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GAMES EXPERTS PLAY

An observer of international monetary discussions over the last four or five years is troubled by a sense of unreality that seems to pervade the interminable argument. A kind of ritualistic play is being enacted. Ominous rumblings are heard behind the scene, and there is much talk about an impending cataclysm. Yet the denouement is not in sight despite many highly dramatized crises, and there is no catharsis to make the public feel that the conflicts have been resolved constructively. The play goes on in a shadowy half-light until the viewer begins to realize that a kind of veil must be concealing some of the reality for which he has been searching—the veil of money of which monetary theory has long been aware.

In retrospect, it does seem strange that the discussion could have been carried on for years, mainly on the monetary level, with but scant regard for the underlying flow of real resources—of goods, of capital, and of technology—on which the growth of the world economy depends. One reason for this myopic approach is the inveterate belief that imbalances of payments are, or ought to be, passing phenomena to be eradicated in short order; and that after administering the popular nostrum, however bitter, economies inflated by overindulgence would be restored to health and quite naturally revert to the straight and narrow path that gently leads up the slope of economic growth toward ever greener pastures. If suddenly the patient were to tell the doctor that he should prescribe a milder medicine and take some himself to share the burden of recovery, the two would clearly be talking at cross-purposes; but this is what the United States seems to be asking of the European monetary doctors who recommend the bitter medicine of deflation.

Upon reflection, the analogy may not appear as absurd as a writer's whimsy makes it seem at first sight. One attempt made in this essay is to unravel some of the untidy tangle of economics and politics confronting us in the current discussion. On the economic side, we need to question the assumptions that underlie the diagnosis of the disease and the suitability of the same harsh medicine for all kinds of patients. Particular doubts are in order if a patient is given to thrashing about and, because of his size, endangering his neighbors. On the political side, a common

recognition that a fast cure is not available may be called for, and that a better rapport is needed for the long pull, some kind of cooperation that resolves an unstable doctor-patient relationship in a broader concept of communal health.

These fanciful analogies are meant to convey the notion that a substantial change in American-European relationships in the monetary field is required if the present dangerous drift is to be reversed. The discussion has been drifting because all concerned were tacitly agreed on playing a game of make-believe based on outdated assumptions and rules. The American balance-of-payments deficit is *not* a short-range phenomenon that can be cured by conventional means. Indeed, attempts to use restrictions of capital as "temporary" palliatives will not cure the underlying difficulty but threaten to reduce the world's capital supply and thus endanger the growth of production and trade over the long term. This consideration is vitally relevant at a juncture when several of the most important industrial countries have just barely managed to emerge from a period of recession or slack growth. Meanwhile, we witness rising interest-rate levels in international markets taking their cue from the American financial center. It is sobering to speculate what further increases are in store if economic growth simultaneously reaches the level forecast or planned in the major industrial countries. Recalling the near-crisis in 1966, one wonders what lies ahead for interest rates that were already close to or exceeding the record levels of 1966 while the growth of investment was still lagging behind the targets set by the policy-makers. In the long view, the world economy may be heading for a hazardous passage between two dangerous shoals: uneven growth, possibly accompanied by harmful restrictions on trade and payments by some important countries; and escalation of competitive bidding for scarce capital resources when the present domestic liquidity (for instance, in Germany) yields again to tightness in a boom.

The basic assumption underlying the four-year marathon exercise in devising a "contingency" plan for supplementing the conventional reserve media was that there would be an early end to the American balance-of-payments deficit. Nearly two-thirds of the increase in the gold and foreign-exchange reserves for all countries since 1950 was in dollars related to the persistent American deficit. Once balance would be restored to the American international position, so the thinking went, this source of international liquidity would dry up. Gold has been making but a small contribution to the growth of official reserves in the past and none at all in the last two years as gold was actually drained away into private hoards on a large scale. Hence, some new international reserve medium would have to be created by fiat when the dollar flow from the United States ended. By the same token, it was assumed that

there would not be such a need while the American deficit continued and presumably would increase international liquidity by the resulting flow of dollars.

Developments over the last several years have invalidated this basic assumption, yet, strangely, the talks continued along the well-beaten path. At Rio de Janeiro a contingency plan for new liquidity was finally adopted in September 1967 after about four years of studying and wrangling. But various speakers pointedly remarked that the "contingency" that would permit validation of the scheme was far away since, clearly, the American balance-of-payments deficit was not coming to an end and indeed might worsen while the war in Vietnam continued.

Meanwhile, however, other countries' holdings of dollars had stopped increasing in line with the continuing American deficit. As total official monetary gold holdings have been declining, much of the increase in international liquidity in 1966 and 1967 was due to a conversion of British long-term securities into liquid holdings, central-bank holdings of a mutual-help character, and greater reserve positions in the International Monetary Fund owing to member drawings in convertible currencies—all nonrepeatable or self-liquidating transactions, not permanent additions to the world's international money.

