

# U.S. Leadership and Postwar Progress

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Twenty years after World War I, the major industrial countries were on the eve of another great war. Recovery from the Great Depression was incomplete in many of these countries. In the United States and some other democracies, per capita income was below the level reached in 1929. Abroad, the spread of **totalitarian** government appeared to be both an unstoppable trend and, given the economic performance of Germany and Italy, a possible solution to stagnation and depression.

At home, New Deal experimentation with economic planning and government direction of economic life had become popular with many voters and seemed likely to continue and to spread. Many believed or professed that capitalism was an eighteenth or nineteenth century idea whose time had passed. And, since comprehensive planning and democratic government lead to conflict, democracy, too, was often seen as an impediment to economic progress rather than an essential feature of a free and progressive society. This message, or something similar, was heard in large parts of Africa and Asia.

More than forty years after the end of World War II, the outlook for democratic government, private ownership, and market direction of economic activity is very different. The postwar generations look ahead guided by a different experience. There have been wars, but no major war. There have been recessions, but no major depression. And, there has been remarkable progress in living standards in the

democratic market economies and in the spread of democratic government.

Looking back, we can see that more people in more countries have experienced larger increases in standards of living or income than at any time in recorded history. Life expectancy has increased. Infant mortality has declined, and health standards have improved in many parts of the world. Japan has become a stable, democratic, and wealthy country. Japan's output and its people's incomes have increased at a rate that **permits** children to enter the labor force at incomes, after adjusting for inflation, that are three to four times the incomes received by their parents a generation earlier. Western Europe turned away from false totalitarian promises to embrace the democratic, market system. They, too, enjoyed large increases in standards of living. Countries like Spain and Portugal eventually rejected authoritarian government, joined the market system, and embraced Western European institutions based on political and economic freedom. Per capita incomes in Taiwan, Hong Kong, and Singapore advanced so rapidly that standards of living in these countries now exceed the levels in Portugal, Spain, or Ireland and are approaching the level of long established developed countries such as Australia, New Zealand, or the United Kingdom. Even in countries like Brazil or Mexico, where the decade of the 1980s has been burdened by debt and mistaken policies, postwar growth has raised standards of living markedly. For example, Brazil experienced real growth of per capita income of more than 3 1/2 percent a year from 1965 to 1988 despite the continuing problems that reduced the growth rate for the 1980s.

The postwar decades constitute a great experiment in the properties of economic systems. The results of the experiment are as clear as is likely to be found in the social sciences. Where the market system has operated, the typical experience is that countries have developed, standards of living have increased, education and health have improved, and democracy has been encouraged. Where some form of socialist planning has been tried, the typical experience has been economic stagnation and political repression. There is less sustained progress than in the market economies and less freedom also. Indeed, if this were not so, we would not have witnessed the rejection of socialist

planning once an alternative became attainable. Communist parties that at times stood on the edge of power now change their names and even their programs.

Of course, exceptions to these generalizations can be found. Not all market economies have progressed, and not all have become democratic. Some socialist countries have raised living standards, as in China, but often the most dramatic improvements have come when state direction and planning have been reduced. Hungary's experience with reduced state control and China's with loosening its agricultural controls are two examples.

The clearest comparisons, and the most useful experimental evidence, come from those countries where we can hold constant factors such as history and culture that may affect the pace of economic development. Taiwan, Hong Kong, and Singapore together can be compared to the People's Republic of China in the same way that West Germany can be compared to East Germany or North Korea to South Korea. In these comparisons, differences in history and culture are insignificant, while social and economic arrangements have diverged widely. After forty years, there can be little doubt about the outcome. Hong Kong and China are of particular interest since Hong Kong's population includes large numbers of migrants who fled from China in the years after 1949. Average income of those who left is now 15 to 20 times the average for those who remained behind.

Yet, not all market economies prosper. Argentina and Bolivia are examples of countries that have not shared in the postwar prosperity. Many historical periods have produced poorer results than the postwar years. The interwar period is an example cited earlier. These differences between periods and countries call for an explanation.

