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Discussion

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The paper prepared by Charles Freedman addresses important policy issues that are likely to challenge central bankers as well as academic analysts throughout the 1980s. He approaches the relevant problem area, coordination of domestic monetary management with monetary policies abroad, through a needle's eye — or to use less biblical language in the conference environment: a narrow canyon, namely U.S.-Canadian monetary relationships in recent years. Given its strong trade and financial links with the United States, *Canada* in some respects clearly represents a *special case.* Nevertheless, the careful empirical and theoretical analysis offered by Charles Freedman is clearly pertinent also to other industrial countries outside the United States.

I can only offer a personal German, or at best, central European, view in this respect. However, taking economic conditions in this restricted geographical area as a point of reference, it seems the paper succeeds in bringing out the following *general issues* bearing on monetary policy coordination:

- Recent experience with U.S. interest rates and dollar exchange rate movements is correctly classified as a major external shock event: In relation to the dominant U.S. economy even larger countries like Germany or the United Kingdom at times feel to be in the "small-open-economy" position characterized in the paper.
- The paper underlines the need for a considerate policy response to exchange rate shocks. In this respect, it undoubtedly reflects a concern shared by all European central banks which pursue pre-announced monetary targets.

- Finally, it is realistically admitted that neither academic analysts nor central bankers are at present well prepared to propose generally acceptable policy solutions to the resulting short-run operational problems.

Let me now make some more detailed comments on the main sections of the paper where I feel a modicum of German or Central European flavor could enrich the U.S.-Canadian menu of issues.

I cannot really quarrel with Charles Freedman's presentation of ***stylized facts.*** His dating of oscillations in short-term U.S. interest rates, the evidence presented on marked swings in uncovered interest rate differentials, and the graphical demonstration of gyrations in dollar exchange rates illustrates the challenges to short-run monetary management emanating from the unusual volatility of U.S. money market rates. To complete the factual picture, European central banks would, perhaps, tend to add two sets of information:

- First, on the effects of U.S. interest rate ***volatility:*** It is apparent from the data that central banks outside the U.S. temporarily "uncoupled" domestic from U.S. money market rates, allowing dollar exchange rates to absorb part of the interest rate pressure. They were less successful, however, in insulating their domestic long-term rates from the unusual variations in U.S. bond rates. In the German case this implied higher volatility in the growth of monetary aggregates; and it may generally have raised uncertainties pertaining to the future development of bond prices and long-term interest rates as anticipated by holders of financial and real assets in Europe.
- Second, on the ***level*** of U.S. interest rates: European observers would tend to translate the decline of their currencies against the U.S. dollar between end-1979 and end-1981 into a combined inflationary/deflationary disturbance impact equivalent to 2 percent of GNP and assume that this partly reflects the perceived high level of U.S. real interest rates. The implied worsening of the inflation/unemployment "discomfort index" is widely seen as a more serious problem than short-run exchange-rate related operational difficulties in achieving announced monetary objectives.

I found Charles Freedman's paper intellectually particularly attractive in the middle section where it develops an operational policy rule for small open economies attempting to maintain control over the money supply in the face of actual or perceived increases in real interest rates abroad. After discussing two polar cases — involving full or no adjustment to the rise in foreign interest rates — he concludes that an *"intermediate" or "in-between" policy* of partial domestic interest rate adjustment is a superior way of ensuring the achievement of domestic monetary targets in the somewhat longer run. The route to be followed in determining the correct interest rate adjustment, however, would seem to be paved with great uncertainties for most European central banks. The relevant empirical judgements to be made include assumptions on the transitory or more permanent nature of a rise in foreign interest rates, the likely reaction of the exchange rate and the dynamic response pattern of domestic cost, price and output variables to external disturbances. The Bundesbank and smaller European economies following Germany's dollar policy have therefore hesitated to change their domestic money market rates as long as there seemed to be a chance that erratic movements in foreign interest rates and the corresponding changes in dollar exchange rates and foreign trade prices could reverse themselves within the intermediate period. Countries like France, where monetary implementation procedures heavily rest on administrative credit, interest rate and exchange controls, have tended to delay domestic policy adjustments even further. In short, the perception of external shocks emanating from U.S. monetary policies seems to differ somewhat among dependent economies on both sides of the Atlantic:

> In Canada, movements in U.S. interest rates as such seem to be regarded as a potential source of disturbance eliciting an early considerate adjustment of policy-controlled short-term Canadian interest rates.
>
> In Europe, confirmation of a more lasting U.S. interest rate movement and its actual spill-over into foreign trade prices may provoke a counter-balancing mid-course correction in the thrust of domestic monetary management. (In fact we may iterate *in practice,* where Canadians only iterate *intellectually* to set the correct path for short-term interest rates.)