The "contingency" that was initially believed to be as remote as the end of the American deficit has thus actually been upon us for some time, but most monetary experts in Europe preferred not to take notice. The reasons, partly political, partly economic, are not hard to perceive. The French, and not only the French, want above all to see the American deficit eliminated, and they shun anything that might conceivably encourage American policy-makers to diminish their efforts in this direction. They fear that more international money in any form could have this effect. It is unlikely that the stagnation in world liquidity has escaped the notice of these experts; but it is convenient from their perspective to ignore it, particularly since a tightening of international liquidity would affect the deficit countries first and foremost. The Americans, for their part, have preferred not to challenge this approach too strongly in order to avoid being accused of pushing the liquidity issue to divert attention from the American failure to eliminate the deficit, or of appearing to seek new liquidity mainly to help finance the deficit.

The dilemma may well have been responsible for an apparent, if tacit, American-European pretense that monetary reform and national payments deficits are two quite unrelated issues. In reality, however, growing liquidity through greater holdings of reserve currencies permits aggregate payment deficits to exceed total surpluses by the amount of the increment (while deliberately created reserves would reduce them

ex ante). Such an increase is indeed needed to counter a prevalent asymmetry that obstructs the adjustment process: most countries do not dislike the accumulation of surpluses while demanding the elimination of deficits by others. Unless the surplus countries change their outlook and by appropriate policies promote a reduction of their reserve accumulation, deficits cannot be eliminated except by the harshest unilateral policies of those afflicted. Growing liquidity can mitigate the asymmetry of these policy positions. Yet the thought of any further financing of the American and British deficits is so unacceptable to the advocates of strict "payments discipline" that, for the sake of international cooperation, both debtors and creditors feel a need to pretend that the issue of world liquidity must be separated from that of deficits that "just have to be eliminated in short order."

Donning blinders so as to avoid confronting unpleasant realities is a popular device in international relations. And, as will be shown presently, misapplied textbook economics has also played a large part in the confusion. But some psychological-political strands can be readily detected in the tangle. The thought that the deficit may not end soon is too threatening to the confidence-oriented psychology of most monetary specialists, and it is inadmissible in international debates precisely because the most outspoken opponents of American policies have been harping on this theme. It is therefore comforting to believe—quite sincerely in the case of many—that the deficit can be attributed to various temporary factors and that it would end once these factors disappeared. Yet, while the apparent causes differ from period to period, the deficit continues, and so does the debate.

THE POLITICAL ECONOMICS OF THE AMERICAN DEFICIT

Political elements are indeed prominently involved in the deficit. One can acknowledge their reality without aligning oneself with those who see in the deficit a deliberate abuse of economic power by a reserve-currency country. But the political conditions for international balance are quite different in kind from the single-minded prescription of greater fiscal and monetary discipline advocated by the conventional approach of specialists abroad and in this country.

As this author has shown elsewhere (*The Dollar in World Affairs*, 1964), a substantial reduction of government expenditures that would clearly cut the deficit will not be undertaken for reasons having to do with the balance of payments, because these payments are determined by overriding considerations of foreign policy related to the American position in world affairs. Before the present huge Vietnam commitment, there were other involvements that kept American government expenditures abroad at a higher level than expected—Berlin, the Congo,

advisers to Vietnam. Even if the war in Vietnam were to end, there may well be others. The recent Soviet occupation of Czechoslovakia and growing political pressure on West Germany are a warning signal. Moreover, the supporters of "wars of liberation" anywhere in the world have the means to keep the United States embroiled in ubiquitous brushfires *unless* this country limits its world-wide involvement.

Since Britain, the world's former policeman, had to retrench, the United States will hardly want to reduce its global role. Indeed, the contrary course appears more likely and the American balance-of-payments problem is apt to worsen by our taking over responsibilities that Britain sheds in order to limit its own deficit. Such is the price of political primacy; and American appeals for more "burden-sharing," unheeded in the past, have even less of a chance of success in the future as our position becomes more isolated on its lofty pinnacle of power.

Such an interpretation will hardly appease critics of American balance-of-payments policy, but it explains why military expenditures, and other politically motivated foreign payments that are hard to tie to American exports, are not being reduced sufficiently to close the payments gap. An attempt to cut another large component of the deficit, the rapidly rising tourist expenditures abroad, was also defeated politically when a proposed tax measure could not be pushed through Congress in 1968.

