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Policies for an Uncertain World

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From 1947 to 1964 the United States maintained a relatively stable monetary framework under which many countries recovered, developed, and prospered. Inflation remained low in the United States and in other nations that tied the values of their currencies—their exchange rates—to the dollar. The framework and the procedures were not ideal, but they produced greater stability than the monetary systems that preceded or followed.

The system of fixed exchange rates based on the dollar, known as the Bretton Woods system, formally ended in 1971 when President Nixon allowed the exchange value of the dollar to be set by market forces. Holders of dollars and dollar securities became less certain about the long-term value of the dollar. Long before the Bretton Woods system ended, however, uncertainty about monetary policy and the future value of the dollar had increased. Inflationary policies after 1964 had eroded much of the credibility of the U.S. commitment to a fixed exchange rate and a noninflationary monetary policy. The unwillingness of the United States to change its policies, and the unwillingness of other countries to increase their rates of inflation or change their exchange rates against the dollar, had doomed the Bretton Woods system.

Many people look back on Bretton Woods nostalgically. They would like to restore some type of fixed exchange system to recapture some of the stability that enabled countries to achieve the benefits they associate with that system. There are several proposals. Some want to establish a world central bank that would issue a common money to be used as reserves and for settlements between national central banks. Others propose a return to some type of gold standard.

Such proposals misinterpret the experience of Bretton Woods. Fixed exchange rates were not a cause of increased stability and the relatively high growth of the world economy during those years. They were the result of the relatively stable policies followed in major trading countries, particularly the monetary and fiscal policies of the United
States. From 1953 to 1964, when the Bretton Woods system flourished, budget deficits remained small on average, and the most common measure of the U.S. money stock—currency and checking deposits—rose at an average annual rate of less than 2½ percent. In the succeeding seven years that ended with the breakdown of the system, average U.S. money growth rose to 5 percent, and the variability of money growth increased.

By the early 1980s, monetary variability had increased dramatically. Actual rates of money growth bear little relation to targets announced by the Federal Reserve. No one can guess whether monetary policy will produce another round of inflation, a severe deflation, or a period of disinflation. No one can be certain whether money growth will be fast or slow.

The effect of unstable monetary policy has been compounded by increasing uncertainty about the world trading system and the fiscal policies of the major Western economies. For thirty years after World War II, businesses making investment decisions could be reasonably certain that trade barriers around the world were gradually coming down. Protectionist pressures began building in the midseventies, however, and during the recent recession these pressures intensified. Recent tax cuts in the United States have led to enormous uncertainty about who will eventually pay for the mounting deficits: If it is future taxpayers, on whom will most of the tax burden fall?

The higher risk and uncertainty are a principal reason that real interest rates have remained above their postwar norms. Greater uncertainty about the future discourages investment in real assets and encourages people to hold relatively safe assets, such as currency, insured bank deposits, and short-term debt. The attempt to shift from long-term debt, land, common stocks, and other real assets to these safer assets raises the real rate of interest on long-term debt and on real assets. In principle, the increased demand for money and short-term securities may raise or lower the real rate of interest on short-term securities. If long-term debt is a closer substitute for short-term debt than for money, real rates on short-term debt rise with long-term rates.

The mismanagement of monetary control by the Federal Reserve increased the variability of both money growth and interest rates after 1979. When the Federal Reserve
changed its procedures and began targeting reserves instead of interest rates, quarterlyaverages of short- and long-term interest rates became two to three times more variable.
The Fed thus heightened uncertainty. And when uncertainty increases, people reduce their holdings of risky assets like bonds and equity shares and increase their holdings of money. The reduced demand for risky assets lowered the price and raised the return received by holders. Asset prices fell and rates of return rose until holders received sufficient compensation for bearing greater uncertainty. The increased compensation takes the form of a higher risk premium on all earning assets. Despite the recent increase in equity and bond prices, risk premiums in interest rates remain at levels not experienced since the early 1930s.

Those increases in risk premiums and the demand for money help to explain several recent developments, including the rapid decline in inflation, the length of the recession, and the strength of the dollar in world markets. The increased demand for money contributed to the decline in inflation by reducing spending and prices, but it also contributed to the recession. The reduced demand for real capital helps explain the persistent stagnation of real output from 1979 through 1982 and the low rate of investment. The rise in real rates of interest attracted foreign capital and contributed to the higher exchange value of the dollar. In each case, the risk premium supplemented other forces that have depressed the economy in recent years.

