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MONEY AND THE COMING WORLD ORDER

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THE CREATION OF INTERNATIONAL MONETARY ORDER

Lewis E. Lehrman

Introduction

Today, national economic policy making is largely concerned with the problems of unemployment and inflation. More precisely, it is their simultaneous combination in nearly all Western economies which preoccupies policy makers. As these problems grow worse, the stakes rise higher. We know that either severe unemployment or sustained inflation, let alone both together, can be expected to have the most serious consequences for liberal democracy.

During the postwar era, some had imagined the issue of widespread unemployment resolved by Lord Keynes who, forty years ago in the midst of a world depression, prescribed activist fiscal and monetary policies: "It may be possible," he wrote in *The General Theory*, "by a right analysis of the problem [of unemployment], to cure the disease whilst preserving efficiency and freedom." [1] Surely it is a proper and compassionate national goal to try to eliminate large-scale unemployment if it develops during the declining phase of the business cycle. But whether ever active monetary and fiscal full-employment policies, during *all* phases of the business cycle, are compatible with a reasonable degree of economic stability, let alone efficiency and freedom, has become a major question for our times. In fact, recurring interventionist government economic policies, in themselves, appear to be unmistakable causes of the intensifying disorders which increasingly characterize the age.

Until recently, at least, the principal ailment of postwar Western economies has not been unemployment, but inflation. Indeed, if the postwar era in the liberal democracies can be accurately described as the age of Keynes, it is also the age of inflation. Inflation plagues all Western economies, even now in the midst of recession and unemployment. Everywhere the value of money deteriorates. The burden of debt, public and private, mounts ever higher. Money it seems, serves less well as a reliable store of value and the means of payment. In a worldwide exchange economy, money no longer impartially mediates between limited resources and rising expectations. Instead, political power, either of governments or of private corporations and trade unions, more and more shapes and supplants the market economy. Some Western nations thus move closer to civil war.

On a larger scale, the interdependent world economic system grows steadily more precarious. The disorders of the global economy, and in particular the disequilibrium of its monetary system, are inextricably tied up with this problem of inflation. Internationally as well as nationally, power replaces the market. The unrestrained use of political power, in pursuit of particular national economic interests, exemplifies an increasing tendency both to circumvent market disciplines and to brush aside temporarily inconvenient systems of international rules. Nowhere, of course, has this tendency toward accentuated nationalism been more obvious than in the growing disorder of the international monetary system.

I believe that the problems of world monetary disorder, endemic inflation, cartelization of raw materials, and unemployment are, in fact, closely linked. They originate in the excessive fiscal and monetary policies of the nation-states which compose the postwar international economic system. These harmful national policies derive their support not only from partisan groups and individuals, whose political influence displaces the true national interest with narrow sectarian goals, but also from a widespread intellectual misunderstanding of the nature of the international economic system. Popular economic doctrines have exacerbated rather than checked the spread of inflation. This potent combination of greed and fallacy has made it increasingly difficult for the world economic system to achieve stability. I would like to develop this point further, first by examining the nature of stability in the world market economy, then by discussing three major schools of national policy making and their characteristic effects upon international stability, and finally by proposing a new basis for international monetary order.

Beforehand, however, it might be useful to discuss the nature of equilibrium in both national and international contexts. What are the signs of equilibrium? In politics, the absence of a revolutionary situation (or a revolutionary party) suggests that the basic preconditions of national political equilibrium have been established. National economic equilibrium might be said to exist when the national supply and demand for goods, services, and financial claims is balanced in open markets; open markets, undisturbed by hyperactive government economic policy, will clear at regular intervals. In such circumstances, the general price level will remain relatively stable in an economy tending toward fully employed resources. Global economic equilibrium might, of course, be characterized in the same fashion. But government stabilization policies, in the national context, may actually disturb equilibrium tendencies in the international economy. In particular, some demand-management policies designed to eliminate domestic unemployment may cause widespread dislocation abroad, which, in due course, may defeat stabilization policies at home as well.

The World Market Economy

What constitutes economic equilibrium depends upon who you are and where you stand. For a housewife, economic equilibrium may exist when all members of the household are housed, fed, and clothed; when her husband is working; and when a modest provision may be easily made for savings and entertainment. To a businessman, however, the housewife's concept of equilibrium might suggest, at most, partial equilibrium—especially if the market for his products were declining, if his inventories were accumulating on the shelves, and if the cash balances needed to make current payments were available only in the form of new bank loans, which would by no means be assured if his business affairs did not take a turn for the better. A market-oriented economist would probably see both of these nontechnical definitions of equilibrium as those typical of micro-economic units, which might or might not describe conditions of general economic equilibrium. After all, the economist might argue, if the markets for goods and services cleared at prevailing prices and present employment levels, what more, in an uncertain world, could any reasonable housewife or businessman desire?

