge, or embryonic, there is the rare opportunity—as well as the need—to build, expand, or rebuild components taking account of their interconnections and of the need for consistency and mutual support among them. To start, therefore, it is essential to recognize major themes that run like leitmotifs through issues ranging over virtually all aspects of the international economic system. And when the discussion moves on to take up the traditional policy categories, particular issues and problems will be discussed selectively, not comprehensively, in order to show how the central themes relate to and are reflected in detailed policy problems and choices.

In the sphere of macroeconomics—issues relating to the general level of prices and real economic activity and to overall economic stabilization—the dominant theme is the tension between the increase in international economic interdependence and the demand for domestic economic autonomy on the part of nation-states, and the search for means to minimize this tension. Few would deny the fact of increasing interdependence brought about by advances in technology, improvements in transportation and communication, and the deliberate reduction of barriers at national borders over the past thirty years. What needs emphasis today is the change in the way that this fact is assessed. For the first two decades after World War II, developments producing increased interdependence were viewed in classical economic terms, as factors enhancing specialization, efficiency, and competition, thus raising output, income, and standards of

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living in the participating countries. Recently, by contrast, another aspect has been more heavily emphasized. Increasing interdependence heightens the sensitivity of national economies to events and policies originating outside their borders and therefore beyond their control.

Tension between international market integration in the sphere of private transactions and the desire for national autonomy in the sphere of public policy was the theme of Richard Cooper's now classic book on *The Economics of Interdependence* nearly a decade ago: "The central problem of international economic cooperation—and of this book—is *how to keep the manifold benefits of extensive international economic intercourse free of crippling restrictions while at the same time preserving a maximum degree of freedom for each nation to pursue its legitimate economic objectives*" (1968, p. 5). Most nations, moreover, have been seriously concerned with this tension for some time. But, as we shall see, a number of developments have served to exacerbate it in recent years. And it has come to prominence in the United States, later than elsewhere, partly because a number of dramatic shocks to the domestic economy in the past few years have served to heighten our perception of the "dark side" of interdependence and to stimulate our recognition that such interdependence is, increasingly, symmetrical.

The reduction in national economic autonomy that accompanies increasing openness has several aspects. The most obvious is the increased sensitivity or vulnerability of the domestic economy to influences originating abroad. The larger the export sector relative to GNP, the more important, generally, are shifts in foreign demand as causes of domestic economic fluctuations; a similar relationship exists between the size of the import sector and shifts in foreign supply. And aggregates are not all that matter here; the more a country depends on imported oil, as we have been forcibly reminded, the more will domestic prosperity be affected by foreign decisions regarding its supply or price. Such vulnerability is not absolute; it "is a matter of degree and varies with the costs and time involved in developing alternatives. This implies hard policy choices about acceptable degrees of dependence and how willing we are to sacrifice the economic benefits of cheaper foreign supplies" (Nye, 1976, p. 134). Nations have some choice between the gains from international specialization and the reduced vulnerability that accompanies greater self-sufficiency.

No government, it is safe to say, has ever regarded a loss of autonomy with equanimity, but the problem is exacerbated today by the fact that, in the years since World War II, the governments of industrial nations have taken upon themselves (or had thrust on them by their electorates) responsibility for an ambitious list of domestic macroeconomic goals—for

achieving and maintaining high levels of employment, an acceptably rapid and stable rate of economic growth, a reasonable degree of price stability, and socially determined standards of equity in the distribution of income. Their ability to discharge these responsibilities is critical to an assessment of the benefits and costs of increased economic interdependence. As Cooper (1974, pp. 58-59, and 1976) has noted, the efficiency gains from market integration are maximized by ignoring the boundaries of the nation-state; for private transactions in goods and factors of production, the optimum size of the integrated area is the world. By implication, the economic justification for the nation-state must lie in the existence of public or collective goods—including stabilization targets, the distribution of income, and the regulatory climate—and of differences in national consumption preferences for such goods (see Whitman, 1972).

An increase in economic openness not only widens the exposure of an economy to external disturbances, it also attenuates (at least under pegged exchange rates) the effectiveness of the domestic policy instruments used to achieve the collective macroeconomic goals just described. For example, an increase in the marginal propensity to import that generally accompanies the integration of commodity markets reduces the domestic impact of fiscal policy by increasing the proportion of that impact that leaks out into imports. Similarly, the integration of capital markets attenuates the impact of monetary policy on domestic economic activity, as flows of interest-sensitive capital across national boundaries offset desired changes in domestic interest rates or credit-market conditions.

The heightened tension between international market integration and the desire for national economic self-determination has encouraged what has been termed “defensive economic nationalism”—a nationalism based not on the desire to extend the nation’s power beyond its own borders but rather on the desire to retain or regain control over economic developments within those borders. Historically, barriers to insulate an economy from foreign disturbances have taken the form primarily of restrictions on imports. Recently, nations have employed a wider variety of devices. Thus, American plans for reduced dependence on imported energy—to the extent that they are translated from words into action—represent attempts at insulation on the supply side. Furthermore, with the acceleration of worldwide inflation and concern about “stagflation,” several countries, including the United States, have sought to avoid importing inflation (perhaps even to export it) by erecting barriers to exports, just as they have long sought to ward off (or export) unemployment by restricting imports. Today, with many countries still in recession, some observers see troublesome indications of a resurgence of conventional beggar-my-neighbor protectionism (see, for example, Bergsten,

1976). On the whole, however, it seems to me that the cup should be regarded as half full rather than half empty. Given the severity and breadth of the most recent recession, I am impressed by the extent to which nations have so far avoided resort to protection and other distortions of international transactions.

This self-restraint may reflect in part recognition of the fragility of the international economic system and recollection of the havoc wrought by self-defeating beggar-my-neighbor commercial policies in the 1930s. It is also undoubtedly due to the change in the exchange-rate system that took place in the early 1970s. The movement from pegged rates to managed flexibility was itself a shift away from integration and the thrust toward "world money." It created a buffer between national monies and therefore between national economies and economic policies. But this form of insulation is far less disruptive of market integration than the alternative of pegged rates and piecemeal restrictions on trade, capital flows, or both. There can be little doubt that the avoidance of a wholesale retreat into competitive protectionism in the face of accelerating and divergent rates of inflation, the oil crisis, and the subsequent widespread recession was made possible by the shift from pegged rates to managed floating. The insulation provided by managed floating is only partial, however, and has indeed turned out to be more limited than had been generally anticipated. The reasons will be discussed later.

The minimization of tension between interdependence and autonomy can be approached from another direction. The integration of national markets can be accompanied by the coordination of national economic policies. The institutional framework constructed for this purpose since World War II has been directed primarily at what might be termed negative coordination; it has aimed at the avoidance of beggar-my-neighbor policies and the reduction of explicit barriers restricting or distorting international trade and investment. The very success of this effort, however, has helped to create the tension just described, and its alleviation will require something quite different and more ambitious: the positive coordination of domestic economic policies by sovereign states, a process with which there has been much less experience and for which an adequate institutional framework does not yet exist. What I mean by positive coordination, what it will require, and the implications of experience so far with limited efforts to introduce it will be explored further later in this essay.

If the key issue on the macroeconomic side is the tension between international interdependence and national autonomy, the leitmotif on the microeconomic side—in the sphere of international trade and investment

relationships—can be characterized, equally elliptically, as the unresolved tension between market orientation and planning orientation, between those who focus on reductions of government barriers to private transactions and those who emphasize the collective management of international economic transactions.

Over most of the postwar period, the primary focus in economic relations among the industrialized countries was on *liberalization*: the elimination, on a reciprocal and nondiscriminatory basis, of measures that explicitly restricted transactions across national boundaries. Reflecting at least in part the laissez-faire orientation and strong leadership of the United States, these ongoing exercises were marked by such milestones as the formal restoration of currency convertibility by European nations in 1958, the subsequent reduction by these same nations in the number and severity of remaining exchange-control restrictions, the substantial reduction in tariff levels achieved by successive rounds of tariff negotiations under the aegis of the General Agreement on Tariffs and Trade (GATT), and, more recently, the significant loosening of trade and investment restrictions by the newest of the major industrial powers, Japan. These developments were major stimuli to the rapid growth of international trade and investment and thus to the advance of economic integration.

Today, however, the focus on the nondiscriminatory reduction of barriers is meeting increasing resistance. There are several reasons. First, there has existed for some time an underlying friction between the relatively laissez-faire globalism of the United States and the more interventionist attitudes of European nations, with their stress on regional relationships and the use of collective management by governments of international economic relationships.<sup>1</sup> And as the hegemonial position of the United States has declined, for both political and economic reasons, the dominance of the U.S. approach has also diminished. Second, the international trading system has broadened beyond the initial nucleus of North America and Western Europe, and most of the newer participants (Japan and the developing countries), as well as potential participants (the Communist-bloc nations), bring with them traditions of strong gov-

<sup>1</sup> For an interesting account of these differences in outlook, see Shonfield (1976). One must be careful, of course, not to exaggerate the homogeneity of European views. The position just described as "European" most accurately describes the French outlook; the German position has tended to be closer to that characterized as American. Whatever the internal difficulties involved in compromise, however, the EEC countries have succeeded in "speaking with one voice" in a number of important areas, particularly on trade issues, and their common positions have tended to reflect heavily the general outlook described above.

ernment intervention in the domestic economy. Third, the proliferation of economic responsibilities shouldered by the governments of the Western democracies, already described, has almost certainly enhanced the pressures for intervention within the original core of trading nations.

In addition, and perhaps most important, barrier reduction has fallen victim to its own success. Although industrial tariffs still exist and are in fact the first order of business in the current round of GATT negotiations in Geneva, previous rounds of reductions have brought them to levels at which they are no longer the principal distortions. Tariff negotiations have been difficult, but tariffs have had the advantage of being distinct and separable from domestic economic policies and of being amenable to some measurement of reciprocity, however rough and analytically assailable. Today, the major barriers to trade fall into two broad groups: nontariff barriers and agricultural restrictions. The nontariff barriers include a broad range of measures, and many are inextricably intertwined with domestic microeconomic policies. Furthermore, it is rarely possible to define reciprocity in the reduction of nontariff barriers and even more difficult to devise a means of measuring it. Finally, attempts to liberalize agricultural trade by the conventional approach of reducing governmentally imposed barriers are brought up short by the fact that virtually every nation, including the United States, has a long-standing and deeply ingrained tradition of government intervention in the domestic agricultural sector (see Warley, 1976, for an historical survey). It is therefore futile to try to negotiate reductions in restrictions "at the border" in isolation from broader domestic policies. Just as in the macroeconomic sphere, the dynamics of interdependence appear to require a shift from negative to positive coordination in crucial microeconomic areas, taking into account the involvement of national governments in these areas but aiming to minimize the extent to which that involvement thwarts or distorts transactions across national boundaries.

Finally, there are broad systemic questions relating to the international economic system as a whole. One has to do with the organizing principle that will characterize the system. Analytically, one can conceive of at least four "pure" principles. One is automaticity: a system such as universal free trade with a pure gold standard or freely flexible exchange rates, one that is subject to an absolute, self-regulating discipline of the marketplace. A second is hegemony: general acceptance of dominance by a single country or group of countries that in turn takes on a special responsibility for the operation of the system. A third is supranationality: collective adherence to the decisions of one or more supranational institutions that would utilize a mixture of rules and discretion

to operate the system effectively, much as national governments do today domestically. The final mechanism is negotiation or pluralism: the system would be enabled to function by hammering out repeatedly compromises among the divergent interests of sovereign participants.

Obviously, no international system has actually functioned according to one of these pure principles. The international economic system that prevailed roughly from the end of World War II until the beginning of the 1970s, for example, was characterized by the unprecedented prominence of international economic institutions: the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), the World Bank, and the Organisation for Economic Cooperation and Development (OECD), to name only the most prominent. But these institutions have been effective less in formulating rules or promulgating binding administrative decisions than in providing an agreed set of procedures by which national disagreements could be discussed, negotiated, and minimized. "The institutions were seen, in other words, as an adjunct to the ordinary processes of diplomacy, not as a substitute for them" (Shonfield, 1976, p. 126). Completing the mixture was a strong dose of hegemonial leadership by the United States, which not only placed its unmistakable stamp on each of the institutions listed above but also enjoyed substantial (although by means unlimited) leadership in the management of economic relationships within the framework provided by the institutions. The hegemonial position of the United States, which was based partly on overwhelming economic dominance throughout most of the period and partly on the security guarantees it gave its allies against Communist aggression, had two aspects. For its part, the United States took special responsibility for maintaining the international economic system; it was frequently willing to subordinate its short-term economic interests, narrowly conceived, to the long-term political and economic advantages of strong economies in other free-world nations and of a viable trading and monetary system. Other countries, in turn, were willing to accord the United States certain special privileges (primarily that of printing international money) as a concomitant of its special responsibilities for the military security and economic stability of the non-Communist world (see Whitman, 1975b).