The superior postwar performance of many countries owes much, I believe, to the institutions and policy arrangements put in place at the end of World War II. These provided for the defense of common interests, rules for trade and payments, and a general disposition—often challenged and not always followed—to rely on markets and market processes to allocate resources.

During the postwar years, in contrast to the interwar period, the United States took the lead in fostering and sustaining a framework that encouraged political stability, economic growth, and reliance on markets. U.S. decisions were not always wise or well thought out. At times, and sometimes unavoidably, mistakes were made, and there was much room for improvement. Looking back, however, we cannot fail to note the substantial progress in living standards and in the spread of democratic government and to inquire about the relation between postwar policies and these developments.

The first task is to develop the linkage between progress and postwar arrangements for political stability, trade rules, monetary policy, and reliance on markets. The second task is to inquire whether, or to what extent, new or revamped arrangements are now required if progress is to continue.

### **Political stability**

Comparison of interwar and postwar political arrangements for defense and their achievements is a study of differences. Collective security in the interwar period was to be the responsibility of the League of Nations. The United States did not join, but even if that vote had been reversed, it seems unlikely that the United States would have been willing or able to organize a coalition against the totalitarian countries. In the 1920s, U.S. defense spending was 15 to 20 percent of the budget but less than 1 percent of GNP. Domestic concerns were dominant in the United States, as in most countries, and the relative position of the United States was much less imposing after World War I than a generation later.

For better or worse, the failure of the League of Nations as a peace-keeping institution was matched to a degree in the postwar. Political divisions between the totalitarian and democratic countries prevented the United Nations (UN) from developing its authorized peace-keeping role. Although agreement was possible in a few instances, generally the UN was a relatively ineffective organization. The major difference in postwar defense or political developments was the organization of defense outside the UN.

There are two aspects. One is the development of regional agreements, of which the North Atlantic Treaty Organization (NATO) was most successful. The other was the commitment by the United States to use force or threat of force in Korea, Vietnam, and Kuwait, but also in Greece, Turkey, and Iran in the 1940s, Iran and Lebanon in the 1950s, Cuba and the Dominican Republic in the 1960s, Libya and Panama in the 1980s and at other times and places. Even where the United Nations was the nominal organizer of the policing activities, as in Korea or Kuwait, the United States took the lead in organizing, directing, and **carrying** out the operations. The United States was not alone, or solely responsible. Other countries joined in some of the operations and worked alone, as Britain did in Malaysia and the Falklands and France in Chad.

All of these operations were not planned or executed wisely or well. Nevertheless, these efforts and the continued relatively large expenditures for defense made the commitment to maintain political stability credible. The costs of ensuring the peace and serving as policeman were high, but the costs of aggression were usually seen by would-be aggressors as higher still. Thus, a public good—political stability—was created and sustained, again not always perfectly. No less important, the Soviet Union and its allies in the Warsaw Pact eventually found the competition too costly to continue, perhaps establishing either that open, democratic societies have a comparative advantage in the development of the new technologies on which modern war is now based or that democracies' advantage lies in the relative economic strength of their economies and their ability to add to that strength. In either case, the result is far different from those early postwar conjectures (or Henry **Kissinger's** pessimism in the 1970s) that had military strength and the projection of power as an advantage of the totalitarians.

Scholars will debate for years about the relative **importance** of three factors leading to the end of Communism as a world force: the failure of the Soviet Union and other centrally planned economies to develop, President Reagan's commitment to U.S. rearmament in the 1980s which required a commitment of additional Soviet resources larger than the Soviets were willing to squeeze out of their economy, and President Gorbachev's personality or personal objectives. What

matters for present purposes is that U.S. defense spending, service as policeman, and organizer of collective security contributed importantly to the outcome. Absent that spending and preparedness, the outcome would have been different, perhaps the gradual extension of Soviet power and U.S. withdrawal that Henry Kissinger feared in the 1970s, perhaps the Euro-communism or "Finlandization" that were prominent concerns at that time.

