Housing and Reform of Financial Structure

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Inflation, Energy and the World Economy:
Prospects for International Cooperation

by

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Washington, D. C.
International cooperation is one of the remedies suggested as a solution to many of the economic problems we face. I have not found a reason to be for or against cooperation in general, and I do not have any reason to believe that such a judgment will help to discriminate in particular cases.

What matters most is what we cooperate about and how we cooperate. The difference is exemplified by the General Agreement on Tariffs and Trade (GATT) on one side and the proposed cartel of oil-consuming countries on the other. GATT sets out agreements that are the rules of international trade. Countries forswear the use of tariff changes as a means of promoting exports or restricting imports. Governments agree to reduce or refrain from particular types of interference in the market system. Income and welfare increase.

International civil servants, some national officials, bankers and even a few economists attribute the large postwar gains in world trade, income and standards of living to the system of fixed exchange rates that, with some adjustments, lasted until 1971. Postwar experience with both fixed and fluctuating exchange rates provides evidence to the contrary. World trade and standards of living rose under both fixed and floating exchange rate systems. I believe the experience of the past few years should be looked upon as a crude but useful experiment testing the relative importance of exchange rate systems and the removal of trade barriers for the growth of world trade. The results suggest that we should assign the larger part of the postwar increase in world trade, income and standards of living to reductions in tariffs and trade barriers under GATT.
Most of the gain from the removal of barriers to world trade is achieved by increasing productive efficiency. Efficient producers have new opportunities; they expand. Inefficient producers face new and more effective competitors; they must increase efficiency, lower costs and prices, or contract. Monopoly positions protected by tariffs and other trade barriers are reduced or eliminated.

A new international agreement to reduce barriers to trade further is a useful and desirable form of cooperation. Reduction of tariff and non-tariff barriers will increase world real income and the growth rate of real income, just as past reductions spurred past growth.

The rest of my comment discusses three main topics of current interest. First, I consider the prospects for negotiations and agreement between oil importing and oil exporting countries. Then I discuss petrodollars. Finally, I recommend some policies and international agreements that seem appropriate for the problems of inflation, recession and energy.

Negotiating with OPEC

Current discussion of international cooperation emphasizes a type of agreement unlike GATT. an international cartel of oil consumers is proposed to negotiate with the international cartel of oil producers. There is no reason to believe that two monopolists or two cartels will reach a good, just or lasting solution that is in the interests of the citizens in the consuming countries. More likely, a cartel of importing countries would offer concessions to the exporters' cartel in exchange for concessions from the exporters' cartel.
What do the importers want and what can they offer? The importing countries have not kept their fears and hopes secret. They desire most of all a reduction in the price of oil and some arrangement or agreement that would prevent the exporters using assets -- both oil and financial assets -- for political ends.

What can the importers offer to the exporters? The main concession of interest to all the producing countries is an agreement to maintain the price of oil above the competitive market clearing price. Even if such an agreement could be made, it would not be a net benefit to the consuming countries, and it would not provide stability. The reason is that there is an excess supply of oil in the world at current prices. Some price reductions have been made, and others are likely. A world cartel with as many members as OPEC, faced with new production and new producers, cannot expect to maintain the current relative price of oil. An importers' cartel willing to prosecute price cutters might assist for a time but cannot succeed permanently. The gains to individual buyers and sellers from circumventing the agreement become too large to resist.

Even granting, as I do, that government sponsored cartels are enforced more effectively and therefore last longer, I find little merit in purchasing stability at a high price of oil. International cooperation to maintain the OPEC cartel is not in the interests of consumers. As usual, the market offers consumers a better alternative.

Petrodollars

The petrodollar problem is the second main reason offered to justify negotiated, political solutions to international economic problems. The
problem is said to arise because oil producing countries invest a large fraction of their receipts in short-term assets. The problem is described as exacerbated by the decision of the oil producers to hold a large fraction of their wealth in U.S. dollars, German marks and Swiss francs and very little in Italian lira and a decreasing share in British pounds.