Clearly, the new international economic system will also be based on a combination of these organizing principles, but it will not be the same mixture as before. The main reason is the attenuation of the hegemonial status of the United States. As cold war concerns have diffused and domestic economic problems have become more urgent, the United States and its allies have each, for somewhat different reasons, grown impatient

with the special U.S. position in the international economic system, particularly in the monetary sphere. European and other countries have increasingly urged a system in which the United States behaves and is treated "just like everyone else." The United States, disillusioned with being world "policeman" and increasingly reluctant to sacrifice immediate economic interests at home for the sake of global economic stability, has given some disturbing indications that it might be only too glad to comply.

The decline in the economic hegemony of the United States has been spurred by détente but began with the gradual decline in its global economic importance. Although the United States remains the world's largest economy, with a GNP accounting for nearly half that of all the OECD countries together, its share of world GNP fell from 39 per cent in 1950 to 25 per cent in 1975.<sup>2</sup> At the same time, the openness of the U.S. economy, and therefore its sensitivity to influences from abroad, has increased. The ratios of exports and imports to GNP have doubled, and the share of foreign earnings in the profits of U.S. corporations has tripled. The openness of other industrialized nations has increased substantially too, and the United States remains the least open economy in the non-Communist world, but the increasing participation of the United States in interdependence has been striking and must be taken into account if the international economic system is to be reconstructed to achieve maximum viability and effectiveness.

If the system of the future is to be based far less on hegemony than was its predecessor, which of the other organizing principles will take up the slack? Academic analysts and political participants alike seem to agree that international institutions will have to play an enhanced role. But this apparent agreement conceals an important divergence of views. One approach, which might be characterized as "the American position," holds that, in the absence of a generally accepted hegemony, the reconciliation of divergent interests and thus the viability of the system can be ensured only by the discipline of universal rules: by some combination of the self-enforcing disciplines of the marketplace and of general rules applied by international institutions, accompanied by the development of effective sanctions against states that try to evade the disciplines or break the rules. Europeans, skeptical of American legalism and doubtful that sanctions can be applied effectively to sovereign states without

<sup>2</sup> The same pattern of relative decline is reflected in alternative measures of economic importance. There are exceptions to this general pattern in three areas in which the position of the United States has held or increased: international investment, agricultural exports, and the financial role of the dollar (see Whitman, 1976, esp. pp. 187-189).

endangering the survival of the system itself, stress the need to develop and expand international institutions to support more effectively the negotiation of divergent economic interests, to develop modes for cooperative management of domestic and regional policies, and to avoid retaliatory escalation during particular disputes.

Finally, the most fundamental leitmotif of all is the preservation of a liberal international economic system. Until relatively recently, it was taken for granted that the nations participating in the international economic system agreed that the ultimate goal of the system was to maximize world efficiency and international harmony by minimizing the distortions and uncertainties created by the existence of national boundaries. The system was *laissez-faire* in orientation and neutral in intent. This characterization must not be pushed too far; each participant in the system practiced interventionist policies, in varying degrees, within its own economy, and the system proved relatively flexible in accommodating the international ramifications of these policies. But the liberal thrust of the system was nonetheless clear and generally accepted.

Today, however, these fundamental principles face serious challenge. One reason is that, over the postwar period, domestic economic goals have broadened from a primary focus on efficiency and growth to an intensified concern with economic and social stability and distributional equity. The political importance of these concerns, together with the increased vulnerability that is one face of interdependence, generates hostility to a *laissez-faire* international framework directed toward promoting market integration. The other major challenge comes from the increasing prominence and activism of the new participants in the international economic system: the developing countries. Despite their heterogeneity, most of these nations share the belief that the "neutrality" of the postwar international economic system has operated to their disadvantage. They are firm in their insistence on the construction of a "new international economic order" that will adopt the international redistribution of income as an explicit and primary goal. Is it possible to fashion an international economic system that can incorporate these emergent participants and reconcile their goals with traditional aims? This is the greatest challenge of all.

### **Macroeconomic Issues**

Moving now from general themes to the more familiar functional categories, two topics confront us in the realm of macroeconomics: the international monetary system and the international transmission of economic

disturbances. The two overlap, in that the nature and functioning of the monetary system is an important determinant of the way in which, and the degree to which, disturbances travel from one country to another. They are distinct, however, because many factors other than the structure of the monetary system determine the nature and intensity of the transmission process, and also because the extent to which the monetary system enables countries to insulate themselves against external disturbances is only one of several criteria—albeit an increasingly important one—for evaluating the effectiveness and viability of that system.

### *The International Monetary System*

It has become fashionable recently to talk about “the failure of world monetary reform” (see Williamson, 1977). If the criterion of success is the ratification of a formal, comprehensive “monetary constitution” comparable to the Articles of Agreement of the International Monetary Fund, one must indeed concede that the reform has failed. It is not clear to me, however, that success in these terms was either possible or desirable under prevailing circumstances. There are currently some loose ends and pieces of unfinished business demanding attention. These raise policy issues for the United States that will be the major focus of this section. Before reviewing them, however, it is useful to establish a point of departure by discussing briefly the progress that has been made to date in the effort to reform the monetary system.

The major achievement of the reform effort so far has been to give *de jure* recognition to the managed floating of exchange rates, thus closing (or greatly narrowing) a gap between rule and practice so wide as to threaten the credibility of the international monetary framework and the effectiveness of its custodian, the IMF. The shift to managed floating has provided a flexible and effective means of international payments adjustment, one that was not provided by the Bretton Woods system as it functioned in practice, whatever the original intent of the Articles of Agreement.

Floating rates, it is true, initially displayed not only more fluctuation than many had expected but, in some instances, more than appeared to be warranted by underlying economic factors. In the last year or two, however, there has been a closer correspondence between changes in rates and divergences in national economic trends, supporting the view that the initial instability may have been caused not only by the intensity of the economic disturbances affecting the world economy in 1973-75 but also by three other transitional factors: the need for “learning by doing,” institutional barriers frequently associated with a period of transition from

one environment to another, and the substantial one-shot adjustment of portfolios required for official and private asset holders to correct distortions built up during the prolonged, cumulative disequilibrium in exchange-rate relationships (see Whitman, 1975c).

Even more specifically, the alteration in the method of exchange-rate adjustment made possible a more realistic valuation of the dollar, the key currency in the international monetary system, an adjustment that was severely inhibited by the special functions performed by the dollar under the Bretton Woods regime (see Whitman, 1974). This dramatic correction of the long-term overvaluation of the dollar (some would argue, overcorrection) had a number of significant effects, among the most important being a considerable abatement in the domestic protectionist pressures that had been stimulated by the competitive disadvantages imposed on American goods. Between June 1970 and October 1975, the dollar underwent an effective (trade-weighted) depreciation of over 12 per cent against the currencies of fourteen other major industrialized countries. Although the degree of causal relationship will be endlessly debated, the fact is that the U.S. balance of goods and services improved substantially, from a deficit of nearly \$6 billion in 1972 to a surplus of roughly \$4 billion in 1973 and 1974 and of more than \$16 billion in 1975.<sup>3</sup>

The more realistic valuation of the dollar has (along with other factors) created pressures retarding the growth of American direct investment abroad and accelerating foreign direct investment in the United States. Although a slowdown is not yet fully apparent in the data on U.S. direct-investment flows, it can be clearly discerned in recent data and projections concerning capital expenditures by the foreign affiliates of U.S. firms. Those expenditures increased by only 5 per cent in 1975 and declined by 4 per cent in 1976, as contrasted with an increase of 25 per cent in each of the preceding two years. They were projected to increase by 12 per cent in 1977, partly reflecting postponement of many projects from 1976.<sup>4</sup> These developments may help to relieve some of the pressure for restrictions on direct investments, pressures that have emanated from widely disparate sources. The nations of the European Economic Community (EEC) have displayed concern about cultural

<sup>3</sup> This occurred despite a huge increase in the oil-import bill. Differences in the timing of the business cycle in the United States and its major trading partners were also an important factor in the improvement in the balance on goods and services between 1974 and 1975, just as they were in the sharp deterioration during 1976.

<sup>4</sup> U.S. Dept. of Commerce, *News*, March 31, 1977. The rate of foreign direct investment in the United States has accelerated substantially, albeit from a small base. It increased by 23 per cent in both 1973 and 1974 and by 19 per cent in 1975, as compared with an average increase of less than 7 per cent per year during the previous decade (Lupo and Fouch, 1976, p. 34).

and economic domination by American business and were also anxious in the 1960s that the United States reduce its cumulative balance-of-payments deficit by some means other than—or in addition to—an improvement of its trade balance at their expense. More recently, organized labor in the United States, concerned about the “export of jobs” and the deterioration of the U.S. competitive position, abandoned its traditional liberal stance and brought pressure for both import restrictions and restrictions on exports of American capital and technology.

In addition to relieving protectionist pressures, the change in the exchange-rate regime has slowed the rapid increase in world reserves associated with the very large U.S. deficits on the official reserve transactions basis of 1970-72, an increase which many analysts argue contributed significantly to worldwide inflation. It has also greatly alleviated the very large flows of speculative funds across national boundaries, which by the early 1970s sometimes amounted to several billions of dollars in a single day and created severe difficulties for the conduct of monetary policies in the affected countries.

In a sense, the world is on a “dollar standard” more completely than it was before, and the special role of the dollar as a key international currency remains essentially undiminished in most respects. Yet the abandonment of parity obligations has modified certain asymmetrical aspects of the Bretton Woods system that were proving increasingly troublesome. Because of the dollar’s reserve-currency position, U.S. monetary policy had a much larger impact on the world money stock than the monetary policy of any other country (or of other countries combined), not merely because of the large size of the United States, but also because the dollars that flowed out of the United States as ordinary money entered other countries as “high powered money,” adding to the monetary base. To put it another way, the United States was able to offset the impact of its payments deficit on its own money supply, and therefore to exercise a disproportionate influence on the money supplies of other countries, partly because of the “automatic sterilization” that occurs whenever other countries hold foreign-exchange reserves as U.S. Treasury bills or deposits with U.S. commercial banks. Automatic sterilization still occurs but arises, under present circumstances, from the voluntary actions of surplus-country central banks that choose liabilities of the U.S. government or of U.S. banks to hold in their asset portfolios. It no longer occurs as a by-product of currency-market intervention conducted by nations fulfilling the obligation to peg exchange rates under the IMF Articles of Agreement.

In addition to its effect on automatic sterilization, the shift in the ex-

change-rate regime has affected in some subtle ways the nature of financial interdependence between the United States and other countries. The most direct link among national money markets over the past decade has been the Eurodollar market, and it was widely believed until recently that "the degree of independence of the Eurodollar market from New York [was] limited" (Bell, 1973, p. 42). Like interdependence on the real side, however, this financial interdependence has become more symmetrical, and one important cause derives from the change in the international monetary system. Until 1971, the key-currency role of the United States enabled it to exert a powerful influence on monetary conditions and prices abroad precisely because it was "the only country that did not (or could afford not to) care seriously about the effect of its price level on its external position" (Nordhaus, 1972, p. 469). Today, with exchange rates more responsive to supply-demand relationships in commodity, asset, and money markets, the situation is reversed: the United States, along with other countries, must worry about the effect of changes in its external position, reflected by changes in its exchange rate, on its domestic price level. The relatively small size of its foreign sector reduces this kind of sensitivity, yet recent history offers considerable evidence to indicate that the United States neither is nor feels immune to the impact of exchange rates on its price level. Thus, the shift to managed floating has probably reduced the asymmetry in responses to external pressures as between the United States and non-reserve-currency countries.

By now it is abundantly clear that the system of flexible exchange rates is and will remain heavily managed. Indeed, given the involvement of governments in myriad activities affecting exchange markets directly or indirectly, it would be impossible even to recognize a "freely floating" rate, much less enforce it. Yet this question of management raises important unsettled issues affecting the viability of the monetary system.

The most urgent of these issues relates to the risk of inconsistent exchange-rate policies, particularly the prevention of aggressive manipulation, direct or indirect, designed to export cyclical problems of inflation or unemployment. A set of interim guidelines "for intervention in exchange markets . . . designed to promote exchange market stability and the international consistency of policies affecting exchange rates and reserves" was proposed by the Committee of Twenty on International Monetary Reform (C-20) and adopted by the Executive Directors of the IMF in mid-1974 (IMF, 1974, pp. 35-36). The first guideline, allowing intervention "as necessary to prevent or moderate sharp and disruptive [short-term] fluctuations," has given rise to an effective set of informal working arrangements among the central banks of the major industrialized coun-

tries. The remaining guidelines, relating to longer-term criteria for intervention, remain unimplemented because they hinge on the concept of a "target zone" for each country's exchange rate and/or reserves. As this is written, no progress has been made on the development of criteria or procedures for defining these target zones.

Interestingly, the U.S. Treasury, which in 1972 proposed the use of "objective indicators" to guide the payments-adjustment process, recently has appeared to oppose further development of guidelines for intervention. It argues that intervention should be minimized and exchange rates left free to be determined by market forces. But management is a fact of life and, given that fact, criteria for judging acceptable behavior are urgently needed. The U.S. Treasury's stress on the importance of heeding market forces would in fact be buttressed by the development of workable "permissive" guidelines defining the conditions under which intervention is (or is not) permissible, as opposed to "prescriptive" guidelines setting forth conditions under which intervention is recommended or required.