A public good is created when all the benefits that the good or service provides are not captured by the producer. By serving as a policeman, the United States provided two distinct types of public goods. First, it mobilized support for political stability and encouraged others to join in enforcing or maintaining peace and stability. Second, it raised the cost of aggression, thereby encouraging many (by no means all) countries to devote their talents to peaceful pursuits.

Spending on armaments absorbs resources. Iran and Iraq, for example, spent heavily on arms and now find much of their arsenals destroyed. More generally, spending for arms by countries in the Middle East lowered living standards in these countries and in neighboring countries that rearm for aggressive or defensive purposes. Resources, including skilled managers, were directed to the military instead of to trade and development. Control of resources was concentrated in a few hands instead of being broadly dispersed by the market. Opportunities for specialization, trade, and exchange were not developed. The Middle East is a region where the efforts by the United States to serve as policeman have not been successful. The region illustrates some of the costs of political instability, just as Western Europe or the trading arrangements among East Asian countries illustrate the benefits of political stability.

With the provision of a public good, there are opportunities for free riding, which occurs if a country acts on the assumption that the benefit will be supplied whether or not it contributes its share of the costs. A small country—even one of the larger European countries—could anticipate that U.S. decisions to defend Europe or spend for defense were independent of the amounts any single European country would spend for this purpose. Each European member of

the alliance had an incentive to shirk on its military spending, thereby shifting the costs to others without commensurately reducing the benefits received. Similarly, European countries had incentives to take a free ride by restricting the use of their troops to European defense, leaving to the United States to bear the main costs of maintaining political stability elsewhere. Some took advantage of these opportunities to free ride.

The total costs to be shared include much more than the expenditures to support troops in the field, as in the recent war in Kuwait and Iraq or the earlier war in Korea. Large sums are spent to develop weapons systems useful in different types of encounters. These costs are part of the successful performance of the police function. Most of these costs have been paid by the United States. Granted, weapons development has some auxiliary benefits for the developer. Some of the technology may be transferred to nondefense industries. It is unlikely that the benefits compensate for the costs, however. Much of the work is specifically military, with little opportunity for transfer. Some is secret and cannot be transferred. Without denying that there have been successful technology transfers, it seems likely that investment in civilian technologies would have provided higher nondefense returns.

Under U.S. leadership, the postwar political order provided a relatively stable political system under which countries were able to develop and achieve the benefits that come from trade and exchange. Countries could concentrate on peaceful pursuits. Many seized the opportunity. Trade expanded, encouraging the rise in living standards, often at rates that were higher and persisted longer than in any previous period.

The political order was sustained by concerns about the intentions and actions of the Soviet Union and by the willingness of the United States to both tolerate free riding and bear a considerable part of the total cost of maintaining stability. Both factors are no longer present to the same degree.

If nations are to be subject to the rule of law and accept peaceful settlement of disputes, there must be enforcement. Enforcement is

costly, but failure to enforce can be more costly. Someone must pay the enforcement costs.

If there is no enforcement, stability and trade will decline or grow more slowly. Petty tyrants aggravate their neighbors; bigger tyrants threaten the entire system. Without agreement on collective action, either the system based on freedom and political stability is weakened or countries bear the enforcement costs individually. Part of these costs could be avoided by everyone if there is an agreement to share the (smaller) costs of maintaining political stability.

The United States seems no longer willing to bear the preponderant share of the costs of enforcing political stability. There has been much discussion of burdensharing—redistribution of the costs. The decision to shift part of the decisionmaking about Iraq and Kuwait to the UN may have helped to get some of the costs of that operation more widely shared. But if others bear more of the costs, they will want more influence over the decisions. The UN Security Council could agree about Kuwait and Iraq, but the UN is not noted for its ability to make decisions quickly or agree about ends and means of settling disputes. Other multinational bodies would face similar problems of agreeing on political objectives. The European Commission is an example.