Senior economic policy makers in Washington may conceive of economic equilibrium in yet another sense. They might believe that general economic equilibrium should be characterized by full employment, low long-term interest rates, and stable prices, and that if these three conditions are not met, government fiscal and monetary policy should be immediately mobilized to achieve them. It is likely that these same policy makers would have endorsed the recent Congressional resolutions which advised the Chairman of the Federal

Reserve Board to activate an expansive monetary policy to achieve full employment, despite the obvious risk of resurgent inflation.[2]

The examples given above serve merely to emphasize different economic standpoints and methods of analysis. Different standpoints are the main sources of theoretical disagreement: The general equilibrium theory of one economist is only the partial equilibrium theory of another. Among alternative viewpoints there is one which takes the world economy as the appropriate unit of economic analysis. To quote Robert Mundell, "its basic conception is a growing world economy composed of intersecting national economies. . . . The only closed economy is the world economy."[3] Such a conception suggests that the necessary, if insufficient, condition for achieving global economic order is the adoption of national policies which are consistent with the requirements of stability in the international system as a whole. Conversely, a balanced and efficient world economic order must be the basis of a stable national economy. A global viewpoint is thus necessary in order to understand both the national and the international economic disorders of our time, for they are inextricably linked. I share this view and will endeavor to illustrate its relevance and implications.

What is the nature of the global economy? As a first approximation, I borrow from Immanuel Wallerstein's description of an emergent "European world-economy" at the dawn of the modern era:

> In the late fifteenth and early sixteenth century, there came into existence what we may call a European world-economy . . . an economic but not a political entity, unlike empires, city-states, and nation-states. In fact, it precisely encompasses within its bounds (it is hard to speak of boundaries) empires, city-states, and the emerging nation-states. It is a world system, not because it encompasses the whole world, but because it is larger than any juridically-defined political unit. And it is a

> "world-economy" because the basic linkage between the parts of the system is economic. . . . I have said that a world-economy is an invention of the modern world. Not quite. There were world-economies before. But they were always transformed into empires:—China, Persia, Rome. The modern world economy might have gone in that same direction . . . except that the techniques of modern capitalism and the technology of modern science . . . enabled this world-economy to thrive, produce, and expand without the emergence of a unified political structure.[4]

Wallerstein's point is a valid one. For better or worse, the modern world system is, to use his phrase, an integrated capitalist world-economy. Fundamental asymmetry and tension develop in such a world because national economies are substantially integrated into an interdependent world economic system, while national polities are not.[5] Close to two hundred sovereign nation-states, almost ten times the pre-World War I number, are the constituent elements of the world political system of our day. The rules and institutions by which to govern such a political system are even less identifiable than the all-too-controversial laws of economics. This fundamental lack of complementarity between an integrated worldwide economic system of trade and exchange, largely subject to the rules of market economics, and an international political system of jealously independent national communities is, we may say, the basic problem of international order. What combination of two hundred independent national economic policies would be consistent with the requirements of a stable world economic order? At what price to national sovereignty must the public good of world economic stability be purchased?

To some extent there is agreement in academia, on Wall Street, on Main Street, and abroad that a desirable world economic order should be characterized by full employment, stable prices, low long-term interest rates, in exchange for which many economic nationalists might even be willing to

accept some compromise to national sovereignty. National political leaders forever debate how to get from "here to there." Despite informal international agreements on vague and general aims, statesmen will, moreover, continue to guard their economic sovereignty. They do so not merely from a love of power but from the belief that, in the real world, they need their independence to safeguard unique national interests. In practice, for better or worse, policies which affect the world market economy will continue to be decided in national political centers.

It would be disingenuous, of course, to overlook the unequal economic conditions of these national communities, or the unequal weight which various countries exert on the world economy. While the great nations of the West may perceive unequal national conditions to be understandable, even inevitable, historical developments, the energetic poor nations may be expected to read history differently. Peaceful accommodation among the unequal participants in international affairs presumably depends upon establishing those institutions and rules which encourage cooperation among contentious countries if only to mitigate unfair and destructive competition for economic advantage.

In any event, if the world economy and the national economy are as intimately related as I have argued, assessing the impact of national economic policy making requires not only a consideration of its domestic consequences but also a careful evaluation of its effects upon the world.

Three Schools of Thought

I shall briefly characterize, from this international perspective, three schools of thought which prescribe economic policies, directly or indirectly designed to effect national output, employment, and the general price level. Each school measures the relative merits of the government's monetary and fiscal policies by their contribution to national economic goals. All three schools assign a more or less prominent role to the free-market economy.

Keynesians and Monetarists

One school originated in the 1930s and its economics dominated the intellectual debates of the 1950s and 1960s. "Its premises reflect the uncertainties of that decade [the 1930s] . . . assumed rigid wages, no growth, a closed [national] economy. . . . [It was] a short-run model . . . dominated by pessimistic expectations." [6] Oversimplified, this was the basis of the Keynesian model. To a great extent this theory subordinated the goal of world economic stability, historically measured by balance-of-payments equilibrium and exchange-rate stability, to national policies designed to achieve full domestic employment. In this sense, Keynesian economic policy may be described as a contemporary nationalist version of an older mercantilist standpoint.

It has been argued by some Keynesians, moreover, that a government-shaped economy ought to displace, if only to stabilize at a higher level of activity, a less-politicized, underemployed free-market economy. To effect this displacement, Keynesians encouraged governments to mobilize a dormant national asset, hitherto utilized only in wartime situations: the fiscal franchise of the state apparatus, that is to say, the taxing and spending power of the modern nation-state. The use of this franchise in peacetime, along with an expansive monetary policy, became known as aggregate demand management, needed, it was said, to achieve full national employment. Because domestic price stability was generally a subordinate consideration, one predictable result of neo-Keynesian demand management policies has been inflation of the general price level.