Discussions of international standards for exchange-rate policy in a world of managed floating have focused primarily on direct central-bank intervention in the exchange markets. Direct intervention, however, is only one of many mechanisms a government can use to affect its exchange rate. The recent history of managed floating is replete with instances in which countries put upward or downward pressure on their currencies indirectly, by altering the volume of foreign borrowing, the restrictiveness of capital controls, or the conduct of domestic monetary policy, rather than by buying or selling foreign exchange. In fact, in three of the recent instances in which countries were suspected of competitive depreciation (Italy, Britain, France), the behavior at issue involved indirect measures. In only one case (Japan) was direct intervention at issue. Whatever the merits of these cases, they imply the need to develop standards of behavior with respect to the determination and implementation of exchange-rate targets broader than guidelines to govern direct intervention alone. What is needed, in other words, is a framework for ensuring the compatibility of national macroeconomic policies, a need that leads us into the question of policy coordination, taken up in more detail in the next section.

A second major shortcoming of present international monetary arrangements is, in the eyes of some observers, "the total lack of control over the volume of international liquidity" (Williamson, 1976, p. 57). Control over the aggregate volume of international reserves has long been regarded as a fundamental characteristic of an effective international mon-

etary system. It has generally been held that excessive reserve creation fuels worldwide inflation, whereas inadequate reserve creation exerts pressure for domestic deflation or, more probably in the present climate, for restricting trade and payments. With an eye to "the better international management of global liquidity," the 1974 *Outline of Reform* declared that "the SDR will become the principal reserve asset and the role of gold and of reserve currencies will be reduced" (IMF, 1974, p. 15). This principle was duly endorsed by the Governors of the IMF at Jamaica in 1976, where they agreed to make the Fund's Special Drawing Right (SDR) the formal numeraire of the system, to take certain courses of action designed to achieve the demonetization of gold, and to take limited steps to enhance the attractiveness of the SDR as a reserve asset and relax restrictions on its use.

In the light of traditional views regarding the need to manage global liquidity, the present situation is indeed unsatisfactory. Experts are still divided as to whether the actions taken on gold will have the intended effect (although recent shifts in its price suggest movement in that direction). Furthermore, the complementary agreement to limit gold holdings by the major countries is binding for only two years, after which the question may surface again. As regards the SDR, the actions taken were disappointingly limited, and the SDR is far from possessing today the attributes that would make it an effective international money.

The characteristics of the SDR are, in any case, irrelevant at the moment to the question of managing international liquidity. Of world reserves totaling SDR 221 billion at the end of 1976, just under SDR 9 billion were in the form of SDRs; in 1973-75, after the move to generalized floating, all but about SDR 6 billion of the SDR 48 billion increase in world reserves took the form of changes in the volume or value of foreign-exchange reserves. In brief, SDRs are a very small tail on a very large dog and, until the international monetary system is perceived to be stabilized and concern about refueling inflation has abated, no further allocation of SDRs is likely to take place. Thus, assuming renewal of the agreement on gold when it expires in 1978, the crux of the problem of reserve management has to do with the creation of currency reserves, primarily those denominated in U.S. dollars.

The concern with global liquidity management came to the forefront in an era of pegged exchange rates and was nurtured by the creation of dollar reserves in the waning days of the Bretton Woods system, culminating in the veritable explosion of dollar reserves in 1970-72. But the phenomenon of liquidity creation and the problem of liquidity manage-

ment have taken on a different complexion in the past three years. The main gainers of reserves in this period have been the OPEC countries, whose relatively low average spending propensities make their reserve accumulations less globally inflationary than those of other countries. Furthermore, for the non-oil countries as a group, the ratios of reserves to imports were on average substantially lower in 1974-75 than they had been during the preceding decade.<sup>5</sup> For these and other reasons, the traditionally conservative Bank for International Settlements dismisses current concerns about inflationary reserve growth succinctly: "... the argument, based on the global reserve statistics, that there is now a potentially inflationary overhang of liquidity in the system . . . comes rather close to saying that Germany, Switzerland, Saudi Arabia and Kuwait are about to spend the bulk of their rather large foreign assets on increased net imports of goods and services" (BIS, 1976, p. 109).

There is, however, a larger reason for saying that the international management of aggregate liquidity is not a matter of urgent concern. It has to do with the change in the exchange-rate regime. Under the pegged-rate system, countries acquired (or surrendered) foreign-exchange reserves in the course of exchange-market intervention undertaken to fulfill their parity obligations under the IMF Articles of Agreement. Under managed floating, countries that accumulate reserves do so voluntarily, out of a desire to add to their portfolios of international assets. They can, alternatively, allow exchange-rate changes to clear the market for foreign exchange without the political difficulties associated with official revaluations or devaluations under the Bretton Woods system. Floating today is managed, not free, and a need for international reserves remains, but the advent of a more effective international adjustment mechanism has substantially reduced, if not entirely eliminated, the problem of controlling the volume of global liquidity.

The change from pegged rates to managed floating has also reduced the related problem of controlling reserve composition or, more accurately, the potential for instability created by shifts among reserve assets in a multiple-reserve system. Shifts can occur even under the new system; indeed, the large fluctuations of the dollar vis-à-vis other currencies in the first two years of floating were attributable in some measure to shifts among reserve assets. This was most probably a once-over change, however, stimulated by an inherited divergence between stock and flow equilibria; the stability of the dollar since about mid-1975 supports this

<sup>5</sup> The IMF calculations value gold reserves at the old "official" price of SDR 35 per ounce, rather than at the current market price. On the other hand, price fluctuations have recently reduced the liquidity of *all* international reserves.

view. And a smoothly functioning adjustment mechanism that prevents the buildup of cumulative disequilibria and thereby eliminates the threat of large, discontinuous changes in rates among major currencies should forestall for the future large, destabilizing shifts in the composition of reserve assets.

Some of the same factors that have made international reserve management less urgent have also made it conceptually more difficult. There is surprisingly little consensus so far among expert observers regarding the impact of the shift to managed floating on the magnitude of global reserve requirements. In addition, two developments have compounded uncertainty about the optimum level of reserves, even about the sign of the deviation between actual and optimum levels. First, there has been a substantial increase in borrowing by public or semi-public agencies for balance-of-payments purposes in private international capital markets. Second, the reserve accumulations of the OPEC countries are most accurately regarded as portfolio or investment decisions, not as residual transactions that make the balance-of-payments accounts "add up." Altogether, there has been a blurring of the distinction between "reserves" and other forms of owned or borrowed liquidity that has created very substantial agnosticism about the state of reserve adequacy. Even if it were considered urgent to control reserve growth by imposing mandatory convertibility requirements or minimum ratios of SDRs to total reserves, the choice of agreed criteria for determining deviations of actual from optimum reserves would be well-nigh impossible. Until some new conceptual framework evolves, it will be difficult even to arrive at the consensus required to permit further allocation of SDRs, which may well become important in the not-so-distant future.

Finally, there remains a technical problem arising from one particular function of the dollar in the international monetary system. As long as the dollar remains the world's principal intervention currency, the value of the dollar in the exchange markets will be affected—at times significantly—by developments that have nothing to do with the United States. This asymmetry in the system could presumably be abolished by the selection of some other intervention medium. The C-20's *Outline of Reform* contained illustrative proposals for SDR and multicurrency intervention, and the EEC has practiced a limited form of the latter in the maintenance of its exchange-rate "snake" for some time. But any alternative system of intervention would have to overcome the very substantial margin of efficiency, convenience, and simplicity conferred by dollar intervention. The United States could in principle undertake intervention of its own to offset undesired effects on the dollar arising from the

dollar's use as an intervention currency. But it would run the risk of escalating intervention at cross purposes, a form of inconsistent and mutually frustrating behavior that could undermine the effectiveness and even threaten the viability of the monetary system.

This need to tolerate, within limits, the effects of the dollar's intervention role on its exchange rate exemplifies the desirability of continued relative passivity on the part of the United States as regards its own exchange rate. Ever since the events of 1971, the United States has displayed a certain ambivalence as regards its role in the international monetary system. On the one hand, it pressed hard for a more symmetrical system, in which the United States would no longer be burdened by unique convertibility obligations and would have the same freedom as other nations to exercise active control over its exchange rate. At the same time, it displayed considerable reluctance to relinquish some special functions—particularly the reserve-currency role of the dollar under the Bretton Woods system. The past five years have borne out Cooper's (1972, 1973) initial prediction that many special functions of the dollar would persist in the new system and that the creation of a genuinely symmetrical system would be enormously complicated and costly. It may also be important for the monetary system, however, to have a continued asymmetry in one aspect of policymaking. The apparent desire of many countries to run current-account surpluses poses a continuous threat of inconsistent exchange-rate targets in current circumstances, when the oil-consuming countries must, as a group, run a current-account deficit corresponding to the collective surplus of the OPEC countries. Were the United States, for example, to undertake an active exchange-rate policy designed to buttress its current account against the pressures just described, it would greatly exacerbate the strains imposed on the international monetary system by recent developments in the world economy.<sup>6</sup>

Clearly, the United States cannot be completely passive under present circumstances. It could not, for example, tolerate a concerted refusal by other industrialized oil-consuming countries to accept current-account deficits of any size whatsoever, as this would impose on the United States the entire counterpart to the current-account surplus of the oil producers (excepting the share that can be absorbed by the already debt-ridden oil-consuming developing countries). Even more fundamentally, the United States could not tolerate the fluctuations in unemployment that would

<sup>6</sup> Since the official devaluations of the dollar in 1971 and 1973, the United States has in fact remained "largely passive as to its exchange rates" (Wallich, 1974, p. 6), undertaking relatively limited and short-term exchange-market intervention, and only in the context of close consultation and cooperation with other leading industrialized countries.

result if a passive exchange-rate role produced wide short-term swings in the current account. This danger will be particularly acute if no effective criteria are developed to prevent other nations from manipulating exchange rates as a means of exporting cyclical fluctuations from their own economies. Any U.S. commitment to passivity must be delimited, in other words, by the development of effective guidelines for exchange-rate management. It follows, however, that the United States should assume strong leadership in the negotiation of guidelines, and such leadership is almost certain to require that the United States be somewhat more flexible in adapting its own payments situation to collective needs than the other oil-consuming countries are willing (or able) to be.

### *International Transmission*

Traditionally, a survey of international economic issues would not have included a separate section on the transmission of disturbances. The issue would have been subsumed under the discussion of the monetary system, with perhaps some supplementary references to beggar-my-neighbor policies in the discussion of world trade. But there is growing concern about the transmission of disturbances from one country to another and the magnification of these disturbances in the transmission process. With the worldwide explosion of inflation in 1973-74 and the subsequent plunge into universal recession, there was even the sense that we face something new under the sun, a situation qualitatively different from what had prevailed earlier in the postwar era. It is therefore worth looking at the empirical evidence before discussing the policy issues raised by this question of international transmission.<sup>7</sup>

One would expect that an increase in economic openness, or interdependence, by widening the channels of transmission on both trade and capital accounts, would have intensified the convergence or synchronization of economic fluctuations among countries—convergence not only of price movements (at least under pegged exchange rates) but of variations in real economic activity as well. The evidence on synchronization, however, has to be interpreted in the light of two developments that have opposing implications. On the one hand, common policy responses to common exogenous disturbances may give the appearance of increased transmission when there has been none in fact. On the other hand, the shift from pegged exchange rates to managed flexibility was generally expected to attenuate synchronization and increase the dispersion among national rates of inflation and cycles in real economic activity.

<sup>7</sup> This section draws heavily on Whitman (1976) and the studies cited there; see especially pp. 201-208.

There have been a number of attempts to measure whether, among industrial countries, national rates of inflation have converged or diverged over time. Unfortunately, they are not fully comparable because of differences in the price indices used, in the time periods studied, in the number and mix of countries, and in the measures of dispersion, and the picture that has emerged is somewhat cloudy. Some studies have shown no clear trend in the dispersion of national inflation rates over the postwar period as a whole; others have found some degree of convergence—that is, a reduction in dispersion—in the years between the mid-1960s and the early 1970s, as compared with the earlier postwar period. Most of them, however, have found some increase in the dispersion of inflation rates beginning between 1971 and 1973—that is, after the end of the Bretton Woods system or the move to generalized floating—but even here the evidence is not free of ambiguity. (Because inflation accelerated in all countries during this most recent period, it is hard to draw conclusions about changes in dispersion when the coefficient of variation—rather than the standard deviation—is used as a measure of dispersion.)

When investigators have gone behind rates of inflation to look at growth rates in money supplies for the major industrial countries, they have found, surprisingly, no clear evidence of increased dispersion during the flexible-rate period, as compared with earlier years. These results even led one investigator (Brittain, 1975, p. 10) to conclude that the nature of monetary interdependence has not changed fundamentally despite a substantial change in the international monetary system; major countries have apparently chosen to continue behaving as if exchange rates were pegged, coordinating their monetary policies, especially with the United States, much as they did before.

When looking at changes in the dispersion of cycles in real economic activity, one confronts a bewildering choice of proxy variables. Furthermore, cyclical fluctuations take place around underlying growth trends which themselves differ among countries, and this complicates the interpretation of results. Nevertheless, the most exhaustive empirical study (Ripley, 1976) did discern changes in dispersion of the type expected on *a priori* grounds. There appears to have been some increase in the synchronization of real cycles between 1952-57 and 1964-70, resulting presumably from increased economic integration, and then some decrease in synchronization from 1964-70 to 1971-74.