Failure to agree on the ends to be pursued and the means to accomplish them risks the loss of the political stability and economic progress. Yet some nation or group of nations must decide which disputes are threats to stability that require collective action and which have costs that are borne mainly by the parties to the dispute. The former require action to enforce stability; the latter do not. Someone must decide, also, how the total costs, including costs of weapons development and policing are to be shared. The solution of these problems requires not only new institutions or arrangements but agreement on objectives and the means of achieving them.

## **Trade rules**

The interwar period was characterized by rising tariffs and protection that hindered the expansion of trade. A crude measure of the



degree of protection in the United States, duties as a percentage of U.S. imports, rose from 16 percent in 1920 to 59 percent in 1932. Increases in U.S. tariffs, in 1922 and 1929, reduced U.S. imports and led to retaliation that reduced U.S. exports, particularly after 1929. During the 1930s, many countries chose policies to increase domestic demand for domestic goods and reduce demands for imports, so-called "beggar-thy-neighbor" policies, to increase domestic employment.

In the postwar years, rules for trade and agreements to reduce tariffs lowered tariff barriers, particularly between developed countries. The principal agreement is the General Agreement on Tariffs and Trade (GATT). GATT rules prohibit discrimination against particular countries, require "national treatment" of imports with respect to taxes and regulation, and provide for dispute settlement.

By 1987, when all the reductions agreed to in the Tokyo Round of trade agreements (1973-79) had been made, the United States, the European Community (EC), and Japan had reduced tariffs on industrial products to less than 5 percent on average. Although tariffs have declined substantially, the 5 percent number is not fully informative. There are four reasons.

First, there is considerable dispersion within the group of industrial products and between industrial products and other goods. Countries typically have lower tariffs on goods that they export than on goods they import. For example, Japan has a 1.5 percent tariff on transportation equipment but a 25.4 percent tariff on food and tobacco. The United States has a 0.2 percent tariff on paper and paper products but a 22.7 percent tariff on wearing apparel.

Second, countries have developed nontariff barriers to trade, and these barriers have increased as tariff barriers have declined. So-called voluntary quotas now cover a wide range of goods, including industrial products. Health, safety, and other regulations are sometimes genuine efforts to exclude undesirable products, but they are used also to protect domestic producers.

Third, many goods and services are excepted from the full force of GATT rules. Protection and subsidies for agricultural products are a familiar example. Intellectual property, including movies, books, and computer software, are not subject to GATT rules but are covered by much weaker agreements.

Fourth, many developing countries, though members of GATT, are not subject to the same rules as developed countries. The General System of Preference allows developing countries to maintain higher duties on imports. These preferences are intended to compensate for lower levels of development, but they also hamper development by raising costs of production in the developing countries and encouraging inefficiency.

Despite these restrictions on open trading arrangements, world trade has spurred economic development and the growth of world output in the postwar years. Between 1950 and 1972, world trade increased at an average rate of 5.9 percent per year after adjusting for inflation. From 1960 to 1972, world output, as measured by the International Monetary Fund (IMF), rose 4.7 percent per year. Notwithstanding oil shocks, disinflation, and the much discussed variability of fluctuating exchange rates, world trade (adjusted for inflation) grew 4.7 percent a year from 1972 to 1990 while world output (as measured by the IMF) rose by 3.2 percent.

Trade encourages development by permitting developing countries to specialize in the production of products and services in which they have comparative advantage, build plants of optimum size, shift labor and materials into world-class industries, finance economic development from the export surplus, and increase their population's skills and opportunities. Many of the same advantages accrue to developed countries. Developed countries have been pushed by the growth of trade and by competitive pressures to invest in technology and education, improve products and production processes, and increase productivity and standards of living.

The postwar years found many countries pursuing development strategies based on export-led growth. These strategies required other countries to accept import-led consumption. The importing

countries gained by shifting resources into more productive uses, by specializing, and by exporting the goods and services for which they had comparative advantage. Thus, exporters and importers contributed to each other's development and to the development of the world economy.

The system of GATT rules is still in place but enforcement is ineffective. Dispute settlement procedures are slow and uncertain. Increasingly, large countries have chosen to operate outside the GATT rules, subsidizing production and exports and imposing quotas and other restrictions on imports. Many of these measures seek, or achieve, cartel arrangements that divide markets among producers and reduce competition.

