Eastern Economic Journal, Volume XI, Number 1, January - March 1985

THE INTERNATIONAL AGENDA

by

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The man whose memory we honor today was not primarily an international economist, but through his brainchild Data Resources Inc. Otto Eckstein did much to promote the application of international economics to the practical problems of business and governments. In a period when most large American firms had become multinational their requirements for economic projections and analyses were not confined to the domestic sphere. Moreover the demand of foreign firms for these services also grew rapidly. Almost from its beginnings DRI therefore developed considerable activities abroad, and it now has numerous foreign branches and affiliates. Not the least of these activities was the gradual establishment of enormous data banks covering virtually the entire world. Otto Eckstein was more than generous in giving scholars access to this invaluable resource, from which this paper has also benefited.

The financial success of DRI suggests that it had understood the needs of the time. It is nevertheless a sobering thought that the demand for the analyses provided by DRI and its competitors was probably stimulated by the difficult economic climate of the last 15 years. Technically speaking economic analysis may well be an inferior good, in the sense that its elasticity with respect to GNP is negative. The depressed 1930's were a golden age for economics. For many years thereafter the main business of economists was to elaborate and test the great insights gained during that decade. In the 1970's the economy was not nearly as bad as in the 1930's, but it was bad enough to call for a fundamental questioning of doctrines that until then had appeared unassailable. It is too early to say whether the accomplishments of the 1970's, particularly the theory of rational expectations, will have as revolutionary an impact as their counterparts of the 1930's.

My remarks today will deal with a more limited subject, namely the apparent causes of the unsatisfactory performance of the world economy in the 1970's and early 1980's. In particular I shall discuss the apparent consequences of the drastic change in the international monetary regime that occurred in 1973-73. Since this change from essentially fixed to essentially variable exchange rates was probably supported by a majority of the economics profession it also has a bearing on a related topic, the influence of economics on the conomy.

A few summary statistics on the economic performance of the world, three of its major divisions and fourteen important or representative countries (seven developed and seven developing) before and after the abandonment of the Bretton Woods system will serve to describe the problem. That system took effect in 1958, when the major currencies became convertible for current-account transactions, but it may have taken a year or two before it was fully implemented. The change to flexible rates started in

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May, 1971 with the floating of the German mark, became irreversible with the abandonment of dollar convertibility in August of that year, and reached completion in March, 1973. To get a cleaner comparison the transition years 1971 and 1972 have been ignored. The fixed-rate period is accordingly defined to include the years 1960-70, and the floating-rate period the years 1973-83. For some developing countries shorter periods had to be used because of data limitations.

The picture that emerges from Table 1 is clear: nearly everywhere growth was much lower, and inflation much higher, under floating rates. In everyone of the industrial countries listed the growth rate was reduced by at least one-half, the best (or least bad) performer being the U.S. which had a recovery towards the end of the period. The inflation rate increased in each of them, least so in Japan and Germany but to more than 2-1/2 times its previous average in the other five. There is more variation among the developing countries: India and Indonesia managed to improve their initially low growth rates, but the other five grew less. The average inflation rate was higher in the five countries for which meaningful data in the fixed-rate period could be calculated. An apparent exception was Indonesia, which overcame the hyperinflation of the 1960's, but in Brazil inflation appears to have been somewhat higher in the more recent period.

Table 1. Growth and Inflation
(Annual rates of change from first to last year)

Group (c) or Country	GROWTH(a)		INFLATION(b)	
	1960-70	1973-83	1960-70	1973-83
WORLD	4.9	2.5	4.4	12.4
INDUSTRIAL	4.4	2.2	3.6	8.4
U.S.	3.9	2.0	2.9	7.4
Canada	5.2	2.2	3.0	9.7
Japan	11.2	3.7	5.0	5.4
Germany	4.6	1.6	3.6	4.5
France	5.6	2.3	4.3	11.0
Italy	5.7	1.8	4.6	17.5
U.K.	2.8	1.1	4.2	13.9
OIL EXPORTERS	(e)	4.4(g)	(e)	17.8(g)
Indonesia	3.8	6.7	(e)	18.7
Nigeria	4.9	2.0(g)	3.8	17.2(g)
Venezuela	6.1	3.2(g)	1.2	12.9(g)
OTHER LDC'S	5.4	4.6	22.3	31.7
Brazil	8.1(d)	4.5	(e)	66.3
India	3.6(f)	3.9(g)	6.6(f)	7.9(g)
Korea	9.5	7.4	16.3	18.3
Mexico	7.0	4.7	3.8	31.9

Notes: (a) GDP at 1980 prices (except GNP for first four countries). (b) GDP deflator (except GNP deflator for first four countries). (c) As defined in the source; includes countries not listed. (d) 1963-70. (e) Not available. (f) 1960-69. (g) 1973-82. Source: Calculated from International Financial Statistics, 1984 Yearbook (International Monetary Fund, Washington, D.C., 1984), updated through December 1984 from DRI databank.