None of these studies goes far to explain why, despite some tendency toward increased dispersion under flexible rates, a considerable common element remains—in other words, why certain channels of international

transmission are still open, even under flexible rates. Why do flexible rates appear to provide only limited insulation of national economies from one another, rather than the high degree of insulation implied by simple theoretical models focused on the trade balance? One immediate answer is, of course, that the present system is far from the free floating of the textbooks; it is a system of managed floating wherein governments still undertake substantial intervention in foreign-exchange markets. Second, some of the continued synchronization is undoubtedly due not to international transmission per se but, as suggested above, to the strength of the common exogenous shocks that struck all industrial countries simultaneously—particularly the oil-price increases of 1973-74. Third, certain institutional features common to most industrial countries would tend to serve as transmission channels for world inflation even under freely flexible rates. Among these are the tendency of the monetary authorities to “accommodate” imported inflation by preventing a fall in nominal incomes when worsening terms of trade cause a decline in real incomes, and the demand-shift inflation caused by the uneven sectoral impact of a rise in foreign prices and the resulting change in the exchange rate (see Richardson, 1975).

More fundamental, however, is the fact that flexible exchange rates cannot be expected to abolish interdependence in an integrated world economy. In models in which the balance of payments is equated with the balance on goods and services, exchange-rate flexibility strengthens national economic autonomy in three ways. First, by making possible a permanent improvement in the balance of payments, it abolishes the need to use macroeconomic policies for the elimination of balance-of-payments disequilibria, freeing them for exclusive use in the pursuit of domestic targets. Second, by foreclosing the “leakage” of domestic multiplier effects through the trade balance, it directly enhances the impact of domestic stabilization policies. Third, by allowing an appreciation of the exchange rate, it insulates the economy against both the direct-cost and aggregate-demand inflationary pressures caused by a higher rate of price increase abroad than at home.

Viewed within a different analytical framework, however, each of these characteristics is seen to have important limitations. Some versions of the monetary approach to the balance of payments imply that exchange-rate changes can cause only temporary changes in the balance of payments; in the long run, the requirements of equilibrium in all markets force the balance of payments to revert to its original condition. The assumptions underlying this approach remain controversial (see Whitman, 1975a, for

a critique), but the insights it offers have posed significant questions about the conditions under which an exchange-rate change can be relied on to effect a durable improvement in the balance of payments.

Similarly, models that focus on the conditions for asset-market equilibrium imply that, if capital is highly mobile internationally in response to interest-rate differentials, a shift from pegged to flexible rates will weaken rather than strengthen the domestic effectiveness of fiscal policy (while the effectiveness of monetary policy will be enhanced). The argument is the open-economy analogue to the idea of "crowding out," according to which the increase in interest rates caused by a government deficit will, with an unchanged money supply (or rate of money growth), discourage private investment and thus offset the stimulative effect of the deficit. In an open economy, the rise in domestic interest rates resulting from a stimulative fiscal policy will attract capital inflows, cause the currency to appreciate, and thus lead to a deterioration in the goods-and-services account that again offsets the desired stimulative effect. Again, there is controversy concerning the assumptions of the model and about the degree to which offsetting actually occurs. But the possibility that such effects may operate introduces a cautionary note regarding the extent to which the effectiveness of domestic fiscal policy is enhanced by a shift from pegged to flexible rates.

Finally, there is the fact that flexible rates provide only limited insulation against foreign disturbances in a world of capital mobility. If there are internationally mobile securities and investors sensitive to interest-rate differentials among countries, a change in one country's monetary policy will affect interest rates in all countries and will thus impinge on levels of economic activity even under flexible rates. In fact, depending on the type of foreign disturbance or stimulus to which international capital flows are most sensitive, the international transmission process may in some cases be magnified rather than dampened by exchange-rate flexibility. Thus, the degree of insulation provided by flexible exchange rates depends both on the type of disturbance that is assumed to dominate in the international arena and on the particular nature of the domestic response.

Because insulation is limited—more limited than had been generally anticipated—something in addition to flexibility is needed to help resolve the potentially disruptive tension between international interdependence and the desire for national economic self-determination. The "something" most frequently mentioned is policy coordination among national governments designed to minimize the transmission of disturbances and help to compensate for the attenuated power of any individual government

to stabilize its domestic economy using the traditional stabilization tools. It is essential at the outset, however, to sort out what is meant by coordination.

At the lowest level, coordination can simply mean the avoidance of explicit beggar-my-neighbor policies, such as the use of trade barriers or exchange-rate manipulation, to solve domestic economic problems. This sort of "negative coordination" has been traditionally both the object and the *sine qua non* of an effective international economic system. It is, in fact, at least part of what we mean by that phrase. But I have already argued that the need to reconcile interdependence and autonomy calls for some form of "positive coordination" of countries' macroeconomic policies. The most limited form of positive coordination, wherein each country takes account of the probable policies of others in setting its own, is clearly essential to avoid the global inflationary or deflationary "overkill" that otherwise results from interdependence and that appears to have exacerbated first the widespread inflation and then the equally widespread recession of recent years. It may be necessary, however, to go further. Indeed, the close relationship between exchange rates and domestic policies creates considerable pressure to move beyond intensified consultation to the development of a framework within which nations actually agree on broad macroeconomic targets and plan policies to achieve them cooperatively, including the coordination of policy timetables.

There is considerable precedent for the modification of domestic policies to conform to international requirements. The increasing conditionality of IMF loans in the higher "credit tranches" relates precisely to the right of the Fund to require modifications of domestic policies. Nor are such modifications demanded only of developing-country debtors; the conditions imposed by the IMF in loan negotiations with Italy and the United Kingdom in 1976 represent the most recent examples of such intervention, but similar episodes occurred during the 1960s (see Strange, 1976, Chap. 5). The question is not, therefore, whether "coordination" under international auspices is to be initiated *de novo*. Rather, the question is whether it can be generalized to apply to creditor as well as debtor nations, and whether it can be exercised continuously and cooperatively rather than intermittently and under duress, while still preserving scope for nations to pursue differing domestic objectives.

As the perception and reality of interdependence have intensified, the situation of the United States has shifted substantially. From the mid-1950s to the mid-1960s, the United States was viewed at home and abroad as an "island of stability" whose behavior helped dampen the waves of

economic fluctuations in other countries. The U.S. inflation rate was well below those experienced in most other industrial countries, and cyclical fluctuations in real economic activity were growing milder in amplitude and duration. The U.S. balance on goods and services was positive throughout the period, representing a net transfer of American output to the rest of the world, and rose irregularly from \$0.5 billion in 1953 to \$8.5 billion in 1964. Looking at the relationship from the other direction, foreign trade appeared to be a stabilizing influence on domestic prices in the United States. From 1954 to 1970, the rate of increase in the import component of the GNP deflator was far below the aggregate rate of increase. The same was true, to a lesser extent, of the export component.

Between the mid-1960s and the end of the Bretton Woods system in mid-1971, the prevailing view of the United States changed dramatically. What had been an island of stability came to be regarded as the major exporter of inflation. Domestic inflation began to accelerate in 1966, and in 1968-70 it rose above the average rate for other major industrialized countries. From 1964 to 1972, furthermore, the U.S. balance on goods and services declined by more than \$14 billion, from a surplus of \$8.5 billion to a deficit of \$5.9 billion. A significant share of the excess demand that would otherwise have inflated the domestic price level spilled over instead into foreign markets.

In addition to the changes in behavior just described, major analytical developments altered perceptions of the U.S. role in the transmission process. One is the proposition, supported by a growing body of empirical evidence (see Balassa, 1964; Haberler, 1973; McKinnon, 1971), that because of systematic changes in relative prices occurring in the process of economic growth, relatively slow-growing countries (like the United States and the United Kingdom) may export inflation to faster-growing countries (like Germany and Japan) even when the overall rate of inflation appears to be lower (or no higher) in the slow-growing countries. The second is the still controversial (see Whitman, 1975a) proposition that, under the gold-exchange standard of the Bretton Woods system, the United States, by virtue of its reserve-currency status, was the one country able to determine its inflation rate domestically, free of any direct balance-of-payments constraint, while money supplies and thus inflation rates in other countries were determined primarily by their balance-of-payments positions. As has already been mentioned, the end of the dollar-based gold-exchange standard and the shift to generalized floating significantly reduced (if they did not entirely eliminate) this particular transmission mechanism.

At the end of the 1960s, moreover, there occurred a major shift in the role played by U.S. foreign trade. No longer did the prices of exports and imports rise less rapidly than the general price level. On the contrary, between 1970 and 1975, the export component of the GNP deflator rose nearly twice as fast, and the import component nearly three times as fast, as the aggregate index. By 1975, several years after the shift to an exchange-rate regime that promised to increase the ability of countries to insulate themselves from external disturbances, the United States and other industrialized nations appeared to be importing inflation from each other simultaneously and to a much greater extent than before.

The intensity of the inflation arising in the foreign-trade sector of the U.S. economy in 1971-74 did much to heighten the perception that interdependence operates in both directions. The apparent impact of the depreciation of the dollar on the domestic price level took many Americans, including many economists, by surprise. Forecasts of this impact based on conventional Keynesian models were very low, because in this framework the primary inflationary effect would come by way of increased prices for imported inputs and finished goods (as long as the economy was below full employment), and the share of imports in U.S. GNP is fairly small. Forecasts based on the integrated world model underlying the so-called "monetary approach" to the analysis of devaluation would have implied a larger increase in the U.S. price level, approaching the amount of the depreciation, but this view did not enjoy wide currency at the time.

There have since been a number of empirical studies incorporating channels of transmission not encompassed by the conventional Keynesian approach (for references see Whitman, 1975a). The evidence is not conclusive, partly because the studies produced a wide range of results and partly because in each case the results are the captive of the assumptions used to generate them, and there is as yet no generally accepted and fully articulated set of assumptions regarding the mechanisms through which a change in the exchange rate affects the domestic price level. In general, however, these studies have put the price-level impact of an exchange-rate change substantially above the one implied by a crude *ex ante* calculation based on the Keynesian model (albeit well below the long-run upper bound implied by the monetary approach). These investigations drive home two points. First, the foreign sector is a significant transmission belt for inflationary impulses, even in a relatively closed economy like that of the United States. Second, in such an economy shifts in *relative* prices are likely to have substantial and prolonged inflationary effects on the general price level, even when they arise on the

supply side, as some have in recent years, and their *real* effects are deflationary.

Despite heightened American perceptions of interdependence as a two-way phenomenon, and despite the accretion of empirical evidence supporting that proposition (see, for example, Ripley, 1976; Klein, 1976; *Economic Report of the President*, 1976, pp. 134-135), other countries still look to the United States as a primary source of, as well as a solution to, their own economic difficulties. This was made clear at the Rambouillet meeting in November 1975. Even if imperfectly accurate, this perception is a fact of political life. It is one reason why, if progress is to be made toward positive policy coordination, the United States will have to assume leadership.

Another reason is tradition. Although its record has not been spotless, the United States has tended to take the lead in promoting "negative coordination" throughout the postwar period. It took the initiative in promoting trade liberalization through successive rounds of trade negotiations, the latest of which is currently underway in Geneva. And because the avoidance of beggar-my-neighbor policies also requires that countries eschew inconsistent targets for their current accounts or exchange rates, the United States stressed the importance of achieving consistency throughout the discussions and negotiations on international monetary reform. Finally, in recent years the United States has pressed for the development of an international framework to govern international investment and for coordination by the industrialized nations of their policies vis-à-vis developing countries.

Can the United States assume effective leadership in the achievement not only of negative but also of positive coordination, or at least of an international framework within which it can develop gradually? The history of past efforts along these lines is not entirely encouraging. In the early 1960s, for example, there were efforts to establish guidelines for cooperation on stabilization policies among the OECD countries. These foundered on disagreement between the United States and European countries as to how formal and restrictive the principles should be. More recently, the discouraging experience of the EEC in its attempts to achieve an economic and monetary union suggests how difficult it is for governments to make the transition from negative to positive coordination.

Some pieces of the necessary framework already exist in embryonic form: the OECD's Working Party 3, in which balance-of-payments targets are compared and potential inconsistencies reconciled, at least on

paper; its Economic Policy Committee, where there are consultations on domestic economic prospects and policies; and its annual review of each country's economic outlook and associated policy stance for the coming year. The IMF also conducts an annual country review, although the reports, unlike those of the OECD, are not made public. Furthermore, the United States is once again leading the world in economic recovery, and its relatively low inflation rate over the past year gives hope that it may once again regain its historic position as an island of stability. It is therefore in a good position to exercise the necessary leadership. Certainly, the effort must be made; both the logic of analysis and the evidence from recent experiences indicate that, despite the partial buffer provided by managed flexibility of exchange rates, tension persists between the vulnerability created by increasing market integration and the fragmentation of policy formation. If we do not find ways to coordinate policies, we will inevitably slip backward from market integration.