Proponents of "fair" or managed trade have encouraged the development of cartel agreements for steel, automobiles, apparel, textiles, semiconductors, machine tools, and many agricultural products. These agreements, and subsidies for agricultural output and exports, reduce competition, raise prices for consumers, damage low cost producers, and divert trade, thereby reducing previous gains to living standards.

Rules for trade are a public good. The rules provide benefits to all participants in the open trading system, but rules must be enforced against free riders who benefit from the rules imposed on others and try to benefit also by preventing the same rules for open access from applying to their suppliers. Quotas, subsidies, and many nontariff barriers must be seen as attempts to gain special advantage—to free ride on the system. The more such actions succeed, the smaller are the gains achieved by the system of rules. This is the crux of current trade disputes. The rules are not comprehensive, and they have not changed sufficiently to reflect the changing composition of trade. Existing rules are not enforced uniformly. Enforcement mechanisms are weak or nonexistent.

Three types of response reflect the lack of enforcement. One is the movement to managed or "fair" trade. This has produced a number of cartels to divide markets for a growing list of products. There is nothing "fair" about these arrangements. Cartels, or market sharing

agreements, stifle competition, discriminate against nonmembers, raise prices to consumers and, until they break down, reduce innovation and growth.

A second response has been unilateral action by individual countries and groups or bilateral negotiation. Bilateral negotiation, often using threats and counterthreats, has not been a very effective means of reducing subsidies, prohibitions, and other barriers to trade. These negotiations typically require one country to incur short-term, visible costs to receive some less visible long-term benefits.

The third response is multilateral negotiation, which **permits** all parties to achieve some visible short-term gains to offset losses. The Kennedy, Tokyo, and intermediate rounds successfully reduced barriers in all countries. The current Uruguay Round attempts to do more—to remove nontariff barriers, improve dispute settlement procedures, and bring agriculture, services, and investment under GATT rules. It now seems unlikely that the bold measures initially proposed will be adopted. Even if agreement is reached, the increase in efficiency and standards of living is likely to be small. If this conjecture is correct, it seems likely that protectionist actions will increase and more of the mutual benefits of an open trading system will erode.

One much discussed alternative to an open trading system is a system of rival trading blocs that permits relatively free trade within the blocs, under enforced rules, but restricts trade with countries outside the bloc. Reduction of trade barriers within the European Community, approval of the U.S.-Canada agreement, possible negotiation of an agreement with Mexico creating a North American trading bloc, with possible extension to include parts of Central and South America, are taken as evidence of this development. Extrapolation gives rise to a conjecture that there will be three trading blocs—Western Europe, East Asia, and most of North and South America—with relatively free or open trade within the blocs and trade restrictions between blocs.

To see what this implies, I have grouped countries into three blocs.

The conjectures do not clearly define membership in the blocs. The European Community is well defined at present but could expand to include countries remaining in the European Free Trade Association or in Central and Eastern Europe. The Americas bloc now contains only the United States and Canada but in the future might include Mexico and parts of Central and South America. The Asian bloc is the least clearly defined. I have chosen to include in the EC only the twelve current members. The presumed membership of the three blocs is:

*EC:* Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, and United Kingdom;

*Asia:* Australia, Hong Kong, India, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand;

*Americas:* Argentina, Brazil, Canada, Chile, Mexico, United States, and Venezuela.

These countries were parties to about two-thirds of the world's trade in the four years **1986** to **1989**. The assignments are arbitrary, of course, and several possible bloc members are omitted. Oil exporting countries, China, and Eastern Europe have not been assigned to any of the three blocs. I believe that changes would not alter main conclusions about the desirability of trading blocs as an alternative to more open trading arrangements.

Table 1 shows average trade data for the years **1986** to **1989** inclusive. The numbers in the table are half the value of exports plus imports within and between blocs during these years, in billions of dollars.