But why, then, does the United States so stubbornly refuse to take the route to adjustment that economic teaching clearly indicates? At this point another set of blinders blocks a recognition of significant evidence that the United States is not "just like any other country" of the conventional textbook variety.

Traditional medicine to cure a deficit consists in fiscal measures to reduce incomes and hence demand, and in a tightening of money and credit that also helps attract short-term capital by higher interest rates. Reduced domestic demand, in turn, would cut imports and redirect idle facilities to export production. In recent years the prescription has worked well in Europe, particularly in Italy and France, though not so well in England. Why should it not work as well in the United States?

The reasons are both economic and political. In Europe foreign trade accounts for a high share of national income and product, in the United States for a very small one. If in Europe imports represent, say, a quarter of GNP (some ratios are even higher), a deflation of four dollars in income may reduce imports by one dollar. In the United States, where the import ratio is only slightly above 3 per cent, a deflation several times as high as in a typical European situation may be required for the same result. (Reality is, of course, much more complex than such an example implies, but the order of magnitude in terms of the comparative policy impact is none the less illuminating.) In

other words, in normal times when imports are not sucked in by inflated domestic demand at an unusual rate, as they were in 1967-68, to reduce American imports by a sizeable amount, say $1 billion, GNP may have to be reduced by perhaps as much as $20 to $30 billion, a drop much more severe than in any postwar recession. Furthermore, if this gain were to last, GNP would have to be maintained at this lower level year after year, while in postwar recessions the pause (usually no overall reduction) in aggregate income was short-lived. Social and political repercussions would be so severe that such a policy could not be seriously entertained by any American political leader except in times of such manifest inflationary pressures at home as prevailed in 1967-68.

Moreover, a large shift in exports as a result of reduced domestic demand could not be expected because, again in distinction from Europe, the export market is such a small component of the American GNP, a little over 4 per cent. For this reason, too, the American corporate structure, with some notable exceptions, has not acquired the strong export orientation prevalent in Europe. A sizeable export effort, commensurate to European custom when domestic business is slack, is therefore quite unlikely. But if it were made and succeeded, European resentment of still greater competition—the United States has enjoyed a sizeable export surplus for a long time—would be very strong and vocal indeed. Also, we cannot be sure that American exports would increase at the expense of countries in payments surplus. It is quite likely that those most affected would be weaker trading nations already in deficit, such as Britain. In this event we may have to provide support to them, as we have so often done in the past.

But supposing, not very plausibly, that the United States were willing to face the disproportionate economic, social, and political consequences of a severe deflation for the sake of its balance of payments, would a lasting improvement in the balance through lower imports really be achieved? We know that an improvement in one item usually entails offsetting movements in others in the interlocking balance of a country's foreign economic relations; and this is probably one reason why our dabbling with this or that item has not reduced the deficit as much as expected, if at all. Common sense suggests, for one instance, that a sizeable cut of American imports is apt to reduce our exports as well, though not necessarily to the same extent. Other countries depend in varying degrees on American imports from them to pay for their own import needs. If we use less of their exports, they may have to reduce their purchases from the United States and probably from others as well who may then in turn try to cut their imports from the United States and from Europe. In the less developed world that usually imports to the full extent of its export capabilities, the trade-reducing

effect would follow promptly. It may take longer elsewhere, but the danger that the inevitable impact of a restrictive American policy might initiate a downward spiral in world trade is very real. While Europeans have been complaining (with questionable economic logic) that the United States was exporting inflation along with capital, there can be little doubt that this giant among traders has the capability of exporting deflation via the trade route. In any event, the policy of reducing imports through deflation would be self-defeating if exports shrank too; and to shoulder the vast burden of deflation at the risk of harming world trade without any real certainty of eliminating the deficit would be quite unrealistic.

The belief that higher interest rates in the United States would reduce the differential with regard to Europe and thereby diminish outflows of capital and the deficit has been widely held in Europe. Advice to raise interests was not heeded by the United States while unemployment persisted. When in 1965 and 1966 credit was tightened because domestic policy called for restraint, interest rates naturally rose. Some narrowing of the (internationally operative) interest-rate differential took place, but it did not endure as European rates followed the American upward trend. This experience was repeated in the summer and fall of 1967 when the incipient recovery from a pause in rapid economic growth sent interest rates soaring again. Kindleberger would probably consider these developments as a confirmation of his view that the American financial center is a major determinant of the international interest-rate level, but that it cannot increase the spread between itself and other centers significantly by unilateral policy. In any event, the actual interest-rate sensitivity (as discussed by Stein, Kenen, etc.) is a controversial issue that need not detain us.