Table 2 shows that in all seven industrial countries mean unemployment rates rose substantially from the fixed-rate to the floating-rate period. Full employment, once considered the principal goal of economic policy and actually attained in the 1960's, is rarely mentioned these days. Even its latter-day substitute, the natural rate of unemployment, appears to be beyond reach in many countries.

Table 2. Unemployment
(Averages of annual rates. (a))

Country	1960-70	1973-83
U.S.	4.8	7.2
Canada	4.9	7.9
Japan	1.3	2.0
France	1.7	5.4(b)
Germany	0.7	3.6
Italy	2.8	3.8
U.K.	2.7	6.5(b)

Notes: (a) Adjusted by the Bureau of Labor Statistics to approximate the U.S. concept. (b) 1973-82. Source: Calculated from Table B-109 in the Economic Report of the President (Washington, D.C., 1984).

Taken at face value Tables 1 and 2 do not bear out the high expectations held by many economists concerning the benefits of floating exchange rates for the conduct of economic policy. The tables do not prove, however, that the poor record of the world economy during the floating-rate period should be attributed to floating rates. Other possible explanations must be briefly examined:

1. The growth rates of the 1950's and 1960's were exceptional by historical standards, particularly for the industrial countries, and bound to decline sooner or later. This point is supported by the work of Kuznets and others on long-term growth, but it does not explain the sharp rise in unemployment and inflation.

2. During the floating-rate period the oil shocks of 1973-74 and 1979-80 overwhelmed everything else, including the effects of exchange-rate flexibility. Although these shocks undoubtedly caused severe strains in the world economy, their quantitative significance should not be exaggerated. To begin with, the limitation of oil supplies by OPEC was hardly large enough to prevent continuing growth in other goods and services (except perhaps in the very short run) and the easing of the oil market after 1980 did not bring about a resumption of growth in most countries. Moreover the increases in oil prices were in part a symptom rather than a cause of underlying inflationary pressures, which had already become strong in the two years preceding the first oil shock. Finally, even at their peak in 1980 OPEC exports (which include some non-oil exports) accounted for only one-sixth of the total exports of IMF countries; the value of OPEC exports increased by $272 billion between 1972 and 1980, but the value of other exports rose by $1224 billion, nearly five times as much. It is therefore difficult to maintain that the oil shocks dominated the behavior of the world economy in the floating-rate period. Needless to say this does not mean that the upheavals in the world oil market were irrelevant from the global point of view; indeed they shed considerable light on the following two tables.

The exchange rate regime is especially relevant to merchandise trade, of which Table 3 provides an overview. It should be noted that in the source world imports do not equal world exports because some countries (notably the Soviet Union) are not included and also because of differences in valuation. For lack of a more accurate measure unit values have been used for deflation.

The most striking feature of Table 3 is that the growth in volume of world trade under floating rates was only one-tenth of what it had been under fixed rates. No doubt the OPEC countries, whose export volume declined in the recent period by as much as it had increased in the previous one, must bear much of the blame for this dsmal performance. As was just pointed out, however, the share of these countries is much smaller than that of the industrial countries, which continue to account for well over half of world trade. In the latter group the growth rate of exports and imports (by volume) fell 56% and 76% respectively. Under fixed rates the import volume of the industrial countries rose more than than twice as fast their GDP under floating rates it just kept pace with GDP.

Table 3. World Trade
(Annual rates of change from first to last year)

Group(a)	EXPORTS		IMPORTS	
	1960-70	1973-83	1960-70	1973-83
WORLD				
in $	9.3	12.0	9.3	12.3
unit value	1.4	11.2	1.0	9.2
volume	7.9	0.8	8.3	3.1
INDUSTRIAL				
in $	10.1	11.0	10.3	11.2
unit value	1.5	7.2	1.0	9.1
volume	8.7	3.9	9.3	2.2
OIL EXPORTERS				
in $	8.8	16.0	6.1	21.6
unit value	0.4	24.5	(b)	(b)
volume	8.4	-8.5	(b)	(b)
OTHER LDC'S				
in $	6.0	15.0 (c)	7.2(d)	15.5(d)
unit value	1.4	8.0(c)	1.0(d)	11.5(c)
volume	4.5	7.0(c)	6.2(d)	4.0(c)

Notes: (a) As defined in the source. (b) Not available. (c) 1973-82. (d) 1961-70.
Source: Same as for Table 1.