### **Microeconomic Issues**

No airtight distinction can be made between macroeconomic and microeconomic issues. The impact of general stabilization policies, of fluctuations in general levels of national economic activity, and of the process by which these fluctuations are transmitted internationally falls unevenly on industries, sectors, regions and economic and social groups within countries. Furthermore, the maintenance of macroeconomic stability is critical for the successful management of microeconomic problems. Trade liberalization is more effective, as well as more likely, when national economies are sufficiently healthy to serve as markets for the exports of other participating countries; agreements regarding international investment will have little meaning in the absence of funds for investment in the home country and opportunities for investment in the host country. Above all, the domestic structural adjustments required when international patterns of trade and investment shift in response to market forces may be socially and politically manageable in the context of steady growth but totally intractable if imposed on an economy already suffering from stagnation or severe fluctuations in economic activity. Fundamentally, an improved management of macroeconomic problems and an improved framework for dealing with microeconomic issues are complementary; success in the former will make the achievement of the latter more probable and meaningful, while progress in the latter will help to realize the opportunities for mutually beneficial international transactions offered by stable growth in the world economy.

## *The Trading System*

The creation and management of the postwar trading system has centered in the multilateral negotiations conducted periodically under the auspices of the GATT. The latest of these, the so-called "Tokyo Round" initiated at the urging of the United States, has been underway for some three years, with little visible progress. To understand why, and what might be required to get these discussions off dead center, it is essential to identify the central issues and, for this purpose, to look at the guiding principles underlying the GATT and at the challenges they face currently.

The initial purposes of the GATT were to achieve "freer and fairer trade" by the substantial reduction of tariffs and other barriers to trade and the elimination of discriminatory treatment. These guiding principles have been expanded and have recently been categorized (Curzon, 1976, Chap. 1) as "the four pillars" of GATT: nondiscrimination and multilateralism via application of most-favored-nation (MFN) treatment to all signatories; expansion of trade via reduction of trade barriers; reciprocity as the basis of trade relationships; and establishment of a world trade order or set of "ground rules" for the conduct of commercial policy. All four, however, are threatened by challenges, some old and persistent, some new or intensified, that complicate the process of negotiation and the very maintenance of an effective trading system.

The concept of multilateralism, embodied in the MFN principle, was the aspect most stressed by the United States in its original support for the GATT, and it was, in fact, the major obligation spelled out in the original text of the GATT. (The goal of barrier reduction appeared only in the preamble; it was not listed as an operative obligation until 1955.) The MFN principle has important advantages. By ensuring that trade barriers are applied in a nondiscriminatory manner, it minimizes the inefficiencies and distortions created by those barriers. By ensuring that any trade concession negotiated between two or more countries will be promptly extended to all member countries, it avoids trade diversion and injury to third parties and increases the scope and impact of multilateral GATT negotiations.

The major threat to the global MFN approach is, of course, the proliferation of preferential trading arrangements. The possibility of regional arrangements was foreseen. The GATT specifically exempts full customs unions and free-trade areas from the obligations of MFN treatment, in the expectation that the growth-stimulating and trade-creating effects of such arrangements would outweigh their trade-diverting effects. Further-

more, the most important regional grouping, the EEC, was urged into being by the United States and received its strong support. (Political considerations were, of course, paramount in U.S. support for the formation of the EEC; it was seen as strengthening the Western alliance and minimizing the threat of resurgent German nationalism.) In the early 1970s, however, a variety of less comprehensive preferential arrangements cropped up, in particular the association agreements between the EEC and forty-six developing countries, mainly in Africa and the Caribbean, formalized in the 1975 Lomé Convention. The partial and selective nature of these and other loose arrangements are cause for concern that their trade-diverting effects are likely to dominate, restricting and distorting international trade.

The tension between the global approach to trade liberalization favored traditionally by the United States<sup>8</sup> and the preferential approach sponsored by the EEC promises to persist, and a frontal attack on preferential arrangements is almost certain to be unproductive. The most promising way to minimize the disintegrative effects of such arrangements is instead to work for more effective multilateral surveillance of regional arrangements and for continued progress in multilateral trade liberalization.

Article XXIV of the GATT, relating to the establishment of customs unions and free-trade areas, provides for an intensive working-party investigation of any proposed union or area and for an annual review once it is in operation. It also empowers a two-thirds majority to ask for changes in any scheme, which then have to be presented for approval or disapproval. The consultative and review procedures have been duly followed, but the formal modification mechanism has never been invoked. Ironically, it was pressure by the United States, concerned at the time to remove roadblocks standing in the way of the EEC, that created the precedent in 1958 whereby a customs union or free-trade area could go into operation without a formal vote by the GATT. This precedent has left nonmember GATT signatories with few practical options other than to request consultations and to "reserve their GATT rights" regarding arrangements with which they are not satisfied. There remains the option of claiming "nullification and impairment" under Article XVI, but this option has never been invoked, probably because of the high risk of creating an impasse that could threaten the survival of the GATT itself.

The moral suasion exercised in consultations and reviews is not entirely without effect. In the face of strong U.S. objections, for example, the

<sup>8</sup> The U.S.-Canadian Automotive Products Agreement, signed in 1965, is an exception to the general U.S. position.

EEC removed "reverse preference" provisions from its association agreements. But the scope for using the GATT framework for such purposes has proved extremely limited. There is need, then, for the United States to win the support of the EEC and Japan for a more effective form of multilateral surveillance over regional trading arrangements. This would be a significant safeguard against the erosion of global nondiscrimination.

The extent to which regional blocs and preferences distort trade patterns depends heavily on the height of their barriers against trade with nonmembers. Thus, general reciprocal tariff reduction would reduce the discriminatory effect of customs unions and free-trade areas. This was a major argument underlying support for U.S. trade legislation in 1962 and 1974 authorizing American participation in the Kennedy and Tokyo rounds of trade negotiations. In the limit, if all tariffs were reduced to zero, a customs union or free-trade area would have no distorting effects (and no reason for being). Similarly, belated U.S. support for the generalized system of tariff preferences for imports from developing countries was motivated in part by concern about the discriminatory effects of EEC association agreements on developing countries outside the EEC network (particularly since many of the latter are in Latin America, an area in which the United States has long had a special interest). Any global change in commercial policy, in other words, that narrows the gap between tariff barriers faced by members of a regional grouping and by countries outside will reduce the discriminatory trade effects of the arrangement. By the same token, of course, members of such groups are apt to resist generalized liberalization precisely because it would weaken the distinction between "insiders" and "outsiders" and thus the group's *raison d'être*. Such concerns have surfaced from time to time in positions taken by the EEC; it is to be hoped that they will abate as—and if—the EEC progresses beyond being a customs union to higher levels of economic integration.

Although the second "pillar" of the GATT, trade liberalization through reductions of tariffs and other explicit barriers "at the border," was not the main aim of the GATT originally, it soon became the arena of greatest success. Certainly the trade-liberalizing negotiations of the late 1950s and 1960s contributed importantly to the remarkable expansion of world trade. Some of the intensified challenges faced currently by this market-oriented approach to trade expansion were mentioned in the introduction: the decline in the economic hegemony of the United States, the major supporter of this approach; the enlargement of the trading system to include countries having stronger traditions of government intervention in the economy; and the proliferation of economic responsibilities thrust

on the governments of the Western democracies, increasing the pressures for interventionism even in the basic nucleus of nations as well. Above all, the success of previous negotiations in reducing tariffs to relatively low levels makes further progress difficult. The tariffs and quantitative restrictions that have not been reduced substantially in several rounds of negotiation are almost certain to be those whose removal is perceived to be particularly troublesome politically or socially disruptive. Furthermore, because tariffs have been reduced substantially, they are no longer the most important trade restrictions and distortions. The more significant barriers today fall into two broad groups: nontariff barriers and agricultural restrictions. These, as I said earlier, are frequently by-products of legitimate domestic social policies and are deeply embedded in domestic law. Domestic and commercial policies are therefore inseparable, and further efforts to reduce trade distortions by bargaining away barriers "at the border" become ineffective.

The challenges faced by reciprocity, the third "GATT pillar," are intertwined with those faced by barrier reduction. Reciprocity is absolutely fundamental to the GATT's trade-liberalizing approach. Liberalization must be reciprocal if it is to be politically acceptable. It is therefore useful to discuss liberalization and reciprocity together.

The definition of "reciprocity" has never been simple. Each trade negotiation (including the current one) has bogged down for many months in the search for an acceptably "reciprocal" formula for tariff reduction. In bargaining about nontariff barriers and agricultural protectionism, moreover, the problems of definition, identification, and measurement multiply many times. Clearly, a broader, more flexible concept of reciprocity is required if progress is to be made in these areas, especially in the agricultural area, where reciprocal barrier reduction has met with little success despite many years of effort (see Warley, 1976).

Early in the 1960s, the traditionally interventionist agricultural policies of the United States began to take a more market-oriented direction, with stress on "getting the government out of agriculture." Accompanying (and to some extent preceding) this shift was an increasing stress on expanding agricultural exports, and the United States thus became the leading proponent of trade liberalization in the agricultural sphere. But efforts to achieve multilateral liberalization, especially to obtain substantive changes in the highly protectionist Common Agricultural Policy (CAP) of the EEC, met with repeated failure and generated mounting frustration. Without delving here into the details of these efforts and policies, I note only a few implications for U.S. policy suggested by experience so far.

First, efforts to reduce distortions in agricultural trade by focusing mainly on barrier reduction, as the United States has tended to do, are almost certain to be ineffective. Commercial policies in the agricultural sphere are everywhere the by-products of domestic agricultural policies. The emphasis here must therefore be on cooperative international management to mitigate the distortions introduced by national policies. Second, efforts to force the EEC to modify the CAP in order to bring it into closer conformity with GATT rules are certain to prove unavailing, inasmuch as the CAP represents a carefully negotiated package reconciling the divergent goals of the EEC members and is also regarded as an important—perhaps the major—bond holding the EEC together. Rather, the focus must shift from issues of principle to a more pragmatic level, concentrating on the implementation of particular CAP provisions—the height of specific support levels, the degree of self-sufficiency in particular products, etc. Third, concern with efficiency in agricultural production and trade must not preclude recognition of the widespread desire for stability expressed by producers and consumers alike in notoriously unstable agricultural markets. The deliberate depletion of government-financed stocks of agricultural commodities in 1972-73 eliminated a substantial burden on the U.S. taxpayer and enhanced the market orientation of American agriculture, but it left producers and consumers all over the world unexpectedly vulnerable to wide price fluctuations produced by shifts in supply and demand.

Several severe crop shortfalls occurring under these conditions helped to alter the focus of concern in recent years, away from perceiving agricultural issues primarily as matters of “farm policy” toward viewing them instead as aspects of “food policy.” At the center of this new focus is the proposal for world food reserves. It is clearly important to accumulate sufficient stocks of major agricultural products, preferably on an international basis, to provide for disaster relief and also to mitigate sudden wide variations in worldwide supply and price. In the absence of such reserves, unilateral efforts by other nations to insulate their own economies against such fluctuations can only exacerbate the instabilities faced by the United States, which is a residual supplier in many important markets. Until world food reserves are accumulated, it is essential that U.S. agricultural policy retain maximum flexibility to respond to sharp shifts in world agricultural markets. Long-term agreements to mitigate erratic fluctuations in demand, such as the one signed in 1975 with the Soviet Union, may also be helpful.

Finally, two comments regarding reciprocity. First, the U.S. position as a champion of agricultural trade liberalization might be more per-

suasive if it were less selective. Its policies toward agricultural products in which it does not have a comparative advantage have been as protective and restrictionist as any. These products include dairy products, cotton, sugar, wool, and certain meats. Import restrictions on some of these have been relaxed temporarily in recent years as an anti-inflationary device. If this liberalization were made permanent, it would be welcomed as an indication of willingness to take the first step toward reciprocal liberalization. Second, it is necessary to redefine "reciprocity" so as to encompass the whole range of policies impinging on agricultural trade. In retrospect, the United States may have thrown away a promising opportunity to initiate a redefinition when it turned down the EEC's offer to negotiate overall levels of protection (*montant de soutien*) on agricultural commodities during the Kennedy round. At the least, its refusal shifted onto the United States responsibility for taking the initiative in developing definitions of reciprocity and approaches to negotiation that reflect the realities of agricultural policies.

Whereas the three fundamental principles of the GATT discussed so far relate primarily to positive acts of trade liberalization, the fourth is essentially negative. It involves the establishment of a world trade order or set of "ground rules" for the limitation and multilateral surveillance of commercial policies other than tariffs. Some specific needs have already been discussed—for surveillance of preferential trading arrangements, nontariff barriers, and commercial policies relating to agricultural products. There are three other areas, however, in which the GATT framework requires modification or expansion.

The first has to do with the use of trade restrictions for balance-of-payments purposes. The GATT escape-clause provision permitting the use for this purpose of quantitative restrictions but not of tariffs or tariff-type measures is simply silly. It should be modified (indeed reversed) to conform both to economic rationality and to actual practice. In the past few years, the United States, the United Kingdom, Denmark and Italy have each used some sort of general import surcharge, rather than quantitative restrictions, for balance-of-payments purposes. More fundamentally, the GATT provision was designed for a world of pegged exchange rates that would have to be supported from time to time in the face of payments disequilibria arising from domestic full-employment policies. With the shift to managed floating, the rationale for this escape clause is undercut; currency depreciation can now be utilized directly to correct payments disequilibria. Thus, the change in the exchange-rate regime offers a promising opportunity for rewriting the GATT rule to limit or even proscribe the use of trade restrictions for balance-of-pay-

ments purposes. The Declaration on Trade Measures appended to the C-20 *Outline of Reform*, which essentially commits signatories to refrain from using current-account restrictions for balance-of-payments purposes, is a promising beginning.