This distinction in the perception of phenomena which constitute "external shocks"-relevant to monetary management seems to be even more important in the context of the final section of Charles Freedman's paper. His discussion of a *modified monetary aggregates strat-*

egy, which combines the achievement of medium-term monetary objectives with a short-run policy of offsetting identified external shocks, adequately describes the broad policy framework on which countries like Germany, the United Kingdom and Switzerland have relied in recent years. On an experimental basis, these countries have allowed domestic monetary objectives to deviate from their intermediate midpoint target paths to mitigate the destabilizing impact from large and sustained exchange rate movements. However, these approaches rarely involved offically announced exchange rate objectives and, as a rule, implied a departure from announced monetary growth targets only when deflationary or inflationary repercussions from movements in foreign trade prices had already begun to erode the credibility of monetary aggregates policies. The resulting policy framework, which the Bundesbank has to some extent formalized in recent years, may be said to represent a monetary targeting approach constrained by the perceived need for offsetting recognized external disturbances.

Such compromise policies are certainly far from constituting a perfect solution to exchange rate and monetary management problems resulting from marked differences in policy goals, operating procedures and economic performance among major countries. They ultimately reflect the recognition that a floating exchange rate regime provides less scope for an independent pursuit of national monetary and ultimate economic objectives than early academic advocates of flexible exchange rates (like M. Friedman or E. Sohmen) and many "progressive" central bankers had been ready to expect. The paper prepared by Charles Freedman therefore seems to rise one ultimate question: Is there really much scope for *individual* countries to improve their monetary and economic performance unilaterally by responding in a more sophisticated manner to policy-induced external shocks?

If I am not entirely mistaken, future research efforts may at least partly have to go in the direction of a *global systems analysis* to enable central banks to deal collectively with monetary coordination problems in the 1980s. First steps along this route can already be discerned. Reflecting the growing disenchantment with the floating rate regime's ability to smoothly absorb pronounced policy differences among major countries, contributors to this newly developing systems-related debate tend to propose more or less radical reforms on existing policy procedures and the basic characteristics of the present exchange rate regime.

At the risk of oversimplification, the following classes of proposals may tentatively be distinguished:

- *The conservative option:* This would involve an explicit return to an *adjustable peg system,* possibly modified to allow exchange rate flexibility within a wider parity band. (A number of smaller European countries, which peg their exchange rate to the D-mark, have always regarded this as a better solution than running an independent monetary policy, and present proposals to extend the European Monetary System geographically or strengthen its internal coherence go in the same direction.)
- *Global policy rules:* Those who believe that simple rules are superior to discretion under any circumstances and could positively impress the exchange markets if such commitments are collectively undertaken, advance such ideas as: The return to a *gold standard* (U.S. gold commission); The joint control of the *world money supply* by major central banks (McKinnon), or The imposition of a *"Real Interest Rate Equalization Tax"* (Dornbusch). (In one way or another these proposals seem to rest on a fairly reduced model of exchange rate determination which is hardly universally acceptable.)
- *The "defeatist" option:* Under this heading I would categorize proposals amounting to a return to early postwar *capital and exchange controls* or similar devices (such as Tobin's external transactions tax).
- *"Front-door" collective policy coordination:* This would require a bold attempt to *avoid major rifts* in policy performance among the larger economies and require a cumbersome international consultation process. (A step in this direction seems to have been taken during the last economic summit meeting which has asked the IMF to monitor reinforced policy coordination efforts.) Whether this is a realistic idea could largely depend on the willingness of dominant economies such as the United States and Germany to define their national interests in a wider geographical and political sense. But "thinking the unthinkable" may be more attractive than another go at intervention or simple-rules-policies on a global scale.

These comments reflect the opinion of the author only.