In these circumstances it is remarkable that the export volume of the non-oil developing countries rose at a significantly higher rate under flexible exchanges, contrary to what happened to their import volume. On the whole, however, Table 3 provides prima facie evidence that the supposed advantages of floating rates for the expansion of international trade did not materialize. Uncertainty about exchange rates may have had an adverse effect on international trade. The rise of protectionism in the U.S., fostered in part by the unimpeded rise in the dollar, may also have been a factor in recent years.

The principal argument against the Bretton Woods system (at least in the excessively rigid form that it had assumed in the 1960's) was the weakness of the adjustment process in the balance of payments.[1] Has there been an improvement under floating rates? That is the question addressed in Table 4, which deals with the current-account balance. That concept has traditionally been the criterion by which the adjustment process is evaluated. One may disagree with this approach, and in particular with the implication that a current-account balance of zero is somehow normal or desirable. It can be argued instead that slowly growing countries should have a surplus on current account and rapidly growing ones a deficit, thus permitting capital to flow where it is most needed. However this may be the current account attracts so much interest that even a preliminary comparison of exchange rate regimes must include an analysis.

Table 4. Current-account Balances as % of nominal GDP or GNP (a)

Country	1960-70		1973-83	
	Mean	Standard Deviation	Mean	Standard Deviation
INDUSTRIAL				
U.S.	0.5	0.3	-0.1	0.6
Canada	-1.7	1.4	-1.2	1.2
Japan	0.1	1.0	0.3	1.0
Germany	0.6	1.1	0.5	1.3
Italy	1.7	1.4	-0.9	2.4
U.K.	-0.1	0.9	0.0	1.8
OIL EXPORTERS				
Nigeria	-5.1	0.6	-0.3(b)	8.0(b)
Venezuela	1.7	2.7	2.4	9.4
OTHER LDC'S				
Brazil	-1.1	1.2	-4.5	1.3
India	-1.8	0.7	0.1(b)	1.3(b)
Korea	-3.0	3.1	-4.8	3.5
Mexico	-2.1	0.6	-3.1	2.3

Notes: (a) See note (a) to Table 1. (b) 1973-82. Source: Same as for Table 1.

It transpires from Table 4 that under floating rates the current-account balance was closer to zero in five of the six major industrial countries for which comparable figures are available. Judged by the conventional criterion just mentioned, the adjustment process has indeed benefited from exchange-rate flexibility. The standard deviations indicate that the current-account balances have also become more variable; thus the persistent surpluses and deficits that plagued the Bretton Woods system have

[1] A further argument was that, because of his weakness, countries tended to rely on direct controls -- on capital movements in the industrial group and more widely in the developing group. There has in face been some relaxation of controls after the breakdown of Bretton Woods.

tended to disappear. As might be expected, the two oil exporters improved their current accounts. So did India, but the other three non-oil LDC's experienced a significant deterioration. This raises the issue of third-world debt, to which I shall return.

Although the adoption of flexible rates appears to have had some success in its narrow objective of strengthening the adjustment process, this hardly makes up for the unfavorable course of growth, inflation and trade. A tentative explanation of the adverse effect of floating rates on world economic performance is offered in Table 5, which compares monetary and fiscal developments in the two periods. In the world as a whole, in each of the three groups, and in a large majority of the countries listed, monetary expansion was considerably higher under floating rates. The main exceptions were Japan and Germany, which also happened to have the lowest increases in inflation and the greatest reductions in real growth (see Table 1).

There cannot be much doubt that accomodating monetary policies were a necessary condition for the inflation that engulfed the world in the 1970's, and that such policies could not have been pursued while Bretton Woods was in force. Without further analysis, however, it is not clear whether these policies did anything to stimulate output and employment. As discussed above, it is conceivable that (a) potential growth in the industrial countries was lower in the 1970's and (b) the increases in the nominal price of imported oil had to be mitigated by increases in domestic prices. In any case it appears that the monetary accomodation was excessive and in the end became an obstacle rather than a help to real activity.

Table 5 also shows that in all the industrial countries, and in some of the non-oil LDC's, budget deficits were larger under floating rates. Indeed in most industrial countries the fiscal deficit, expressed as a ratio to GDP or GNP, was at least four times larger than under fixed rates. Since the deficits have not been adjusted for unemployment it is not possible to assess their effects on the performance of the economies concerned. Here again policy may have gone out of hand to an extent that would have been difficult or impossible under Bretton Woods.

