

Discussion

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I agree so extensively with Freedman's sensible, middle-of-the-road conclusions — including his call for some well focused empirical research — that I find it difficult to comment directly on the paper. One of its appealing features is its emphasis on the continuing search for information in the emerging data and the suggestion that all of the information at hand should be used to ascertain the possible source of economic disturbances; it has the perspective of a policymaker in this regard. He also reaches the eminently reasonable, but puzzlingly controversial, conclusion that the monetary authorities should pay attention both to prices and to quantities and, at least in the short-run, should even target both entities.

Rather than comment on Freedman's paper in detail, I will offer several reflections induced by reading it. First, the conveners of the conference are to be congratulated for inviting a paper on Canada, or some foreign country, to a conference devoted predominately to the United States, with its **closed** economy orientation. Freedman's paper reminds us that doctrine that may or may not be suitable to the United States certainly is not suitable to other countries, which are more open and more dependent on the world economy. In particular, foreign shocks can have an impact through the exchange rate, and for this reason the authorities of other countries may want to dampen movements in exchange rates.

As a footnote on the history of thought, I note that the current emphasis on expectations is not entirely new and can be found at least 20 years ago in the literature on foreign exchange rates. The Canadian dollar floated freely against the U.S. dollar during the 1950s, but it never deviated far from a ratio of one to one. The most commonly accepted — although not necessarily correct — explanation for this

phenomenon was that expectations induced private speculation which kept the rate near to parity. Moreover, in a dissertation at Yale in the early 1960s, Robert Aliber studied floating exchange rates during the 1920s and found that a sudden switch in expectations regarding the future value of the French franc during 1923 — a switch that was induced by realization that Germany would not make the large reparations payments which the French had expected, a real phenomenon — had a profound influence on subsequent movements in the exchange rate of the French franc and, via those movements, on the French economy. Furthermore, although Belgium pursued a very different and less expansionist monetary policy than did France during the early 1920s, expectations based on prewar parity between the Belgian and French francs induced a steady decline in the Belgian franc in parallel with that of the French franc. The sharp decline in the Belgian franc represented a major external disturbance to the Belgian economy, and the decline in the franc became largely self-fulfilling. It would be useful to reexamine these episodes with modern tools and concepts.

A second reflection: if a small open economy should intervene in the exchange market to inhibit movement in its exchange rate in order to reduce the transmission of outside disturbances, why should it not go the whole way and simply fix the exchange rate, as Ireland did with respect to the British pound for many years? Freedman's answer would be that in that event it would import purely monetary disturbances emanating from abroad. And even when the disturbances abroad were real in nature, pegging the exchange rate would deflect money growth from its long-run steady growth path and would require subsequent correction. I do not find the second objection very compelling, especially the meaning of domestic monetary targets in a truly small open economy is entirely unclear. If international trade and financial transactions are high proportions of GNP and are heavily invoiced in foreign currency (the U.S. dollar), is it meaningful to focus on a conventional national demand for money function? This is ultimately an empirical question. But if it is appropriate, would it then be advisable to separate the Boston dollar from the New York dollar, and both from the Kansas City dollar, with a view to achieving superior stabilization of income, prices, and monetary growth within each Federal Reserve district? We shrink from addressing such wholly hypothetical questions. But if the argument applies to Canada, why does it not also apply to regions within the United States? I am convinced that we will not understand

fully monetary policy in open economies, where one money exchanges for another until we can give more satisfactory answers to such questions than we can at present.

My third reflection involves a question: can any change in foreign interest rates be regarded as exogenous by a small open economy, as Freedman implicitly suggests? If so, this represents a great simplification in the analysis of policies for such economies. Unfortunately, we cannot be confident that any change in interest rates is purely exogenous. The same factors that make an economy open in terms of goods and services and finance also open it in terms of technology and expectations and "animal spirits" of businessmen. If interest rates rise abroad, very likely the same factors will tend to raise interest rates in the small open economy, except in the singular case where the rise in interest rates was brought about solely by a change in policy abroad.