The second point relates to the imposition of trade restrictions to cushion the domestic impact of abrupt changes in trade patterns, particularly rapid increases in imports. The present GATT escape clause permits temporary action in cases where import competition threatens injury to domestic producers. But the clause can be invoked only when the increased import competition is attributable to previous tariff concessions, and the country invoking it to impose trade restrictions is required to compensate its trading partners by equivalent reductions in other trade barriers. The economic and social commitments of governments, already discussed, have made them extraordinarily sensitive to the adjustment problems posed by rapid increases in particular imports, and most of them therefore regard the GATT escape clause as too restrictive. Most of the industrialized nations, including the United States, have developed unilateral safeguard mechanisms that fail to conform to GATT requirements. For these reasons, the United States has for some time urged the development of a multilateral safeguard system that would recognize the political pressures on governments to utilize import restrictions but would subject them to internationally agreed criteria and provisions for multilateral review and surveillance. Multilateralization would reduce the potential for friction latent in unilateral arrangements and diminish the danger that restrictions imposed for temporary purposes could become permanent.

Finally, the GATT coverage of trade policies is incomplete in that it does not extend effectively to controls on exports, and these have proliferated rapidly in recent years. Such controls are of two types. There are, first, so-called "voluntary export restraints" negotiated at either the government or industry level. These restraints are disguised forms of import quotas; the exporting country agrees (generally under threat of the imposition of explicit import quotas) to limit the rates at which its exports of particular products grow in particular markets. Such agreements are usually brought into being by rapid changes in trade patterns of the type discussed in the previous paragraph. They reflect demands in the importing countries for a cushioning of the adjustment process, and they should be subjected to the same multilateralization of criteria and procedures that I have suggested for other safeguard measures.

The other export controls that have proliferated recently are those that have been instituted at the initiative of the exporting country and in pursuit of its own self-interest. They have been applied for a variety of rea-

sons (see Bergsten, 1974b, pp. 4-14), but most recent uses by industrialized countries have reflected attempts to protect the domestic economy from physical shortages or rapid price increases. With the acceleration of worldwide inflation and increasing concern about "stagflation," countries have sought to avoid importing (or even to export) inflation by erecting barriers to exports, just as they have long sought to ward off (or export) unemployment by restricting imports. The short-sightedness and ultimate ineffectiveness of these policies are particularly transparent in a world of floating rates; export restrictions of any significant magnitude exert downward pressure on the price of domestic currency and thus upward pressure on the internal price level. United States experiments with export controls in 1972-74 were limited and short-lived. They nevertheless made our foreign customers nervous and lent support to protectionist forces in Europe and Japan that had long advocated reducing dependence on U.S. agricultural exports by promoting high-cost domestic self-sufficiency. The episode therefore suggests not only the advisability of unilateral abstention from the use of such controls but also of filling the gap in the GATT rules with provisions regarding export restrictions that would be symmetrical with those regarding import restrictions (see Bergsten, 1974b, pp. 27-50, for detailed proposals). Now that concern about the transmission of inflation has become no less important an influence on policy than concern about the transmission of unemployment, restrictions on access to supply can come to distort international trade as seriously as restrictions on access to markets. The rules of the international trade system should reflect that fact.

### *International Investment*

In the trade and monetary spheres, there is a need to adapt or expand existing institutional arrangements to meet changed conditions and new needs. In the sphere of international investment, the problem is larger—to create from scratch an institutional framework. The "grand design" for the postwar international economic system was to have been based on three institutions: the International Trade Organization to provide ground rules for international trade and private investment, the IMF to service the international monetary system, and the World Bank to mobilize private capital for the tasks of economic reconstruction and development. But the International Trade Organization was stillborn in the face of U.S. Congressional opposition, based partly on objections to provisions regarding the rights of host countries to control foreign investment within their borders. The GATT became a partial and somewhat awkward substitute, and it does not cover international investment. The

OECD adopted a Code of Liberalization of Capital Movements in 1961, but it remains nothing more than a general statement of intent.

There is a second difficulty in the way of dealing with problems of investment. The United States is almost alone in holding that freedom of international capital movements contributes in the same way to the maximization of world income as freedom of international trade. The United States imposed capital-export restraints for balance-of-payments purposes in the 1960s, but did so partly in response to European pressures. It welcomed the opportunity afforded by the move to flexible exchange rates to rescind all restraints at the beginning of 1974. Europeans tend to doubt that the benefits of international integration are as great potentially for capital markets as for commodity markets. Their view is reflected in the IMF Articles of Agreement, which stress the avoidance of restrictions on current-account transactions but make no mention of restrictions on capital-account transactions. This asymmetrical view carried over into the *C-20 Outline of Reform*, which included a section on measures to limit "disequilibrating capital flows," including administrative controls.

Views regarding international investment and capital flows are closely intertwined with those regarding the multinational corporation, the major vehicle for such investment. Together with the Eurodollar market, multinationals are the primary agents of interdependence. As such, they embody the potential for increased global prosperity but are also targets for all of the tensions and frustrations generated by interdependence. They are uniquely conspicuous in appearing to threaten national economic sovereignty, even as they are uniquely effective in promoting international integration and the global diffusion of capital and technology.

National concerns about the economic effects of multinational corporations and efforts to limit their operations are rationalized by three closely related but distinguishable arguments.

First, multinational corporations, because their scope is greater than that of any national jurisdiction, can undermine or evade the tax and regulatory regimes of sovereign states. The capital embodied in a multinational corporation is the most "footloose" of all factors of production; any government that tries to establish a fiscal or regulatory environment less favorable to that capital than is available elsewhere may watch it migrate to greener pastures. This mobility can also set up situations in which nations "bid" against each other to attract capital by modifying their domestic environments in ways that are not necessarily in the national interest of any competing participant or that at least distort the internal distribution of income by increasing the share going to internationally mobile capital. Finally, there is widespread concern that multi-

national firms are able to use internal transfer pricing and related devices to minimize their total tax burdens in ways not available to other taxpayers.

Second, international investment in general, and multinational corporations in particular, can become pawns of national governments. This concern is in a sense the mirror image of the first. Because multinationals operate across national jurisdictions, a nation able to affect their operations can sometimes extend its own jurisdiction beyond its borders to alter the international distribution of income or power in its own favor. At one time, the focus of concern was the ability of the most powerful parent country, the United States, to extend its political jurisdiction by controlling the behavior of the foreign subsidiaries of U.S.-based multinationals. Thus, U.S. efforts to force the Canadian subsidiaries of American firms to abide by the U.S. embargo on exports to Cuba provoked strong reactions by other governments. More recently, however, a shift in the distribution of power between home and host countries has taken place, and today there is concern about the efforts of host countries to harness and direct multinational investment (Bergsten, 1974a; Vernon, 1977). The most dramatic recent example was the OPEC countries' use of the multinational oil companies as "policemen" of the 1973 petroleum embargo. But many countries can and do employ a wide variety of measures to affect international patterns of investment and the associated patterns of production and trade.

Third, it is increasingly asserted that multinational corporations cause economic realities to differ so much from the classical competitive-market model as to vitiate the arguments deriving from that model for freedom of trade and investment. Multinationals respond to incentives, such as tax differentials, that have nothing to do with economic efficiency and the maximization of world production. Furthermore, it is argued, an increasing proportion of world trade involves intra-firm transfers rather than arm's-length transactions, making international flows of commodities less responsive to marginal changes in relative costs and prices, the keystone of the competitive-market model. Large multinational corporations do possess market power, and they do represent one source of divergence between reality and the classical model. But those who use these truths to justify restrictions on trade and investment invariably fail to demonstrate that the restrictions they propose will in fact decrease the degree of divergence.

Under the pressure of these concerns, the traditional *laissez-faire* attitude of the United States has undergone modifications, although the United States remains among the least interventionist of nations in matters

of international investment. Reflections of this shift include the 1973 proposals (not so far enacted) to limit tax deferral on the reinvested earnings of foreign subsidiaries in particular instances, including those where foreign governments offer particular tax incentives to attract investment. Recently, moreover, as the devaluation of the dollar has made the United States more attractive to foreign investors and the newly rich OPEC countries have sought investment outlets for their surplus earnings, concerns have been voiced about the possibility of foreign "takeovers" of key U.S. industries, echoes of complaints voiced frequently in other nations fearful of investments by U.S.-based concerns. Suggestions have been made for broadening the few limitations on foreign direct investment in the United States (presently confined to investments in electronic communications, atomic energy, shipping, airlines, and fishing), and new or intensified prior-consultation, monitoring, and review procedures for such investment were introduced in 1976.

One significant obstacle to the formulation of rational policies regarding foreign investment and the multinational corporation is ignorance about their economic impact. There is little knowledge and even less agreement about effects on such economic aggregates as income, employment, the trade balance, and the balance of payments, whether in the parent or host country. Major studies have failed to yield common conclusions, largely because they have made different assumptions about the "counterfactual" situation, that is, the conditions that would have prevailed in the absence of international investment. The one major conclusion that can be drawn from studies in this area (see, for example, U.S. Senate Committee on Finance, 1973, and Bergsten *et al.*, 1977) is that, whether the effects be positive or negative, they are probably small, not only in relation to total GNP or employment but also in relation to the gross fluctuations in these economic aggregates. Nevertheless, international investments can have large effects on output and employment in particular sectors or industries, suggesting that the dynamic processes involved, like the rapid changes in trade patterns associated with them, may cause significant transitional problems of structural adjustment, raising the same sorts of policy issues already discussed with respect to trade.

Increased knowledge is not a guarantee of rational policy. Indeed, more information might sometimes encourage beggar-my-neighbor policies in matters of investment; it could increase the effectiveness of countries' efforts to redistribute benefits in their own favor. Countries would have divergent interests even if they had perfect information, and mechanisms are required to prevent the policies based on these divergences from reducing the contribution of multinational investment to world economic

welfare. This need is the more urgent now that the question of chronic "capital shortage," or inadequacy of aggregate investment to sustain acceptable growth of employment and real wages, is becoming a matter of concern in industrialized as well as developing countries. Fears about inadequate levels of global aggregate investment are bound to exacerbate problems relating to the geographical distribution of that investment. An institutional framework, analogous to the GATT in the trade sphere and the IMF in the monetary sphere, is needed to establish multilateral ground rules regarding international investment.

Ideally, such a set of rules would be symmetrical, covering both the behavior of multinational firms in relation to their home and host countries and the policies of national governments vis-à-vis the firms. More specifically, they should serve several functions. They should establish criteria for good behavior on the part of multinational firms, directed toward ensuring that firms would not act to undermine the economic policies of home or host countries. They should, in turn, provide for "national treatment" of foreign investment, eliminating the inefficiencies and frictions created by discrimination on the basis of nationality of ownership. At a minimum, they should regulate selective national incentives to and restrictions on foreign investments to prevent distortions and conflicts arising from beggar-my-neighbor struggles over the division of the benefits from investment. Going one large step further, they might provide a basis for harmonizing national tax, antitrust, and related policies to minimize their influence on decisions regarding the location of international investments—influences that bear no necessary relation to differences in the marginal social productivity of capital. Finally, they should provide procedures for adjudicating disputes and for surveillance of the nonconforming policies that would inevitably arise.

This is a tall order. A welcome first step is taken by the OECD's 1976 *Declaration on International Investment and Multinational Enterprises*. This document calls for national treatment, "transparency," and cooperation regarding incentives and disincentives to international investment, as well as consultation and review procedures. An annex sets forth guidelines for multinational enterprises, stressing the need for them to conform to the policy objectives of the countries in which they operate and spelling out specific implications of this general injunction. The OECD document contains a number of controversial points relating primarily to the disclosure of information that has heretofore been regarded as proprietary by multinational corporations; these would have to be ironed out in the development of a viable and effective institutional framework. There are, in addition, large substantive and procedural gaps to be filled

in. The critical question, however, is whether the developing countries would find such a framework acceptable and, more fundamental, whether industrialized and developing countries can ever agree on the appropriate balance between the responsibilities of multinational firms toward host governments and those of host governments toward the firms. Aspects of the requisite framework will be considered in discussions of proposed codes or agreements relating to transnational corporations, illicit payments, technology transfer, and restrictive business practices, currently being conducted under the auspices of the United Nations or UNCTAD. But differences in view are wide and, at the moment, the outlook is not greatly encouraging.

### *Relations with Developing Countries*

Seizing the rhetorical initiative with demands for a "new international economic order," the developing nations have raised a host of issues relating to trade, investment, technology transfer, debt rescheduling, foreign assistance, and the functioning of the international monetary system. Through all these issues run some major common threads.