On balance Table 5 suggests that most countries have not learned to make good use of the additional freedom in economic policy provided by flexible exchange rates. When the balance-of-payment constraint was removed they adopted expansionary monetary and fiscal policies that would previously have been considered imprudent, and whose rsults were disappointing at best. One cannot help but wonder how the 1970's and early 1980's would have looked if fixed rates had still been in effect.

The principal item on the international agenda is to improve the performance of macro-economic policy in the industrial nations. This means either to formulate monetary and fiscal rules that will work under floating rates, or to go back to fixed rates and to the polices that worked well enough under that constraint. Progress along either of these lines is not likely to come overnight. At present there are no policy rules appropriate to floating rates, and no agreement among economists on what they should be. A return to essentially fixed rates[3] would require a set of more or less realistic

[3]In the final years of the previous regime promising ideas were developed on how to improve the adjustment process by introducing greater (but limited) flexibility in exchange rates. If these ideas had been implemented a reformed Bretton Woods system could probably have been preserved.

Table 5. Monetary and Fiscal Indicators

Group (c) or Country	MONEY(a) 1960-70	MONEY(a) 1973-83	BUDGET SURPLUS (b) 1960-70	BUDGET SURPLUS (b) 1973-83
WORLD	7.6	13.4	(d)	(d)
INDUSTRIAL	6.2	8.7	(d)	(d)
U.S.	4.1	6.2	-0.7	-2.8
Canada	5.5	7.4	-1.0	-3.7
Japan	19.4	8.0	-0.9	-4.0(e)
Germany	7.7	6.9	-0.4	-2.0(f)
France	11.1	11.3	-0.9	-1.1
Italy	15.3	17.2	-3.0	-12.2
U.K.	3.5	11.0	-0.7	-4.5
OIL EXPORTERS	9.3	27.1	(d)	(d)
Nigeria	10.5	32.3	-4.0(g)	+0.8(h)
Venezuela	5.3	20.0	(d)	(d)
OTHER LDC'S	15.8	31.9	(d)	(d)
Brazil	38.2	55.8	-2.0	+0.1
India	9.3	14.9	-4.5	-5.3(f)
Korea	27.6	26.3	-0.5	-1.8)i)
Mexico	11.7	32.2	(d)	(d)

Notes: (a) Annual rate of change from first to last year; the year following a change in definition has been disregarded. (b) Average of ratios to nominal GDP (except nominal GNP for first four countries). (c) As defined in the source; includes countries not listed. (d) Not available. (e) 1973-79. (f) 1973-82. (g) 1965-70. (h) 1973-78. (i) 1973-81.
Source: Same as for Table 1.

initial parties and a sharp reduction in the U.S. budget deficit. However, if progress is to be made in the foreseeable future economists will have to devote more attention to these vital problems now. Otherwise the economic historians of the next century may well blame our profession for the adoption of an idea (namely floating rates) that turned out to have been inadequately considered.

Better economic policies in the developed countries will also go a long way towards solving the second item on the international agenda, the third-world debt. There is nothing wrong with moderate borrowing by developing countries, but it became a problem when the industrial and oil-exporting countries failed to maintain the current-account surpluses necessary to sustain such borrowing. The problem was aggravated when real interest rates rose from the abnormally low levels of the 1970's.

The basic reason for these low interest rates, it appears, was the initial inability of the OPEC nations to spend their suddenly large export receipts. When the OPEC surplus evaporated after a few years real interst rates inevitably rose. As was shown in Table 3, the non-oil LDC's did increase their exports, but not enough to cover the greatly

increased interest bills. Excessive reliance on short-term bank financing (as opposed to bonds and direct investment) put the third-world borrowers in a severe squeeze, which was in no way relieved by the highly inflationary policies followed by most of them. Although a temporary solution to the debt problem may be in sight, in the longer run it can only be overcome by an improvement in global economic performance. The developing countries are potentially the most dynamic element in the world economy; it would be most unfortunate if they had to curtail their growth because of merely financial difficulties.

The third item on the international agenda is the spread of protectionism, in which the U.S. is unfortunately the leader. The high value of the dollar permitted by the floating-rate regime has disrupted several of our industries. Instead of dealing with the underlying cause, the Administration and the Congress have responded to their complaints by introducing more and more trade restrictions, thus setting a bad example to other countries where protectionist pressures are also strong. Much of the progress of the last twenty years towards freer trade is in danger of being undone. A commitment to sounder macro-economic policies, and perhaps to less flexible exchange rates, is needed to re-establish a climate in which international trade can flourish again.

To sum up, the world economy is not in good shape and the economic policies of the leading countries are in disarray. There will no doubt be disagreement with my tentative conclusion that the adoption of floating rates is to blame. I hope that those who disagree will show how countries can improve their policies to make better use of the opportunities created by floating rates.