The table shows that two of the three blocs have more trade outside than within the bloc. The exception is the EC, with **\$289** billion average trade between members of the bloc, far more than the EC's trade with the other blocs combined. Intra-Asian trade has increased markedly during the period, partly as a result of slow growth in the Americas and partly as a result of substantial Japanese investment in other Asian countries. But, as the table shows, Asia and the Americas

are each other's largest trading partners; Asian trade with the Americas is almost twice the volume of intrabloc Asian trade.

**Table 1**  
**Volume of Trade Within and Between Supposed Trading'**  
**Blocs, 1986—1989 (in billions)**

	Americas	Asia	EC
Americas	\$108		
Asia	\$144	\$78	
European Community	\$102	\$70	\$289

These data suggest the importance of trade among blocs. For the United States or Japan, a bloc within Asia or the Americas is an inferior substitute for interbloc trade. The detail reinforces the conclusion from the aggregates; Canadian-U.S. trade is more than \$70 billion of the \$108 billion average inter-American trade; **Japan-U.S.** trade is \$63 billion, 80 percent of total intra-Asian trade and 125 percent of Japan's average trade with its Asian partners. It would not be in the interests of either Japan or the United States to develop intrabloc trade as a substitute for open, international trade. Even for the EC, trade with the Americas—particularly the United States—is 7 to 8 percent of total trade and nearly 20 percent of trade outside the bloc. A significant reduction in interbloc trade would be costly to the world economy and to the major trading countries.

Costs would not be limited to the loss of trade and income. There would be less competition, reducing pressure to improve products and processes. The mix of products traded, hence the composition of output, would be altered. Western Europe and **Japan** buy and sell a different mix of goods and services to the United States than Latin America. Latin America cannot supply consumer durables and autos to the U.S. market competitively, and the United States does not have a comparative advantage in producing and supplying many of the goods that Latin Americans buy from Europe or Asia. The same would be true of an Asia bloc substituting for the trade that Japan, does with the United States and the EC. A shift in trade from the global market to a system of regional blocs would change demands in a direction unfavorable to the exploitation of countries' **compara-**

tive advantages.

Further, the United States and most of the countries in the Americas as a group are net debtors while Germany and Japan are net creditors. The debtors cannot service their debts, and the creditors cannot be paid, unless the debtors have net current account surpluses. This requires net exports from the debtor countries to the creditors, not in a single year but on average over time. A movement toward trading blocs would make debt service more difficult.

The high cost for major countries of a system of trading blocs suggests that countries will be slow to move in that direction. A more likely alternative is continued growth of trade restrictions. This would erode the open trading system and reduce **opportunities** for more efficient production, specialization, and increases in standards of living.

Rules requiring more open, competitive trade contributed importantly to making the postwar experience significantly better than the interwar experience. These rules are no longer adequate, and they are poorly enforced or not enforced at all. Failure to develop and enforce new standards for open trade has eroded one of the main forces raising postwar living standards in the market economies. Unilateral action, including action by the United States in response to perceived and actual restrictions abroad, has further weakened the international system. Improvement of the trading system and more rapid expansion of world trade depend upon the development of enforceable rules, improved enforcement, and therefore, on the sacrifice of some national sovereignty.

### **Monetary stability**

The postwar years, particularly the 1970s, were years of widespread, persistent inflation. Although disinflation in the 1980s lowered the rate of inflation in the developed countries, inflation continued in most of these countries. High inflation became the norm in several developing countries, including Argentina, Brazil, Peru, and Yugoslavia, while countries such as Israel and Mexico restrained their high rates of inflation but did not achieve price stability.

Although the postwar record is far from the desirable goal of price stability, major countries have fared substantially better than they had in the interwar years. Market economies avoided both the 1920s' hyperinflations in Germany and Austria and the 1930s' severe deflation and unemployment.

In the early postwar years, low inflation in the market economies reflected the low inflation in the United States and the operation of the Bretton Woods system. The latter provided that members of this international system would maintain fixed exchange rates against the dollar, so their rates of inflation depended on U.S. inflation. U.S. inflation rose after the middle 1960s, until the Bretton Woods system ended in 1973. The Bretton Woods system transmitted the inflation to the rest of the world.