The first is the question of power or economic sovereignty. The developing countries are intent upon acquiring increased control over their own natural resources—over investment, production, and prices. This they perceive as a process of "catching up" with the governments and firms of developed countries. Ironically, these efforts come at a time when the industrialized nations in general and the United States in particular are themselves acutely insecure about their own capacity for economic self-determination. They have been shaken by the OPEC oil embargo and subsequent price increases and the worldwide waves of commodity-based inflation and subsequent recession, all superimposed on longer-term trends of declining self-sufficiency and growing reliance on imports of key raw materials. Of 13 industrial raw materials required by a modern economy, the United States imported more than half its supply of 4 in 1950 and 6 in 1970; the number is projected to rise to 9 by 1985 and to 12 by the end of the century (Brown, 1972, p. 194). Ideally, concerns about self-determination would be a basis for restructuring relationships between developed and developing nations. But this would call for recognition of mutual needs and potential benefits. Unfortunately, national insecurities have contributed instead to a hardening of rhetoric on both sides.

A second thread running through the debates about specific issues is a confusion between the concept of economic development, involving structural changes in the economies of developing nations, and the notion

of redistribution, involving a reshuffling of income and/or wealth between developed and developing nations. This confusion has in turn obscured the vital distinction between reforms that would eliminate market distortions afflicting existing patterns of international trade and investment, thereby increasing global income, and reforms that would redistribute income without increasing it. Attention to the former would not preclude discussion about the distribution of the gains among the various participants, but that discussion could take place in a positive-sum context; all participants could hope to gain to some extent. The context would be fundamentally different from one involving a zero-sum or negative-sum outcome, in which some participants can gain only if others lose, in absolute as well as relative terms.

In my selective discussion of specific issues, I shall try to show that the route to resolution requires a common acknowledgment of the desire for self-determination and a greater concentration on reforms that promise positive-sum outcomes.

Among the trade-policy issues dividing developed and developing countries, the one that has engendered the most interest and controversy is the demand for commodity agreements and the closely related question of price indexation. Here, we encounter a particular confusion that compounds those I have already mentioned. Two distinct sets of concerns are entangled in discussions of commodity agreements: those relating to the *stabilization* of prices and/or incomes and those relating to the *redistribution* of income in favor of commodity producers through the maintenance of prices permanently above market-determined levels. Obviously, it is only in terms of stabilization that one can talk meaningfully about positive-sum outcomes—about balancing the interests of producers and consumers in such a way that both can gain. Wide fluctuations in commodity prices have economic costs, and increased stability can be expected, *ceteris paribus*, to enhance the economic welfare of all market participants. Furthermore, recent boycotts, crop failures, shortages, and export controls have driven home the importance of *availability* and the complementary relationship between access to markets and access to supplies.

There is wide agreement among economists (see Fried, 1976, p. 645) that buffer stocks are preferable to production controls or export quotas as devices for reducing price fluctuations, and that question will not be reargued here. Yet experience suggests that even buffer-stock approach is applicable only to a limited number of commodities and that, even in these cases, arrangements are hard to negotiate and even harder to implement. "Past attempts at using buffer stocks generally have foundered

upon the inadequate size of such stocks, the high costs of holding inventories, and breakdowns in agreements among members on operating the stocks" (*Economic Report of the President*, 1976, p. 152).<sup>9</sup> Thus, these general *caveats*: First, buffer stocks, when and where employable to provide a cushion against short-term price fluctuations, should not stifle responsiveness to longer-term market forces; presumably, this can best be achieved by requiring that "substantial changes in such stocks are used as a decisive signal for changing the price range" within which the stock manager remains passive (Fried, 1976, p. 645). Second, stabilization arrangements that insulate producers and consumers in participating countries from fluctuations in world market prices can exacerbate the problems of residual suppliers outside the arrangements—a role currently played by the United States in respect of several important commodities (see Carter, 1976, p. 317). Third, it is important to be clear on what is to be stabilized: price stabilization is not the same thing as income stabilization. Indeed, in cases where price fluctuations are caused primarily by variations in demand rather than in supply, price stabilization may actually destabilize total revenues, and therefore foreign-exchange earnings.

Finally, it is essential to avoid setting expectations so high that disillusionment and mutual recriminations follow. For certain commodities exported primarily by developing countries, buffer-stock arrangements may prove useful in stabilizing the export earnings of producing countries and in assuring availability and cushioning sharp short-term price fluctuations for consuming countries. By smoothing producers' revenues, they may help to avoid disruptions of development programs and, by reducing uncertainty, stimulate investment in the production of the covered commodities. But the moderation of economic instabilities associated with trade in primary commodities is likely to "depend more on financial measures, such as a major expansion of compensatory financing measures and of development assistance programs, than on individual commodity agreements" (Fried, 1976, p. 646). And it is likely to depend most heavily of all on the maintenance in the industrialized countries of policies conducive to high employment and steady, noninflationary growth.

Difficult and controversial as they are, the issues relating to stabilization hold some potential for arrangements that would benefit both producers and consumers. The same cannot be said for the other use of commodity agreements: to hold prices permanently above market-determined levels and thus turn the terms of trade in favor of producers and against con-

<sup>9</sup> The candidates most frequently mentioned for buffer-stock agreements are coffee, cocoa, and tin, for which agreements have been negotiated, and possibly copper, rubber, tea, sugar, and hard fibers.

sumers. This aspect of the commodity-agreements issue is closely linked to the demand for indexation, which, by linking commodity prices to the prices of manufactures in industrialized countries, would freeze relative prices and prevent any deterioration in the terms of trade of commodity exporters, whatever the pressure of market forces.

The developing countries demand price-raising commodity agreements or the indexation of commodity prices to combat what they are convinced is a long-run tendency for the terms of trade to turn against producers of primary commodities in favor of producers of manufactured goods. The demand must be rejected on at least two grounds. First, a number of major studies (the most recent is UNCTAD, 1975) have failed to produce conclusive evidence regarding long-term trends in the terms of trade. Second, the direction of trends in the terms of trade is less relevant than another question: have market distortions created deviations of actual from socially optimal allocations of resources and thus of the actual terms of trade from those that would prevail with optimal allocations, and, if they have, what should be done?

Such market distortions may have existed in the past and may persist today, particularly in the form of different degrees of deviation from the competitive model in markets for primary commodities and for manufactures.<sup>10</sup> But even if there are significant deviations, the remedies currently being proposed by the developing countries would build in new rigidities, create excess supplies, and exacerbate worldwide inflationary pressures. Furthermore, although a number of developing countries are heavily dependent on commodity exports for foreign exchange, the bulk of commodity trade is among industrialized countries. Price-raising or price-indexing agreements would redound to the benefit of less-developed producers only for a small number of commodities; in a much larger number of cases, the major beneficiaries would be advanced nations; and, in all cases, a number of developing countries, including some of the poorest, would suffer significant income losses as a result of the terms-of-trade shifts. All these considerations suggest that the emphasis on pure redistribution is misplaced. The focus should be placed instead on trade-policy changes that would produce positive-sum results.

The emphasis on commodity trade is misplaced for another reason: the most promising trade opportunities for developing countries may well lie in exports of manufactured goods. Over the period 1963-73, the share of

<sup>10</sup> Two facts support this possibility: the greater degree of product differentiation among manufactured goods and the relatively high proportion of intra-firm transactions involved in trade in manufactured goods.

manufactures in the total exports of developing countries increased from 15 to 25 per cent, and the rate of increase of manufactured exports was higher for developing than for developed nations (Inter-American Development Bank, 1975, p. 14). Focusing specifically on trade between the United States and developing countries, in 1967 U.S. exports of manufactures to developing countries were 3.2 times as large as U.S. imports of manufactures from those countries; by 1973 they were only 1.6 times as large, a substantial narrowing of the gap. It is therefore vital to focus the dialogue with developing countries on trade in manufactures, especially on measures to expand access to the markets of the industrialized countries.

It is certainly true, as developing countries insist, that the structure of tariffs maintained by industrialized countries, including the United States, tends to militate against the expansion in developing countries of export-oriented processing and manufacturing activities. To this end, the institution by the United States of the generalized system of preferences, lowering or eliminating duties on many imports from developing nations, was an important step, albeit embarrassingly tardy, delayed as it was until 1976. But this preferential system is subject to important limitations that are likely to prevent it from having significant short-run effects; it excludes certain products of particular interest to developing-country producers, and the benefits are limited in size and duration. Furthermore, if the current round of trade negotiations does indeed achieve significant multilateral tariff reductions, the margins of preference enjoyed by developing countries will be correspondingly reduced.

There is reason to believe, moreover, that the "cascaded" tariff structure of the United States is less important in restricting access to the U.S. market than the nontariff barriers maintained in the form of import quotas or "voluntary" export restraints on certain products, such as shoes and textiles, characterized by simple, standardized production processes and correspondingly low skill intensities. These are products in which developing nations appear to have a clear long-run comparative advantage. Indeed, a handful of fast-growing developing countries have expanded their exports of these products rapidly despite restrictions on access to the markets of industrialized countries—the fact that is, ironically, the major reason for the restrictive policies of the industrialized countries. The situation is reminiscent of trade relations with Japan during the 1960s. The concern for stability and problems of adjustment foster strong defensive reactions on the part of established producers to fast-growing dynamic exporters who threaten to cause rapid shifts in established trade patterns. The problem is exacerbated by the fact that the industries in

which developing nations typically tend to acquire rapidly increasing shares of the market are precisely those that employ large numbers of the lowest-paid and least-mobile workers in the older industrialized nations. But these problems of adjustment, genuine though they are, should not be allowed to block trade expansion beneficial to the developing countries and to consumers in the industrialized countries. Some cushioning of the adjustment process may be essential politically; there may be need for temporary and automatically declining restraints on import growth, along with expanded adjustment assistance. But prompt and credible self-destruct mechanisms must be built into all such safeguard schemes if the potential for mutual gain is to be realized.

A second area of major concern in relations between developed and developing nations has to do with the international transfer of private capital and technology. The developing countries have made it clear that they seek to expand the flow of these resources—which today are transferred primarily by multinational corporations—but also to modify and regulate the terms on which they are transferred. These are conflicting goals. Regulations regarded by multinational corporations as hostile to them are likely to reduce rather than increase flows of capital and technology to developing countries. It is thus understandable that the developing countries ask that industrialized countries take measures that would help to reconcile these aims, including measures to transfer technology through new public channels.

In a country like the United States, however, much of the technology desired by developing countries is in private hands. The government can, of course, use the tax system, regulations, guarantees, and joint participations to stimulate—or discourage—flows of privately owned technology and capital in particular directions. A variety of guarantee and joint-participation schemes were tried in the 1950s and 1960s, and the U.S. government currently offers direct investors in developing countries insurance against particular risks through the Overseas Private Investment Corporation. Experience with risk-sharing schemes suggests, however, that they have not stimulated large flows of private funds and that the offer of insurance does not neutralize a hostile climate for investment. My calculations indicated that, over the period 1946-63, the U.S. risk-sharing schemes required as many as 4 public dollars to move 1 private one (Whitman, 1965, p. 347). Today, when private American investment is regarded with widespread suspicion by developing countries, guarantee schemes are likely to be even less effective and might actually discourage innovation in resource and technology transfers. Even now, new types of management contracts and licensing arrangements are being worked out

between some developing nations and certain multinational firms. Risk-sharing arrangements between public and private capital may be most effective under the aegis of international lending institutions and should probably be focused more on private portfolio funds than on direct investments by multinational firms.

The most important contribution the United States can make at the moment is to refrain from certain changes in its policies regarding transfers of technology. Traditionally, the U.S. government has limited such transfers only in cases involving the national security, construed in fairly narrow military terms. Recently, however, concern about the erosion of technological lead time and its impact on the U.S. competitive position has led to a serious reconsideration of the laissez-faire attitude toward technology transfers. In particular, it has been suggested (U.S. Department of Defense, 1976) that the criteria for limiting transfers should be broadened to include economic as well as traditional national-security considerations. Although the immediate target is the transfer of "front-end technology" to other industrialized nations, any shift to technological protectionism would inevitably discourage transfers to other nations as well.

The issue of technology transfer is too broad to be discussed comprehensively here; let me note only that a coherent national policy is urgently needed. An essential first step is the development of an analytical framework for identifying instances where corporate interests and the national interest diverge and for determining, where external diseconomies exist, the optimal policies for eliminating them. Analogies with trade theory suggest that a domestic tax or subsidy, or changes in patent policy, would be more efficient for this purpose than export restrictions. International criteria to guide policies on technology transfer could help minimize any danger of spreading technological restrictions, which would probably prove ultimately detrimental to the technological advance of those imposing it as well as depriving developing nations of one of the most critical factors in the development process.

The need for an international code of conduct governing the behavior of both multinational firms and of national governments toward such firms was discussed in an earlier section, as was the discouraging outlook for finding a balance between the responsibilities of firms and those of governments acceptable to both industrialized and developing nations. One piece of that framework, however, might be put in place unilaterally by the industrialized countries. The developing countries have argued for some time that their ability to benefit from capital and technology supplied through multinational firms is limited by a variety of restrictive

practices followed by the firms, and by the secrecy afforded by intra-firm transactions. It is frequently asserted, in fact, that the foreign-domiciled components of multinational firms do things that would be illegal under U.S. antitrust laws if done domestically. It would be a mistake, however, for the United States to extend its antitrust laws unilaterally to entities outside its borders. This is a form of jurisdictional imperialism that has been troublesome in the past, and it would also put American-based firms at a disadvantage vis-à-vis competitors whose parent companies are subject to looser antitrust provisions. Effective antitrust provisions should instead be incorporated into an international instrument adopted by all industrialized nations, perhaps under the auspices of the OECD, and developing nations might be invited to adopt it too. The extension of antitrust principles to multinational investment on a multilateral basis would help to eliminate market distortion in the international allocations of capital and technology and could also serve as a meaningful demonstration of good faith and thus an effective lever with which to pry from the developing countries some significant commitments concerning their own behavior toward multinational firms.