In the postwar Western world, the advent of government demand management, by means of ever active national monetary and fiscal policies, has, as I note above, politicized the economic process and marked a decisive decline in the primacy of the private market economy.[7] This development, of course, has presented our political and economic systems with many new problems. As I have argued earlier, these problems have more than national implications. For reasons which I develop below, national economic disorders, which result from unforeseen excesses of the Keynesian revolution, are soon passed on to the international economy as well. Moreover, if the political process is to decide the allocation of resources and the distribution of income, how can essentially coercive political decisions be reconciled with economic liberty, economic efficiency, and fiscal discipline? How, in a free society, can a nation forestall the misappropriation of growing government economic power by organized special interests—whether they be military establishments, improvident corporations, trade unions, or sprawling welfare bureaucracies?

But we are contending today with much more than the legacy of the Keynesian revolution. There is also the now-fashionable and powerful monetarist school of thought, generally identified with the University of Chicago and with Milton Friedman. This school developed largely in opposition to neo-Keynesian orthodoxy during the 1950s and 1960s. To the extent that its theorists advocate the principle of price flexibility in a free-market economy, the monetarist school draws inspiration from the classical tradition represented by David Hume, Adam Smith, David Ricardo, and Jean-Baptiste Say. However, many monetarists (assuming that the effects of monetary policy are more neutral and efficient influences on output and resource allocation than neo-Keynesian fiscal policies) in effect elevate the state over the market by asserting the supremacy and independence of national monetary policy. In other words, as Keynesian fiscalists invoke the state's taxing and spending power to modify free-market outcomes, some monetarists similarly invoke the state's control over the money supply. Thus, to encourage the government to achieve optimum employment levels in a mixed-market economy, monetarists recommend specific national monetary policies. Some monetarists have recommended a national monetary rule of constancy, say a 3 percent growth rate in the national money supply. Others recommend a variable rate of growth in the money supply. Many advoate a monetary policy designed to maintain low interest rates. All seek to influence domestic production, employment, and price levels and also to provide financial reserves for a growing national economy.

To achieve these specific economic growth rates, central bankers have often been persuaded to try to impose their policies upon national monetary aggregates or interest rates. An aggressive central bank, presumably in pursuit of full employment, has often implemented its policies with little regard for price stability or the free market process of allocating credit and determining interest rates. The predictable result of hyperactive central-banking policies, at least during the past decade, has been the inflation of the general price level. In short, while for each monetarist there may well be a unique monetary policy, nevertheless, for most, monetary policy is an instrument by which the sovereign nation-state can shape the domestic market. Perversely, as it happens, an interventionist monetarism often combines in national policy with an interventionist Keynesianism. The latter dogma encourages government deficits, the former finances them. The combined doctrine, called "fine tuning," has ruled the market place of economic ideas for a generation.

For many members of the monetarist school, moreover, the international implications of their domestic monetary prescriptions do not appear to weigh very heavily. Many do not appear to give much thought to how world economic benefits might be inequitably and inefficiently distributed among unequal nation-states as a result of the United States Federal Reserve System's pursuit of a nationalist monetary policy. They do not perceive that the monetary policy of the United States, designed primarily to affect the general price level domestically and the level of unemployment nationally, could lead to the reduction or redistribution of production, employment, and income throughout the rest of the world.

The fact is that the short-run objectives of national monetary policy, especially the national monetary policy of a great power, have serious global implications. The monetary policy of the United States particularly affects monetary conditions in many foreign countries because the dollar is a reserve currency and, in its role as world money, serves as the basis for other national currencies. Leaving aside for the moment the theories of optimal currency areas, reasonable men might well wonder why management responsibility for a common world currency is permitted to gravitate to a single government, the national self-interest of which may only rarely coincide with an efficient and equitable distribution of world economic benefits. To understand the significance of this point, we might pause for a moment to consider why the power to create and to regulate international money is so important to the average citizen and therefore why he should be reluctant to delegate this unique power to any foreign government. The money supply of a contemporary nation-state consists primarily of the liabilities of its central and commercial banking system. How that money supply is regulated will, of course, directly affect the value of assets denominated in that currency. An expansionary or contractionary monetary policy must inevitably benefit some and harm others.

United States citizens are, as the creditors of their government and banks, subject to the authority of their duly constituted monetary authority. Whatever United States citizens may think of the national monetary policy, it is nevertheless, the monetary policy of their own legitimate governmental authorities, in whose election they have participated and over whom their collective opinion must have some influence. But the currency area of the dollar incorporates many nations of the world. And it is quite a different matter of political obligation if one is a citizen of another country. As a holder of dollars, a foreigner objects to the debasing of the value of his asset by an extraterritorial monetary authority, the control of which may not be subject to his vote or influence. Of course, no alien need maintain his creditor position in United States dollars or bank deposits. He may liquidate them in the market if he disapproves of American monetary policy and its effect on the value of his assets. But this privilege may come as little comfort to those foreign governments which, over the years, have been persuaded, in the larger interests of the stability of the world monetary system as a whole, to accumulate their reserves in these currencies now subject to the depreciation brought about by their liquidation in the foreign-exchange market.