In the years since 1973, the major currencies—the dollar, deutsche mark and yen—have fluctuated against each other. Many countries have chosen to fix their exchange rates to one or more of the major currencies. The principal countries of Western Europe have adopted a system of fixed but adjustable rates—the Exchange Rate Mechanism of the European Monetary System. More recently, this European system has moved toward a system of fixed and unchanging parities, and controls on capital movements have been removed by all of the principal members as a first step toward introduction of a common currency. Other countries have tied their currencies to the dollar, the French franc, or to a basket of currencies.

Experience with inflation since 1973 permits no clear conclusion about inflation under fixed or fluctuating exchange rates. Several countries in Europe have lowered inflation by fixing their exchange rates to the German deutsche mark and, to avoid repeated devaluation, have brought their rates of inflation close to the German rate. But countries with fluctuating rates, such as Japan in the 1970s and the United States and the United Kingdom in the early 1980s, lowered their rates of inflation also.

Fluctuating exchange rates can reduce domestic costs of production and selling prices of exports during recessions without forcing steep reductions in money wage payments and other contractual



agreements. Evidence shows that during periods of disinflation unemployment has increased less on average in the principal fluctuating rate countries. Also, unemployment has declined more rapidly in countries with fluctuating exchange rates following periods of sustained disinflation. This evidence is consistent with the claim that costs of disinflation are lower under fluctuating exchange rates.

A common conjecture suggests that the world economy is moving toward three currency blocs. The conjecture gains some plausibility from the proposed development of a single currency for the European Monetary System by the end of the decade. The demand for the new currency, the ECU, if it comes into use, would lower the demand for other reserve currencies, principally deutsche marks and dollars. If the Europeans fail to agree on a common currency, the deutsche mark will be more widely held as a reserve currency and used as a unit of account.

At the end of the 1980s, the dollar remained the principal reserve currency; about 60 percent of official reserves were in dollars; the deutsche mark was second with 15 to 19 percent of official holdings. The yen was in third place, but the yen's percentage of official reserves never exceeded 8 percent.<sup>1</sup> Perhaps more relevant for the idea of currency blocs is the yen's share of the reserves held by principal Asian countries—20 to 30 percent. The Asian countries continued to hold most of their reserves in dollars.

If the years 1988 and 1989 are representative, based on data gathered by the Bank of England, one-third of all straight bond issues on the Euromarkets were denominated in U.S. dollars; more than ten other countries shared the remainder. For equity-related bonds, the dominance of the dollar as a unit of account was more striking; more than 70 percent of the issues were dollar denominated. The major competitors were not the deutsche mark and ECU but the Swiss franc and yen for straight debt and the Swiss franc for equity-related bonds.

Whether the dollar is displaced as the principal world currency will depend on relative rates of inflation, on trade patterns, and on the relative freedom of asset transactions in the United States and

other markets. If the United States continues as a principal trading partner for many countries in Asia, Latin America, Europe, and North America, the dollar will remain as a medium of exchange,<sup>2</sup> and dollar assets will continue to serve as reserves for these countries. If the United States achieves and maintains domestic price stability, dollar assets will remain a store of value for many foreigners and the dollar will remain a principal reserve currency, most likely *the* principal reserve currency, for many years into the future. Most commodity prices would continue to be denominated in dollars, and payments for these commodities would be made in dollars.

The monetary system now differs from the earlier postwar years. There are now viable alternatives to the dollar. A return to an inflationary policy that produces higher average inflation for the dollar than for other currencies would devalue the dollar, erode the position of the dollar as a reserve currency, and expand the use of less inflationary reserve currencies. Variable rates of inflation for the principal currencies would contribute to instability in currency markets, and possibly in economic activity, by inducing more frequent shifts in asset portfolios, interest rates, and exchange rates.

Price stability for principal currencies provides a public good for other reserve currency countries and for small countries. No country, acting alone, can achieve price and exchange rate stability. Small countries have a particular problem; they are too small to affect world prices. Their efforts to achieve domestic price stability in an inflationary world can be realized only, if at all, by allowing exchange rates to change enough to buffer price movements on world markets. This is costly for small countries that depend on world trade.