Here, one concludes, goes another rationale for the righteous tenet that the American deficit is primarily a matter for American policy to solve and that the remedy is at hand if only the political will could be mustered. The myth of America's self-healing powers will endure as long as specialists, fenced in by their conventional, narrow monetary approaches, do not acknowledge the self-defeating impact of uncoordinated American action on the flow of trade and capital on which everybody's prosperity depends; and as long as politicians prefer to blame American predominance rather than face their own dilemmas in acknowledging the need to reduce their surpluses by deliberate policy. As long as adjustment is considered a task for the deficit countries alone, there will not be any enduring adjustment.

THE POLITICS OF FINANCIAL DOMINANCE

In the running debate about the American balance-of-payments deficit

and the blame for its perpetuation, no serious official attempts have been made on the American side to question the ground rules or the doctrine on which they have been based. As long as the United States basically agrees with its critics that the deficit must, and can, and will, be eliminated in short order, pressure can be applied by those who insist that we get on with the job. Since the issues are basically political, purely economic arguments challenging the false assumptions that call for unilateral American adjustment will not carry conviction, and critics of American policy will view them as a rationalization of the status quo. Some influential Europeans see the real issue as the use of American financial power through the role of the dollar as a reserve currency. Some have said so publicly while others, more diplomatically, have not. Perhaps they have been more realistic than many Americans who feel embarrassed when they are publicly accused of using power. In such a constellation, the economic arguments of experts tend to become pawns to the politicians' game.

The Meaning of Financial Power

But what is "power"? Some fundamental facts about this country's huge foreign impact on other economies have been more realistically recognized in Europe than here because they are more strongly felt and therefore resented there. We want to leave aside the United States' military supremacy, but acknowledge that a military man, say a general, would be specially sensitive to the prevalent inequality. An extension of this simplistic concept of power into the economic and financial field—domination by American industry, aided and abetted by the key position of the dollar—followed quite naturally in the French view.

Lest this thought be seen in the United States as singularly French, we ought to note the presence in American opinion of parallel sentiment, such as that of Grampp (*Challenge*, February 1965), who sees as "The purpose of dollar policy . . . to use the dollar as an emblem of United States power and also as an instrument of power itself by creating a financial network that enables the United States to influence the decisions of other governments."

An "emblem" stands for prestige, and this seems also the political ingredient of the dollar "game," as Kindleberger sees it (Princeton Essays in International Finance, No. 61). The exercise of power, however, involves a good deal more than prestige. The real question appears to be whether a key currency is an instrument of pressure as Grampp believes, or whether it is a reflection of power as another observer suggests (Schmitt, *International Organization*, 1965).

The distinction is important, because the power aspect of the dollar in the first sense would work in reverse, too, and imply that an accumu-

lation of dollar holdings by others enhances their ability to apply pressure on the United States. This is indeed the way Birnbaum sees it: ". . . international monetary power relates to who holds international monetary assets, and who controls their form and issuance" (Birnbaum, Princeton Essays in International Finance No. 66); and "International purchasing power is transferred when money is passed" (pp. 5f); hence, "Payments surpluses tend to shift power from the United States to the reserve hoarders even if dollars are accumulated rather than being immediately converted into gold" (Birnbaum's Address to the National Association of Business Economists, September 28, 1967).

There are many Americans who have felt this shift of relative "power" in their recent dealings with the Europeans. Yet one senses that financial pressure is only part of the story. The United States has a good deal of "power" that is not primarily derived from the role of the dollar. As soon as military aspects are involved, as in the offset agreements for American expenditures in Europe, a different kind of logic emerges, one that reflects the quality of cooperation in defense between the United States and others. As a result, we note at the same time a heightened hostility toward the dollar in France and a desire for accommodation in Germany, even though the *quid pro quo* character is played down for obvious reasons.

However, on the financial plane, too, a more complex view emerges if one does not believe that power and influence wax and wane simply in proportion to foreign dollar holdings as Birnbaum seems to imply. Hitherto, a good deal of foreign influence rested on a conception that the United States has so far been willing to accept without challenge: that the United States is a "debtor" country and that therefore the "creditor" is naturally in a position of power. But is this nineteenth-century concept of power really still valid, or has it vanished with the days of the gunboat? The United States has been painfully taught this lesson by small debtor countries that have resisted pressures with a dare to the great power "do something about it." Initial refusals of further loans were often quietly followed by bailing-out operations with some face-saving features because the creditor, not the debtor, would not chance an overt default. It is very questionable indeed whether the creditor still has the power attributed to him; more often the debtor has the whiphand over him for political convenience's sake. If this is true for small countries, surely a creditor's influence over the United States rests on American willingness to play the game according to the old concepts and rules. If the United States ever seriously decided to challenge them, the game would take a very different course.

Only in a strange kind of politically motivated semantics can the United States, the largest capital exporter of the world, be termed a