While it takes a willing foreign creditor to accumulate his assets in United States dollars or sterling liabilities, nevertheless, it is in the nature of an *official* reserve currency system to encourage the accumulation abroad of the reserve currency, say, sterling or dollar claims, in both private hands and in the currency reserves of foreign central banks. For reasons to be discussed below, these reserve currencies almost inevitably become overvalued. Later, under changed circumstances and often in periods of stress and bitter national conflict, the crumbling reserve-currency system cannot forestall the disorderly liquidation of these same reserve currencies. If the period of liquidation and currency depreciation is accompanied by trade wars, or tariffs, or competitive exchange-rate changes, it is little comfort to hear from the historian that such is often the outcome of a breakdown in the hegemonic currency system, bound as it must be to the strengths and weaknesses of a sovereign national monetary policy and its unique national political interests. It is even less reassuring to argue that although such an unhappy outcome characterized the period of the 1930s, it certainly does not characterize that of the 1970s, if only for the reason that the tale is not yet fully told.[8]

Classicists

In Europe, the seventeenth and eighteenth centuries were characterized by frequent wars, bankrupt dynasties, mercantilist national policies, high and proliferating taxes, and the impoverishment of productive social groups as a result of substantial and unpredictable governmental intervention in the domestic and external trade of the nation. Here was fertile ground for the development of a revolutionary doctrine of political and economic liberty which advocated the careful delimitation of the scope and competence of the government's powers. Classical liberal economic theory called for balance in the government budget, reduction of certain taxes in the long-run interest of national economic welfare, and positive law in matters of public and private contracts. According to this school of economic thought, sound money and private market sovereignty, established and maintained by strong but constitutionally limited governments, would preserve liberty and orderly growth in the world society of nations, a society which, to endure, must be characterized by balance, equity, and a sense of limitation.

Equity in such a civil society depended on the subordination of the infinite desires of governments and individual citizens to the limitations of their earned and real resources. Real resources in the classical liberal view had to be earned and thereby gave rise to the genuine financial claims of an individual, an enterprise, or a nation. Economic society was delicately held together by the fact that the claims (assets) of the creditor were the counterparts of the financial liabilities of the debtor. As these claims were often held by workers, producers, and pensioners in near-money form (such as bonds and bank deposits), money was expected to maintain a constant purchasing value. To this end society provided the necessary institutional discipline over the creation and abuse of purchasing power, that is to say, money. Should the outstanding financial liabilities of an individual or corporation exceed the assets available to reimburse them, insolvency occurred and liquidation ensued. Men respected money, therefore. Not to do so meant financial extinction. If the goal of such a social system was equity to the useful and lawful producer, bankruptcy provided its indispensable economic discipline.

Finally, classical economic theory assumed an integrated and growing international economy, an open world market with price flexibility, and a stable supply and demand for money. The classical international monetary system tried to rule out global monetary inflation through a treaty agreement among nations to abide by the inherent limitations of the gold standard system. Nations voluntarily limited their sovereignty, that is to say, their monetary autonomy, by subscribing to a regime of fixed exchange rates based upon currency convertibility into gold. The financial discipline of gold convertibility was the simple regulating mechanism of the international economy. Interestingly, bankruptcy of the improvident firm (or individual) had a political counterpart among undisciplined nations. When the financial claims on a government exceeded its capacity to reimburse them, the result was the loss of acceptance of its currency on world markets followed by the turmoil of monetary depreciation. Sound money was therefore the basis of an ordered world economy, according to this classical view.

There was little but eternity to mitigate the severe law of limitation which the threat of bankruptcy enforced on individuals and states alike. An ordered society was not organized to satisfy men's infinite desires but rather to establish and to maintain the public interest, strictly defined among its producing members by the stable rules of economic equity. Within the framework of the market economy, sternly upheld by the state and reenforced by the essential equilibrium of the international order, private preferences would then prevail in a free and open society.

Nowadays, this view is not often seriously considered. Instead, it has become altogether too easy for some to identify the public interest with the interests of the government bureaucracy itself and with government financing of private (and often insolvent) individual and corporate interests. All sorts of self-seeking parochial interests have joined their efforts in an unholy alliance to plunder the public treasury in order to forestall the bankruptcy which would inevitably overtake them, were they required by the market to finance their demands on society with real resources. This process, by which vested interests commandeer the state to serve their narrow interests, takes many forms. Oligopolistic businesses seek subsidies under the pretexts of national welfare and military security—and even more subsidies when they feel threatened by foreign competitors. Labor unions seek and obtain restrictive government legislation to enforce their monopoly control over the price, the working conditions, the supply, and the apprenticeship of labor in order to require the community to subsidize union members' wages at a higher level than would otherwise prevail in a free and open market for the supply of labor. Government planners, bureaucrats, and legislators press to provide for the welfare of their various constituencies whose narrow interests are often tied to specific economic plans and policies which are improperly put forward as being in the national interest.