Predictions of near-term disaster are not new. Those who forecast disaster in 1974 have not learned from past failures. The relative success of the market in redistributing petrodollars in 1974 is instead used as evidence of impending disaster. The reasoning is that short-term assets and liabilities have increased to the point at which the crisis is near.

The solutions offered as alternatives are, I believe, misdirected. An inter-governmental agreement to issue medium term bonds so that the oil producing countries can continue to hold their monopoly profits in short-term assets has no advantage for most consuming countries and delays adjustment of interest rates on long- and short-term assets. The bankers risk of lending long and borrowing short is not reduced. It is shifted to the citizens of the developing countries, some of the principal victims of the cartel.

Consider the alternative offered by the market if there is no governmental interference. Each bank or financial institution examines the risk inherent in its structure of claims and debts. If the maturity structure of the liabilities is large relative to the maturity structure of assets, the bank reduces the interest paid for short-term deposits and increases the interest paid on long-term liabilities. No single bank, acting alone, has much influence on rates. Decisions of this kind, if repeated at a large number of banks, reinforce the effect of the current world recession on the structure
of interest rates. The members of the cartel -- the owners of the assets -- are induced to shift from short-to long-term assets.

Proposals to interfere with the market process emphasize the very large change in short-term liabilities during the past year. U.S. data show that in the year ending October 1974 U.S. short-term liabilities to foreigners increased by more than $20 billion. In the same period, short-term claims against foreigners rose by $14 billion, so that the net increase in U.S. short-term liabilities to foreigners was $6 billion. This figure is considerably smaller than the comparable figure for 1971. More importantly, the accumulation by official institutions is considerably smaller than in 1970 or 1971, so the ability of foreign countries to control domestic money stocks was much greater than in the period of partly-fixed exchange rates. The table shows these data.

[Insert Table here]

The net increase in liabilities of banks and others is small. Almost the entire net increase in U.S. liabilities is to foreign official institutions. The net increase is not only smaller than in 1970 or 1971, it was accomplished with a smaller fluctuation in the exchange rate than in the earlier years. In 1970 and 1971, the dollar depreciated by 1% and 3-1/2% against a trade weighted average of currencies of 47 IMF member countries. In the year ending October 1974, the dollar appreciated 1% against the same currencies.

These data speak to the benefits of fluctuating exchange rates. The accumulation of dollars by official institutions is smaller; the annual change in the market value of the world's principal medium of exchange is smaller
Changes in Short-Term Liabilities to and Claims on Foreigners, United States, 1970, 1971 and 1974

(in billions)

<table>
<thead>
<tr>
<th>Year ending</th>
<th>Changes in Short-Term Liabilities to Foreigners</th>
<th>Changes in Short-Term Claims on Foreigners</th>
<th>Net Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>To Official Banks &amp; Institutions</td>
<td>To Others</td>
</tr>
<tr>
<td>Dec. 1970</td>
<td>$1.6</td>
<td>$8.3</td>
<td>$-6.6</td>
</tr>
<tr>
<td>Dec. 1971</td>
<td>13.7</td>
<td>20.3</td>
<td>-7.3</td>
</tr>
<tr>
<td>Oct. 1974</td>
<td>20.2</td>
<td>5.6</td>
<td>14.5</td>
</tr>
</tbody>
</table>

Source: Treasury Bulletin, December 1974, pp. 84 and 92
or no larger than in recent years of stress. The smaller accumulation of dollars by official institutions means that those central banks desirous of reducing inflation are permitted to contract, not forced to increase the growth rate of money. Western European central banks as a group sold dollar securities in 1974, a marked contrast to the large increases in 1970, 1971 and some earlier years. Yet, these adjustments, and the adjustment to the new and unpredictable events of 1974, were accomplished with little net change in the exchange value of the dollar.