Little has been done to solve the long-term problems of the economy. Uncertainty remains high. No one can possibly know what the Federal Reserve will do, because the Federal Reserve has unlimited discretion and little accountability. The only monetary discipline that remains is achieved by market forces that cause an increase in interest rates or a flight from the dollar. The markets have forced the Federal Reserve to correct past errors but has not produced disciplined policies. Fiscal and trade policies are just as uncertain. Who knows within a large margin what tax rates will be in two or three years?

What is needed now is a new set of monetary, fiscal, and trade policy rules to reduce uncertainty and encourage the stable growth and relatively low interest rates of the fifties and sixties. Rules that increase stability are not difficult to write.
To restore monetary stability, I propose that the central banks and governments of the United States, Japan, West Germany and the United Kingdom maintain the growth rate of their monetary liabilities, known as the monetary base—currency and bank reserves—in relation to the average rate of growth of domestic output (measured in real terms) during the preceding three years. The relation would allow for the trend rate of growth in the demand for money relative to output and would be set to maintain an average rate of zero percent inflation in each country. Other countries could make a similar commitment, or fix their exchange rates in relation to one of the three currencies, or remain outside the system.

Price levels would continue to fluctuate in the three nations, and exchange rates between the dollar, the yen, and the mark would vary. Fluctuations would remain bounded by the commitment of these major trading countries to maintain policies that aim at non-inflationary money growth. Each country would gain from its own policy even if other countries did not honor theirs. The gain to participants would increase, however, as the number of nations honoring the agreement rose.

The proposal increases stability in five main ways. First, there is a stable framework for policy that reduces uncertainty about the future price level. Second, although exchange rates are free to fluctuate, long-term changes are constrained by the commitment to noninflationary and nondeflationary policies. Third, the system adjusts gradually to changes in output or money demand. Fluctuations in output or prices are not eliminated, but they do not cumulate. Fourth, monitoring is relatively easy, so the credibility problem is reduced. Fifth, instead of basing policies on uncertain forecasts, central banks would be required to control the liabilities on their own balance sheets, a task that is within their capability and can be achieved with precision.

A stable monetary framework encourages people to hold a smaller share of wealth in precautionary balances and to invest a larger share in capital. By reducing present uncertainties, the monetary system would contribute to lower real interest rates, a larger capital stock, and increased output.
The monetary framework should be supplemented by rules that strengthen trade in capital and reduce the risk of exchange controls. People choose to own foreign currencies and invest in foreign assets because they perceive risks at home. Restrictions on capital movements that attempt to block the operation of this mechanism encourage people to diversify into short-term foreign assets or diamonds and precious metals. This reduces investment in long-term capital and lowers real output.

Governments can contribute to the expansion of the world economy by reaffirming their commitment to the rules guiding trade policies during the last three decades and by reducing many of the remaining restrictions on trade and capital movements. By removing barriers to trade and capital, the principal market economies of the world can increase output and raise standards of living. The expansion of world trade is one of the main ways that permanent gains in living standards can be achieved.

Yet rules for money, trade, and capital movements cannot assure that resources are used efficiently. Government tax and spending policies in many countries encourage the transfer of resources from future to current consumption. Variable fiscal policies that increase uncertainty about future tax rates on labor and capital also encourage current consumption and leisure.

Budget deficits are one such factor. Deficits must be financed either by increasing tax revenues or by selling debt to savers. But when the savings rate is too low to finance a large deficit without a substantial increase in interest rates and when paying the interest on outstanding debt becomes a burden, governments typically rely on inflation to reduce the real value of the debt and to tax the owners of wealth.

A fiscal policy that fixed the relative size of government or the relative growth of government would increase certainty about future tax rates. The growth of government spending could be tied to the average growth of nominal output, for example, and tax collections could be tied to the average level of government spending. A rule of this type would produce a cyclically balanced budget and more predictable average tax rates.

In the two decades that followed World War II, real per capita income probably increased at a higher rate in more countries and for more people than at any other time.
in recorded history. The progress of the fifties and sixties continued in the seventies. Estimates by the World Bank show that between 1970 and 1977, nearly 50 percent of the world's population lived in countries that experienced increases in real per capita incomes of 4 percent or more. But somewhere around 1977—before Reaganomics and Thatcherism—the world economy began to stagnate as a result of greater monetary, fiscal, and trade uncertainty. This uncertainty can never be fully eliminated, but it must be considerably reduced before the world economy can return to the real growth rates of the fifties and sixties.