Some political authorities, moreover, are wont to congratulate themselves on the increasingly sophisticated planning techniques of today's economic management. But are these developments improvements? On the contrary, the Western world in the postwar era has been indulged, not improved, by such plans—first by the Keynesians, whose spending on behalf of special interests has run up the public debt, second by the hyperactive monetarists, whose central banking and monetary policies have financed the same debt, and finally by the socialists, whose compassionate schemes for the redistribution of income have obscured and befouled the wellsprings of national wealth and power, the true sources of which, throughout history, have been the social incentives to save and to accumulate productive capital. Though its ultimate limits are not known, the exponential growth of public and (government encouraged) private indebtedness has clearly reached an alarming level, as has the present devastating inflation which inevitably develops in a social order whose economic demands exceed the limited human and natural resources available to satisfy them.

How will the long-term national or public interest ever prevail if, in a free society, private citizens, partisan groups, and public authorities try to maximize their individual interests by seizing control of the machinery of government to advance narrow short-run goals? [9] If all tend to appropriate the public interest, who and what will insure its survival? If there are no rules to compel financial order and to insure that claims to real resources are based on work and efficiency, how can it be possible in the long run to achieve any stable, rational economic order, national or international? Clearly, some other view of the role of government and of the public interest must prevail if the national community is not to experience a permanent drive by its members toward financial disorder and insolvency. And we remember, to emphasize an earlier theme, that financial disorder in one large country spreads rapidly through the international system as a whole. Indeed, the contemporary social disease of inflation is communicated by means of an efficient, if obscure, economic mechanism which ineluctably establishes and maintains the links between national price levels throughout the global economy. We must now discuss the nature of financial linkage in order to penetrate this underlying transmission mechanism.

The Market Mechanism: Arbitrage

Some contemporary economists and historians have integrated several systemic views into a comprehensive theory of the world market economy. They have revived the classical conception of the modern world as a single integrated market economy (in which a variety of political and economic entities compete for power and prosperity). Although many of the political units in this world economy retain only the mere vestiges of the capitalist system in their domestic economies, nevertheless even they are obliged to conduct certain international economic exchanges in the framework of a world market system.[10] And to this limited extent, it may be said that even Russia and China are unmistakably a part of the closed world economy.

Over the long run, national economies tend toward international integration. The most potent economic mechanism behind this tendency is the irresistible market force of arbitrage. Entrepreneurs and agents of the state will tend to buy and sell goods (and financial assets) for a profit if price differentials exist between different segments of the market that are not fully compensated for by disparities in the costs of transportation, insurance, transactions, and information. International arbitrage, we might say, is the efficient economic mechanism whereby different national prices are equalized in world markets. It has been argued that for this mechanism to have a universal impact, the physical volume of international trade would have to be substantially larger than at present because the variety of national price disparities must be substantially greater than the number of national and international economic exchanges which tend to equalize them. The answer is that effective arbitrage tends to move the price level of a product (or a financial asset) in the United States to its higher exchange price in, say, England, with a minimum of physical movement of goods between the two places having taken place. This form of arbitrage is carried out through the spot and forward markets for goods and foreign exchange.

For example, if the spot (cash) price of copper in United States dollars drops below the equivalent spot price of copper in English pounds, net of all carrying charges, one can purchase the copper in the United States (cash) market, simultaneously sell it for the differential in the English spot market, hedge the proceeds by sale of sterling for dollars, repatriate the same, and subsequently arrange by boat to make physical delivery of the copper to England. Alternatively, one might buy copper in the spot market in the United States, and sell, for example, a three-month forward contract for the same copper in the English market, if the forward market price for copper in London reflected exactly the same spot differential. One would hedge the currency exchange risk by making a simultaneous three-month forward sale of sterling for dollars. However, instead of physically delivering the copper to England when the contract has matured, one might buy back the forward copper contract in London before its maturity, lift the hedge sale of sterling, and sell the copper in the United States cash market, if the United States price has been fully arbitraged to equality with the English market through mine and other traders' domestic purchases in the United States. In the absence of a higher, now-equalized, spot copper price in the United States, one would of course deliver the United States copper in London to fulfill the terms of the matured forward contract.

In either case, over time, one's decision to buy in the United States spot market (accompanied perhaps by other entrepreneurs) raises the United States cash copper price to the English cash price and tends to maintain it there. In the first instance one ships the goods to England, and thereby adds to the volume of international commodity trade; in the latter, one sells the copper in the United States and the physical

volume of international trade in commodities does not rise. In both cases arbitrage equalizes prices in different national markets through the sensitive mechanism of international spot and forward markets for commodities and currencies.

Because of universal arbitrage, price levels in different countries converge toward mutual parity over the long run, regardless of the political and administrative efforts made by national authorities to influence them otherwise. It is a mistake to assume that a minimum volume of trade between two distant countries proves their mutual economic isolation. The truth is that transnational parities in certain price relationships are achieved through interest-rate and exchange-rate changes, as well as through hedged forward-market arbitrage. Moreover, to the extent that contracts in the hedged forward markets are lifted and do not lead to actual movement of goods between nations, they tend to conceal the equilibrating effects of the arbitrage mechanism.[11] This same arbitrage mechanism transmits the inflationary consequences of expansive national monetary and fiscal policies within dominant national economies to the world at large.