My fourth reflection concerns the applicability of Freedman's reasoning to the United States. Canada, after all, is not really a small economy on the world scale. It ranks seventh or eighth among countries. It is small only relative to its most important trading partner, the United States. The United States in turn is smaller than the rest of the world taken together. If it makes sense for a small open economy to respond partially to disturbances from abroad by acting directly on some price, the interest rate or the exchange rate, does not the same logic apply qualitatively to the United States? It too can import inflationary pressures via the exchange rate. The magnitudes may differ, but the underlying logic applies: the domestic effects of direct impulses from abroad can be dampened by directly offsetting actions. Of course, an economy as large as the United States must take into account the repercussions of its own actions on the rest of the world, and back again on itself—something that perhaps Canada can safely neglect. Thus, when the United States acts in response to developments abroad, it involves at least an **implicit** choice about the appropriate **world** economic policy, and this in turn raises the question of coordination of policies across national boundaries. But it seems to me that the underlying point remains. If Freedman's arguments apply correctly to Canada, as I believe they do, they also apply, appropriate changes being made, to the United States.

My fifth and **final** reflection is this: if U.S. actions are a source of disturbance to Canada and other **countries**, and disturbances—whether inflationary or contractionary in impulse—are undesirable,

should the United States modify its behavior in the interests of Canada and of other countries? Charles Kindleberger suggested many years ago that on the basis of economic structure Canada should become the 13th Federal Reserve district, with a seat on the Federal Open Market Committee, since the FOMC's actions have such a strong influence on Canada. The European Community these days perhaps should be added with the 14th seat. Short of that improbable development, should the United States itself try to take foreign considerations into account in framing its own policy?

Many people have an instinctive negative reaction to this kind of question. United States political instrumentalities exist to serve U.S. objectives, not those of the world as a whole. But it is not mere altruism that would guide U.S. policymakers to take into account developments abroad and our impact on them. When we engage in changes of policy; monetary or otherwise, we assume that the change takes place within a given economic and political structure. We have a sense about how far we can go without altering the structure fundamentally. Yet action within the limits of U.S. tolerance may be outside the limits of tolerance in other countries. Actions by the United States may alter their structure, even their political system. Three recent events come to mind as possible examples of this phenomenon. The latest fall of the Italian government, which came about over the economic austerity program forced in part by world economic conditions, may be just the nth in a long line of falls of Italian governments. But it may also be the one that brings the Communists into the government for the first time, which will mark a watershed both in economic policy and in military policy for the Italian government. Second, the attempted coup in Kenya failed; but if it had been successful that could have well altered greatly the strategic situation in Each Africa. That too was produced in part by economic adversity. Finally, the Argentine invasion of the Falkland Islands was a desperate move to divert public attention from economic adversity at home. Admittedly much of that adversity was self-generated; but economic circumstances would have been much easier — and the invasion possibly avoided — if world economic conditions had been more bouyant.

Already in this conference we have seen economists move extensively into psychology, recognizing the importance of "credibility" and "expectations" for the effectiveness of economic policy. By the same token, economists also must move into political science and take

into account the influence of policy actions on future and foreign economic and political structures. Suppose as social scientists operating within a full general equilibrium system — including economic and political responses abroad, not just responses of economic agents within the United States — we could forecast that one more year of the current U.S.-induced world recession would spell the demise of the liberal trading system for at least a decade. This is not an improbable event, since monetary policy now acts heavily by the exchange rate. Tight money appreciates the dollar as well as raising real interest rates. But domestic producers in export and import-competing industries do not perceive this as a new channel of monetary policy and hold the Federal Reserve responsible. Rather, they blame "unfair foreign competition" for their current difficulties and call, via the political process, for protection against such competition. Foreigners are more than ready to respond in kind. The liberal trading system may be the major casualty of the fight against inflation.

Or suppose that we could forecast that two more years of the current U.S.-induced world recession would so disturb our allies and friendly countries that our defense expenditures would rise by 1990 to 10 percent of GNP, well above the recent 5 percent or even President Reagan's preferred 7 percent, with corresponding supply-side effects on the U.S. economy. I would think that such external considerations as these should influence U.S. economic policy. Of course, we are in no position today to make such forecasts with any confidence. But that does not mean that such external considerations should be left wholly out of account. A well-integrated and well-coordinated economic policy must also take account of its impact on the rest of the world.