If each of the major developed economies maintains domestic price stability, this source of variability in fluctuating rates between the dollar, deutsche mark, and yen will be removed. Countries on fluctuating rates will achieve greater price and exchange rate stability. Smaller countries would be able to avoid inflation and deflation by fixing their exchange rates to the currency of one (or more) of the major developed countries. Their price levels would remain relatively stable, reflecting the price stability of the major

economies. Since their exchange rates are fixed, they would achieve both price and exchange rate stability.

### **In defense of the hegemon**

Criticism of the United States as "hegemon" of the postwar, market economies neglects the importance of rules and institutions that sustain stability and provide opportunities to increase standards of living in a peaceful (or more peaceful) world. I have argued that the postwar rise of living standards, in comparison with living standards in the interwar and other periods, owes much to the political, trade, and monetary stability achieved under U.S. leadership.

The rules for political, trade, and monetary stability were not ideal. Nor was the implementation ideal. There was much room for improvement. A clearer sense of political objectives and the cost and benefits of achieving them might have avoided the use of force in some cases or invoked greater use of force in others. The rules for trade and monetary stability were often circumvented, ignored, or sacrificed to other objectives.

Rules alone did not make economies grow and prosper. Falling transport and communication costs contributed to the growth of trade and living standards. New technologies increased opportunities for investment and growth. Improvements in education and particularly the spread of higher education in many parts of the world broadened horizons and increased opportunities. No doubt, other factors can be added. One must remember, however, that falling transport costs and new technologies did not produce comparable results in the interwar period or, in the postwar era, within the socialist countries operating under a different **hegemon** and very different rules.

What matters for current purposes is that the rules worked so well that the relative positions of the United States and other countries have changed markedly. The United States has become wealthier, but others have gained in relative wealth. The United States is now less willing to enforce rules for trade and political stability and less able to impose the rules of the trade and monetary system on others.

Fortunately, Japan and Germany have been more committed to monetary stability than has the United States. Unfortunately, they seem less committed to extending, strengthening, and enforcing rules for trade and political stability when such actions would impose costs on them.

Rules for trade, defense or police, and price stability are required, I believe, if living standards are to rise in the future at the rates of the past 40 (or even 20) years. Each will affect resource use and economic efficiency. All affect the distance people look ahead and their perceptions of opportunities that are worth undertaking.

The United States, as *hegemon*, provided a framework of rules that worked better than the rules of the interwar years. Enforcement has been beneficial, but it is also costly. The United States has shared the benefits more fully than it has shared the costs. This distribution of costs and benefits is not likely to continue. Indeed, it has begun to change.

A problem for the market economies is to maintain and enhance stability. This requires new or revised rules and a system for sharing costs and responsibilities more fully. Without new rules and new commitments to enforce them, the exceptional progress of the postwar years will not be sustained.

## Endnotes

<sup>1</sup>The three currencies have approximately the same shares of Euro-currency market deposits. See G. Tavlas, *On the International Use of Currencies: The Case of the Deutsche Mark*. Essays in International Finance 181. Princeton: March, 1991.

<sup>2</sup>Tavlas and Ozeki compared the currencies used for exports and imports of major countries in 1980 and 1987 or 1988. The use of the dollar for U.S. exports and imports and the deutsche mark for German exports is dominant. About half of Germany's imports are denominated in other currencies. The yen lags behind, used for less than 30 percent of Japanese exports and 14 percent of Japanese imports in 1989. See G. Tavlas and Yuzuru Ozeki, "The Japanese Yen as an International Currency," International Monetary Fund, January 1991, Table 13. Tavlas and Ozeki show that the yen denominated share of the debt of five principal Asian borrowers rose from 20 percent in 1980 to 38 percent in 1988, while the dollar share fell from 47 percent to 27 percent. The yen replaced the dollar in these transactions as Japan became a major creditor country and the United States became a major debtor.