Today, as in similar circumstances in the past, many economic policy makers in the United States are recommending Federal deficit spending as a means to revive national economic growth and to reduce unemployment. These goals are understandable, even if the optimum means to achieve them are debatable. Along with a compensatory fiscal policy, based on the Federal deficit, these same policy makers often advocate expansionist central bank monetary policies in the belief that an expanding money supply will finance the Federal deficit without unduly raising interest rates in the short term. It is also assumed that a larger money supply will provide the necessary financial reserves to accommodate the higher level of economic activity desired. Others believe that the monetary reserves that are created by the central bank are the indispensable means by which economic activity is accelerated to higher levels of output and employment.

The precise institutional actions required to implement these policies are very simple. The United States Federal Government experiences a cash deficit during a period of economic contraction and declining tax revenues. Instead of raising taxes or cutting expenditures, the Treasury sells bills, notes, and bonds to raise cash equal to the deficit. During the same period, the Federal Reserve buys government securities in the open market from government dealers for cash, thereby providing indirectly to the banking system the new cash resources needed to finance the Federal deficit. (The central banking authorities may also lower commercial bank reserve requirements or they may expand discounting to the commercial banking system at lower interest rates, providing even more monetary reserves to the financial markets, part of which will wind up financing the Treasury's rising demands for cash balances.) It is crucial to remember that the sole intent thus far of the economic policy makers has been to reduce domestic unemployment and to activate underutilized productive capacity—stimulating domestic demand by expanding the money supply and by increasing government expenditures on goods and services. No significant international consequences were consciously intended.

Remember also that the decisive institution in the process of domestic reflation is the Federal Reserve, which has supplied additional cash balances to the domestic financial markets through the open market purchases of government securities described above. What is likely to be the economic outcome? The additional supply of money disturbs the previously prevailing equilibrium in the market for cash balances. The new excess cash balances are now used by some profit-maximizing holders to purchase so-called income-producing cash equivalents. (Initially most of them purchase pure interest risk financial claims, e.g., government securities.) The increased demand for government securities, all other things being equal, raises the price of government securities and simultaneously lowers the interest rate they bear. Thus, money market interest rates tend to decline so long as the original disturbance—the excess supply of cash balances created by the Federal Reserve—prevails in the money market. As the Federal Reserve continues its policies of directly or indirectly financing the Federal fiscal deficit by buying government debt securities, it continues to supply short-run excess cash balances to the money market, thus maintaining the downward pressure on short-term interest rates.

If this were the end of the financial market process, we might begin to anticipate the expansionist effects the policy makers desired. But because national fiscal and monetary policies are carried out in a relatively open and integrated world economy (and what is more today, in a world of floating exchange rates), declining interest rates on the United States money market will lead United States arbitragists, dealers, and speculators in government securities, who might have sold government securities for cash to the Federal Reserve system, to shift some excess dollar cash balances abroad in search of higher short-term foreign interest rates. Sales (in the foreign-exchange market) of excess dollar cash balances for foreign currencies, all other things being equal, will bring about a decline in the value of the dollar against foreign currencies. And if the sale of dollars against foreign currencies goes on, in response to the continuing drop in relative United States interest rates, brought about in this case by the Federal Reserve's open market operations, the value of the dollar must continue to decline. The excess supply of dollars in the market can only be absorbed at ever lower prices, which is to say, at a continually falling dollar-exchange rate. The decline of the dollar will be arrested only when the demand for dollar cash balances increases to the point where the demand for dollars equals the rising supply, as, for example, it must when the general price level in dollars rises, or when the volume of economic activity increases, or when the Federal Reserve, the source of excess dollar supplies, ceases its open market operations.

Inflation begins, that is to say, the general price level will rise, when the excess supply of dollar cash balances ceases merely to be exported for the purposes of interest rate arbitrage and is used in addition to purchase goods and services domestically. If the foreign-exchange value of the dollar declines more rapidly than the national price level rises, the relative price of our dollar manufactured exports, all other things being equal, will decline below the price of the same goods of foreign competitors, priced and invoiced in the rising foreign currencies. As a result, American export industries will be stimulated; similar foreign export industries will contract. Moreover, as the dollar declines in value abroad, the United States economy may become relatively more attractive to foreign long-term direct investment. Since the dollar prices of some foreign manufactured imports will have risen in the short run, the production of lower-priced substitutes made in the United Staetes will be encouraged, especially if there are substantial unemployed domestic manufacturing resources available. Unemployment in the affected foreign industries could develop quickly. If the affected foreign industries and labor unions have powerful lobbies, foreign governments, hoping to protect domestic employment levels, might become concerned enough to think about trade and exchange controls, or competitive currency depreciation.