An additional reason that the problem of petrodollars is considered troublesome is that many financial writers confuse money and bank credit. They view the increase in petrodollars as inflationary and are concerned, that a new and higher rate of inflation is an almost certain consequence of the high price of petroleum.

Money consists of currency and demand deposits. If all Euro-dollar and petrodollar liabilities were payable on demand, it would be proper to add these liabilities to the stock of world money. However, only a small fraction of total Euro-dollar liabilities are demand deposits. The much larger part consists of deposits with fixed maturity held by the owners as earning assets. The particular form in which the earning assets are held depends on the preferences of the owners and the market rate of interest on claims and debts of varying maturities. No new international agreement or cooperation is required to solve this problem. A reaffirmation of a well-established policy would be helpful.

The central banks of all leading countries should affirm that individual banks or financial institutions will be permitted to fail, but
failures will not be allowed to spread. Central banks have been able to achieve stability during periods of crisis by lending on demand to solvent institutions. Periodic banking crises in 19th century England were resolved, generally in days or weeks, once the Bank of England suspended gold payments and lent to the market on demand. U.S. banking crises were resolved with equivalent dispatch once appropriate policies were adopted.

The problems of the 1930's were most often exaggerated by the delay in suspending gold payments, a problem not likely to recur soon, and by the failures of central banks to lend on domestic markets or to domestic financial institutions. A statement by central bankers of the policies to be followed in the event of a banking crisis will make current and future risks clearer.

Some Additional Proposals

About nine months ago, I suggested a program to control inflation in the U.S. The program is, in a general way, applicable to any country suffering from inflation. The main points of my proposal do not require international cooperation or international agreement. They require what seems much more difficult to achieve -- a determined, steady, consistent approach by the U.S. government including the Executive, the Congress and the Federal Reserve.

Recession is now more widespread than I anticipated then. Some adjustment seems appropriate to reduce the social cost and the cost to individuals here and abroad of a recession, to assure that the decline in output terminates and that expansion resumes. I believe now, as I stated then, that when recession occurs, inflation and recession must be treated together.
My earlier proposal had three main points:

(1) Reduce fiscal 1975 government spending by 5% or more.
(2) Gradually reduce the growth rate of money. Five and one-half percent seems an appropriate maximum current annual rate of monetary expansion in the U.S.
(3) Maintain the system of fluctuating exchange rates.

In the event of recession a tax cut seemed appropriate. The response to the current recession should be a reduction in corporate and personal taxes. The appropriate size of the tax cut depends on the size of the reduction in government spending. The smaller the reduction in government spending, the smaller should be the tax reduction. The controlling factor must be the anticipated deficit and the effect of deficit finance on inflation in 1976 and later years.

Corporate tax reduction has been found to have a larger effect on real output and employment than personal tax reduction. It seems desirable also to restore some of the loss in the assets of pension funds and in consumers real wealth. A combination of corporate and personal tax reduction helps to achieve these ends. In addition to tax reduction, I propose two additional steps to remove uncertainty and improve efficiency.

(4) A reduction in corporate taxes and individual taxes to provide a maximum $25 billion fiscal 1975 deficit.
(5) Elimination of authority to maintain ceiling rates of interest on deposits at banks and thrift institutions.
(6) A Congressional joint resolution renouncing the use of price and wage controls including the control of the prices of oil, gas and coal.
Two additional steps require international cooperation.

(7) A joint statement of central bank governors that they will permit individual bank failures but will function as lender of last resort to financial institutions within their jurisdictions.

(8) Further reductions in tariffs and non-tariff barriers under the GATT rules.

The world economy has many problems, inflation, recession, energy and an excess supply of Cassandras. If disaster occurs, we cannot claim to have been without warning. Unfortunately, many proposed international arrangements are more likely to add than to reduce our current problems. I believe we need more market solutions, not more international cooperation, more freedom, not more restrictions, more efficiency, not more controls and regulators.