Issues involved in the transfer of public resources—foreign aid—are one major source of friction between the United States and the developing countries. One obvious issue is, of course, the fairly steady decline in the U.S. commitment to foreign assistance and the discrepancy between its current aid effort of about one-fourth of 1 per cent of GNP and the 0.7 per cent target agreed to by 13 of the 17 members of the OECD's Development Assistance Committee. In the early 1960s, the United States accounted for more than half the flow of official development assistance from the OECD countries; a decade later, it accounted for about one-third. The reasons for this decline have been widely discussed (see, for example, Whitman, 1975b, pp. 155-156), and there is no need to repeat them here. Suffice it to say that a wholly new rationale for foreign aid would have to be developed before the U.S. Congress would be willing even to consider the increase of aid required to bring the United States up to the 0.7 per cent target (to which, incidentally, it has never agreed).

Although a significant increase in bilateral aid would be helpful, the aid-giving process is likely to be less troublesome and more effective in the current environment if it is channeled to a greater extent through multilateral institutions. There has already been a significant expansion in the lending facilities of the IMF, largely in the form of new facilities designed to meet the needs of developing nations, and the one-third increase in IMF quotas now underway will considerably enhance the ability of the Fund to maintain and further expand its lending facilities.

All its lending is short- or medium-term and is conditional, and developing countries continue to press for unconditional funds by way of an SDR-aid link. But I will not go over the arguments for and against such a scheme because it appears to be of little practical significance for the moment. No new allocation of SDRs is on the horizon, nor is there likely to be one until the international monetary system has settled down and worldwide inflationary fears have receded. Of much greater immediate significance is the need by the World Bank and its International Development Association for increased capital to permit an expansion of long-term development lending. The attitude of the United States will be decisive here, formally because its approval is required for any agreement on an increase of capital, and practically because each dollar provided by the United States would be matched by about two additional dollars from other industrialized nations.

Finally, there is the question of debt rescheduling. Some developing countries have incurred a frightening increase in debt-service charges relative to export earnings; they have borrowed heavily to finance increases in their current-account deficits arising primarily from increases in petroleum prices but compounded by the slump in export earnings caused by the recession in industrialized countries. The external indebtedness of oil-importing developing countries increased in nominal terms by 50 per cent between the end of 1973 and the end of 1975. There are intermittent rumors that one or another is about to default, and that one or more large New York banks may be significantly affected.

The developing countries have exerted strong pressures, in UNCTAD meetings and elsewhere, for a generalized moratorium on official debts and for support by the governments of the industrialized countries in arranging for a stretchout of debts to private institutions.<sup>11</sup> But any such generalized moratorium or stretchout would have a devastating effect on the creditworthiness of the developing countries, reducing drastically their already limited access to private capital markets. Furthermore, a generalized approach is unnecessary; the problems of some countries are already being rendered more manageable by rising commodity prices, the economic recovery in the industrialized world, and increased lending by the IMF. As for the danger to U.S. banks, almost all bank credits are to governments or are government-guaranteed, and defaults by governments are rare, being as much political as economic decisions. And most (though not all) of the countries that have borrowed from U.S. banks

<sup>11</sup> It has been reported, however, that they abandoned their demand for a general debt moratorium at the October 1976 Bank-Fund Annual Meetings in Manila (*New York Times*, Oct. 10, 1976, Sec. 3, p. 18).

have sound economies and are very much concerned to protect their credit ratings. Finally, the loans of the twenty-one largest U.S. banks to developing countries amount to less than 5 per cent of the banks' assets, and market forces have already produced a cautionary slowdown in new lending (Citibank, 1976).

Having argued the case against a universal moratorium or rescheduling, I must also point out what does need to be done. First, individual countries do indeed face unmanageable debt and debt-servicing problems; some reschedulings have already occurred. Serious attention to their difficulties is urgent. More effective than unilateral U.S. action would be a concerted approach by actual and potential lenders among the industrialized nations; debt-rescheduling "clubs" of lenders are already operating, and they have good records of effectiveness (see Prout, 1976). Second, along with the need to expand the capital of the major international lending institutions, already discussed, there is an urgent need to devise imaginative guarantee and joint-participation arrangements between these institutions and private lenders to increase the flow of private debt capital to developing countries. Third, in administering bilateral assistance programs, the United States and other donors should develop economically rational criteria (such as those suggested by Schmidt, 1964) for distinguishing between situations in which loans are appropriate and those in which grants are more realistic. In the past, the United States has tended to favor loans over grants for general development purposes because Congress was more willing to approve loans. But it is far better, economically and politically, to make a clear and rational distinction *ex ante* between loans and grants than for some of the former to turn into the latter *ex post*, making it more difficult to finance all development projects, including those where loans are appropriate. Finally, it is worth stressing more than once that the manageability of the debt positions of developing countries depends above all on the economic health of the industrialized nations that are the primary markets for their exports. If further sharp price increases for petroleum products or other events caused recoveries to abort in the United States and other industrialized nations, the difficult debt-service problems currently faced by some developing countries would spread with frightening rapidity.

Moving from substantive issues to matters of perception and process, two final comments are in order. First, the nonhomogeneity of the "developing countries" has long since become a cliché, but developments in recent years have underscored its importance. Not only is there the crucial distinction between oil producers and oil consumers (the "third" and "fourth" worlds), but also the vast difference in needs and capabilities

between the international "middle class" of developing nations, whose per capita incomes are beginning to overtake those of the least affluent industrialized nations, and the desperately poor nations at the bottom of the scale. Economic generalizations about this diverse array of nations are becoming less and less possible, and the formulation and implementation of policies vis-à-vis these nations must be increasingly selective and discriminating. Second, the political cohesion displayed by the developing countries on economic issues, together with the need argued earlier for policy coordination among the industrialized nations, stresses the importance of a coordinated approach by the developed countries in their economic relations with the developing world. The strong commitment to a coordinated approach that emerged from the Puerto Rico "Summit" meeting in June 1976 and the creation of the Conference on International Economic Cooperation are important first steps.

### **The Viability of the System: Reprise**

At the outset of this essay, specific issues were classified into three broad groups: macroeconomic questions, microeconomic questions, and questions relating to the nature and existence of the international economic system itself.

At the macroeconomic level, the common theme was defined as the tension created by the closer international integration of markets for goods and assets and the continuing quest for economic sovereignty on the part of national governments, which feel that economic interdependence threatens their capacity to meet an increasing variety of domestic responsibilities. The introduction of insulating mechanisms, particularly flexible exchange rates, has been part of the answer, but the insulation provided has been more limited than anticipated. More extensive policy coordination among national governments, especially in stabilization policy, is also essential to help resolve the tension, and thereby to avoid backsliding into forms of defensive economic nationalism that would vitiate many of the benefits of international market integration. This task is complicated by the emergence in some instances of what appear to be "vicious" and "virtuous" circles of interaction between exchange rates and domestic price levels. In the absence of mechanisms for coordination, these feedback processes threaten to amplify divergences between rates of inflation in weak and strong economies.

At the microeconomic level, there is a pervasive need for a constructive synthesis between the market-oriented, universalistic, and legalistic

approach associated with the United States and the more interventionist, regionally oriented approach espoused by the European Economic Community. It is needed to resolve a host of issues relating to international trade, investment and multinational corporations, and economic relations between industrialized and developing countries.

I conclude, then, with a few brief comments on the third broad category of problems: "systemic issues" that relate to the framework within which international interactions occur at both the macro- and microeconomic levels. My comments deal with two fundamental questions. The first has to do with the organizing principle on which the international economic order will be constructed. The second has to do with the preservation of a liberal international economic system in the face of mounting challenges, both normative and positive, from many quarters.

No international economic system has been based on a single "pure" organizing principle—automaticity, hegemony, supranationality, or pluralism. There has always been some combination of the four. At any point in time, however, some combinations will function better than others. In particular, there is almost certainly some tradeoff between the degree of hegemonial leadership and the degree of "looseness" that can be tolerated if a system is to function effectively. With the decline in the hegemonial position of the United States, the international economic system must probably be made "tighter" than before in order to minimize the pursuit of inconsistent goals and forestall mutually frustrating behavior. This "tightening" can, of course, be achieved in several ways: by a greater willingness to accept automaticity embodied in self-enforcing rules and abstention from interference with market-determined solutions; by a greater acceptance of supranational authority and of discretionary judgments by international institutions; or even by widespread agreement to submit a larger number and variety of issues to structured negotiating processes.

Both Americans and Europeans have stressed the need to strengthen international institutions to ensure the viability of the international economic system, but they do not always appear to agree on what is meant by increased international authority. Americans tend to stress the need for the discipline of universal rules, including the self-enforcing disciplines of the marketplace. Europeans tend to regard the quest for universal rules and effective sanctions as chimerical, if not downright threatening to the survival of the system, and stress instead the need for international institutions to provide a supportive framework for the negotiation of divergent economic interests, the development of mechanisms for

the cooperative management of domestic policies to minimize distortions in international markets, and the avoidance of retaliatory escalation in the course of specific disputes.

In fact, there is validity in both positions, and some measure of each organizing principle will be required to create an international economic system capable of meeting the challenges that face it. The history of international economic relations since World War II suggests, for example, that international institutions are better regarded as complementary to and supportive of, rather than as substitutes for, the negotiations of conventional economic diplomacy. At the same time, one major function of the International Monetary Fund will be to police exchange-market intervention, thereby to uphold the discipline of markets. Finally, recent experience with flexible exchange rates has demonstrated both the essentiality and limits of this insulating mechanism; managed floating has not banished the vulnerability created by interdependence, but it has allowed the "affluent alliance" to avoid lapses into economic nationalism when confronted by extraordinary pressures.

There can be no illusions about the gravity of the threat to the survival of a liberal international economic system—a system described above as being fundamentally market-oriented in focus and neutral in intent. I have already dwelt on the growth of forces antithetical to these principles, some within the industrialized nations and some associated with the new prominence of developing nations with a very different *Weltanschauung*. It is indeed impossible to forecast with confidence that the international system will meet these challenges—there will emerge a synthesis that incorporates emergent concerns and new participants while retaining basically liberal characteristics. But this much can be said: successful macroeconomic management is essential to the resolution of this issue. High levels of employment and reasonable price stability will do more than anything else to make microeconomic problems tractable. When these conditions have been absent, trade and investment problems have become intractable and international economic relations have deteriorated. I have made this point in the discussion of issues dividing the industrialized countries. I have repeated it in the discussion of relations with the developing nations. None of the specific changes in the system demanded by developing nations is as important to their chances for development as is the maintenance of stable and growing markets for their products. Furthermore, the distributional demands made by the developing nations will be manageable, if they do indeed prove manageable at all, only in the context of widespread economic growth. The

achievement and maintenance of favorable economic conditions in the industrialized nations may not be a sufficient condition for the survival of a liberal international economic system, but it is unquestionably a necessary condition.

Finally, there is the compelling need for leadership by the United States in fashioning a viable framework for the conduct of international economic relationships. No other nation or regional group in the affluent alliance has shown itself willing and able to assume leadership, and the mechanisms for multilateral decision making are insufficiently developed at present for the system to function effectively without leadership. Even those at home and abroad who view the special international role of the United States with wariness, suspicion, or simple resentment acknowledge that there is no obvious alternative save to risk global economic disorder—to retreat into defensive economic nationalism or advance into escalating confrontation.

Many have written about the gradual decline in American hegemony associated with recovery and growth in other industrialized nations and with the diffusion of cold war concerns. Less attention has been paid to the continuing financial dominance of the dollar and the recent strengthening of the international economic position of the United States. Somewhat surprisingly, the world has emerged from the monetary upheavals of recent years more firmly than ever on a dollar standard. And the increasing importance of the United States as an agricultural exporter, its relative self-sufficiency in energy production, and the fundamental improvement in the competitive position of the U.S. economy are aspects of this enhanced situation. At the start of 1977, moreover, the United States was once again leading other industrialized nations in economic recovery, and its recent price performance has been superior to that of any other major industrialized nation except Germany. With good economic management, the United States may once again regain its historic position as an island of stability in the international economy.

In a world where it no longer exercises hegemony, effective international economic leadership by the United States will not depend on its economic performance alone. But one additional economic fact may be relevant. The increased vulnerability of the United States to external disturbances and its dawning recognition of economic interdependence as a symmetrical phenomenon may, paradoxically, be the *sine qua non* for effective economic leadership. Only if other nations come to believe that the United States asserts responsibility for the maintenance of a viable and orderly international economic system because it perceives

such a system to be in its own economic self-interest, not out of a sense of *noblesse oblige* or cold war security needs, is there a modest chance that leadership based on dominance can be superseded by leadership based on persuasion and compromise.

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