Thus, the understandable and perhaps innocent initiative by the United States to raise its own domestic employment levels by means of expansionist domestic monetary policies can give rise to an international economic struggle over appropriate currency exchange rates and export-import policies. It goes without saying that similar reflationary economic policies in, say, France or Germany (if as a result of which their money supply growth rates were to exceed that of the United States) would very likely occasion a depreciation of the French franc and the German mark against the dollar, leading under similar circumstances to precisely the same international economic consequences. The point of this extended analysis is straightforward: There is, in an open world economy, a tragic irony inherent in expansionist government demand management policies. National policy makers, intent exclusively and quite understandably on solving domestic unemployment problems, unconsciously cause disturbances in international financial markets by virtue of expanding fiscal deficits and the creation of excess money supplies. The inevitable international results (for example, the unintended depreciation of the dollar) are subsequently interpreted by foreign governments as diabolical and narrowly nationalistic efforts to export unemployment and to expand domestic economic activity at the expense of one's neighbors. National policy makers will and do argue that they have no conscious exchange-rate policy in mind. They will protest that they merely let the market decide the appropriate exchange-rate relationships. They appear to be genuinely unaware of the relationship of expansionist domestic money-supply policies to foreign exchange-rate changes even as they describe the monetary links to domestic price inflation. As we have observed, these exchange-rate changes are brought about unwittingly by the sometimes obscure mechanism of international arbitrage. We know that a country's reflationary policies may not be intentionally joined to a policy of exchange-rate depreciation; but to a foreign government, which may care only about the shrinking market for some of its overpriced manufactured exports and the related rising unemployment, it makes little difference.

The unforeseen international consequences of expansionist domestic economic policies, engineered purely to reduce national unemployment, are felt quite promptly in a world system of flexible exchange rates. Volatile exchange-rate changes, during a time of high international unemployment, could pit nation against nation in a setting of mutual recrimination and "beggar-my-neighbor" policies. National policy makers, however, rarely realize that international arbitrage transmits most economic disturbances from one nation to another. Most importantly, they seem to ignore the fact that economic disturbances, which are created by fiscal and monetary policies within a dominant economy (especially in a system of floating exchange rates), are rapidly arbitraged throughout the world, often with destructive and destabilizing effects. Is it, then, too much to say to these government policy makers that, in order to ensure global price stability, national policies must be as consistent with the requirements of international economic order as they are with the national interest of domestic full employment?

We now know that if hyperactive national full-employment policies lead to inflationary excess, this inflationary instability must be transmitted to the international system as well. As a result, hoped-for domestic-employment benefits might easily be outweighed by the very real consequences of international economic disturbances. Accordingly, is it unreasonable to suggest that in order to end national monetary disorder and therewith to stabilize the general price level, one genuine alternative open to government policy makers might be to subscribe to the impartial rules of an efficient and enforceable international monetary system, the very operating principle of which might forestall inflationary national monetary and fiscal policies? If it is true, as some argue today, that inflationary economic policies are imposed upon reluctant political authorities by powerful sectarian lobbies, one convenient discipline, available to these same authorities, would be a constitutionally binding monetary treaty which might have the effect of stiffening governmental resistance to these special interest lobbies. Political authorities who ought anyway to say *NO* to sectarian demands for excessive monetary and fiscal policies (because such policies are unreasonable, unfair, and disruptive of international stability) would certainly be strengthened if their veto were backed by a duly established ***constitutional*** rule—an international exchange-rate treaty. This line of reasoning leads us directly into the present international debate over the relative merits of fixed- and floating-exchange rates.

Fixed or Floating Exchange Rates

Currently it is fashionable to believe that floating-exchange rates can effectively uncouple a national monetary system from the world system. Floating, it has been argued, can prevent the transmission of inflation from one country to another.

Monetarists as well as neo-Keynesians have argued that benign neglect of currency exchange rates would yield the benefits of a truly national monetary policy and provide, if desired, a defense against imported inflation. Interestingly, this view has coincided with the recent rise of economic nationalism throughout the world. Moreover, a policy of benign neglect in the United States would, some have said, release the Federal Reserve Board from the constraints of the postwar fixed-exchange-rate regime and dollar convertibility. In addition, it was argued, such a policy would allow United States authorities to carry out the necessary national policies to achieve the goal of domestic full employment. These arguments against the Bretton Woods regime have become the conventional wisdom of the postwar period. During the past few years, they have formed the basis of the international monetary policy of the United States government. During this period the nation has experienced the suspension of dollar convertibility, two price freezes, price control Phases I, II, III, and IV (between 1971 and 1974), two attempts at setting "stable but adjustable" exchange-rate parities, a super boom, and endemic inflation. The subsequent precipitous decline in commodity prices and national output, combined with a 8-9 percent domestic unemployment, not to mention similar phenomena worldwide, suggest that floating-exchange rates are not the panacea for our domestic and international economic problems. Advocates of floating exchange rates argue that the present exchange-rate system (or the lack thereof) has had insufficient *time* to do its stabilizing handiwork.

The point is, of course, that economic policy making and monetary management is not merely a question of technique. Economic policy making is essentially political and normative in its nature. It has to do with the appropriate limits to be placed on individual action in civil society and the appropriate limits to be imposed upon national power in an integrated world economic system; that is, generally speaking, we should determine to what extent national interests should override individual interests or global interests override national. In practice, however, we must not only find the proper limits, but we must also organize the most efficient institutional arrangements to determine and to guard those limits. The chief institutional issue, as it affects the world financial system, may be simply stated: Since we know that the desired balance in world economic relations cannot be sustained without *required* government self-restraint, is there any reason to believe that national self-discipline will endure without an established international monetary system, the efficacious regulating mechanism of which might tend to enforce the needed domestic discipline? It is true that no international monetary reform, in the absence of minimum good will among nations, can be relied upon to underwrite balance and order in the world economy. Undisciplined great powers can destroy any system. But agreed-upon simple rules, rooted in enlightened understanding of national self-interest, and solemnized by treaty organizations, can obviously help to mobilize the forces for domestic self-restraint.

At the moment, fixed-rate systems are unfashionable in many circles. We have, after all, experienced a fixed-rate regime throughout a good part of the postwar era—the much criticized Bretton Woods system. It collapsed in 1971, if not indeed before. But the Bretton Woods international monetary system *was* a *defective* fixed-exchange rate regime, not because, as the advocates of floating would have it, *all* fixed-rate regimes must fail, but because Bretton Woods lacked the essential and impartial rule of universal currency convertibility into gold. The Bretton Woods system was doomed to extinction as a simple consequence of the privilege and the burden it imposed upon the reserve currency status of the dollar which, among other things, led to the dollar's overvaluation and to regularly recurring United States balance-of-payments deficits. The overvaluation of the dollar was the mirror image of the undervalued national currencies of our export competitors, whose manufactures invaded the United States domestic market and displaced certain United States manufactured goods abroad.

Inevitably, the Bretton Woods system, undermined as it was by the permanent balance-of-payments deficit of the reserve-currency country, led to spreading inflation and world financial disequilibrium. Foreign nations perceived United States balance-of-payments deficits as dollar imperialism, while the United States perceived the same deficits as one result of the growing burdens of The Bretton Woods agreement, which symbolized American financial and military leadership throughout the postwar world. The desire to be rid of the unshared financial burdens of leadership provoked economic nationalism in the United States, since increasingly strident demands from the United States for burden-sharing were partially rejected by not entirely responsive foreign allies. At the same time, economic nationalism arose in Europe as a way of protecting European economies from the pervasive inflation which resulted from the permanent American balance-of-payments deficits. For, under the reserve-currency system of the Bretton Woods regime, American balance-of-payments deficits were automatically converted into an expansion of other national money supplies through purchases by European and Japanese central banks of the excess dollars in their financial systems.

Is it any wonder that the Bretton Woods system collapsed? Such a defective fixed-exchange-rate regime, based as it was upon the insupportable privileges and onerous burdens of a reserve-currency system, survived longer than past history suggests it should have. The same official reserve-currency system, based on the pound sterling, had been established in the Western world by the Monetary Conference in Genoa in 1922. This earlier form of the reserve-currency system, called the gold-exchange standard, had collapsed nine years later in 1931, during the early stages of the world depression. Even before 1914, the *unofficial* world reserve-currency system, based largely on sterling convertibility, had shown incipient tendencies toward instability, which had culminated, of course, in the collapse of the gold standard and sterling convertibility at the onset of World War I.

The classical liberal perspective provides, in my view, the definitive objection to a national currency serving as the world curency in either a fixed or a floating exchange-rate regime. For it raises the fundamental historical and theoretical issue: Can one truly expect a national currency to perform its function as a store of value and a medium of exchange, over the long run, beyond its territorial borders, simply because in the short run one observes that the optimal reserve-currency area coincides with the prevailing dominant economic order of the moment? Some suggest that as long as nation-states differ in size and wealth, their optimum currency areas must extend far beyond their territorial borders. History, they argue, ordains the development of reserve currencies and with them must come the risks inherent in such an international financial system. This argument certainly derives some support from the history of the gold and gold-exchange standards of the past one hundred years. Both the pound sterling and the United States dollar during the past century emerged as the world's primary reserve currencies, not least because governments and banks throughout the international system often chose voluntarily to use them as the official basis for the creation of national money supplies.

But history supports even more decisively the view that reserve-currency systems eventually break down, with real and often disastrous economic consequences. Almost all economic historians agree that the collapse of sterling in 1931 was closely associated with the duration and severity of one of the longest depressions in modern history. The suspension of dollar convertibility in 1971 terminated the rule of the ailing Bretton Woods fixed-exchange-rate regime; the subsequent fall of the dollar-exchange rate is clearly associated with the intensification of world inflation between 1972 and 1974. The ensuing world economic contraction has not been as severe as that of the 1930s, but the role of the dollar, as the unimpeachable official reserve currency in the Western world, is surely less certain. Foreign national authorities increasingly realize (as they debate the relative merits of SDRs, dollars, and gold) that as long as the world currency has a national monetary identity, its value will be determined largely by the monetary policies of a single dominant country, the self-discipline of which cannot be taken for granted.

In addition, exemption from effective convertibility requirements tempts the country providing the reserve currency to economic and political excess, which may lead to impossibly ambitious social programs at home and imperial projects abroad. Moreover, history suggests that a reserve currency such as the post-World War II dollar tends toward overvaluation, a monetary condition which may subject its national community to the burden of unemployment in certain labor-intensive manufacturing industries. Prolonged unemployment in certain economic sectors, especially those promptly responsive to world competition, has often afflicted those countries when unrealistic exchange rates prevailed for a long while (as with England between 1925 and 1931). Moreover, destabilizing flows of international capital (as well as