

rency Unit (ECU) an actual currency, issued against gold backing, to assume monetary functions left vacant by the dollar. A simpler possibility would involve a European banking consortium issuing securities in gold denomination at an extremely low interest rate. Under present circumstances the European banks could assume as many cheap liabilities as they wanted. This plan would depend on action by European central banks to stabilize the gold price within a certain range of fluctuation—but the Swiss monetary authorities deny Europe's intention to do this. At this point, any bank that failed to join in this procedure would immediately go bankrupt, and the world would be back on a sort of gold exchange standard. In either case, Europe's will and ability to turn Volcker's offensive back against him should not be underrated.

—David Goldman

## What is Volcker's policy

*On November 9, 1978, Paul Volcker delivered the Fred Hirsch Memorial Lecture at Warwick University in England where he outlined what in less than a year has become the Federal Reserve's monetary policy. Fred Hirsch, a New York Council on Foreign Relations economist, authored the Council's Project 1980 economic sections before his recent death. Volcker's speech, excerpted below, was published in the January 1979 issue of the London monthly The Banker.*

... I was tempted to take as my text today one of Fred Hirsch's last dicta: "A controlled disintegration in the world economy is a legitimate object for the 1980s. ..." The phrase captures what seems to me the prevailing attitudes and practices of most governments in this decade, as they struggle with two central issues that bedevil so much of our negotiations and our actions, not just with respect to money, but over the full range of international economics....

... Let us be aware of the difficulty of controlling disintegration, once fairly started....

I do not suggest that we stand on a knife's edge forced to choose between integration and autarchy. But I would much rather take as my rallying for necessary negotiations, as an ideal from which to measure progress, the challenge of "managing integration" rather than disintegration....

... The happy days of Bretton Woods, often viewed today with nostalgia, were a special case, workable

## The reaction in Europe

*French press reaction to the Federal Reserve hike of interest rates to 14.5 percent are exemplified by Le Figaro, which headlined: "The West threatened with a recession" in its Oct. 10 edition. The article, quoted below, warns of the possibility of an international interest rate "war."*

International financial circles were expecting, at the same time dreading, such a measure: it is the logical consequence of the plan of anti-inflation and defense of the dollar announced last Saturday by American monetary authorities. Like a spot of oil, it will further exacerbate the war of interest rates between industrialized countries. At the end of the road, a major risk for the United States and the Western countries: a recession. Already the experts don't hesitate in predicting bankruptcies. And not only among the "small."

... At first glance, one could interpret the new threshold crossed in the inexorable increase of American interest rates as the continuation of a movement begun months ago. But that would be to misjudge its real importance. It is in fact a new monetary policy in America. Or rather an attempt to implement a real monetarist policy....

In the short term, the effects on Europe will first concern interest rates. In a first stage, we can hope

because of a particular economic and political setting....

The system held together for a decade and more after the first signs of weakness, despite the resistance to more fundamental adjustment measures....

### 'Inherent contradictions'

But in the end, the inherent contradictions in the system were too great. With the benefit of hindsight, it would seem that an erosion of the United States competitive position was implicit in the postwar arrangements. First Europe and later—with even greater momentum—Japan brought its industrial capacity and efficiency close to United States standards. It took some 20 years, but eventually the United States payments position was irreparably undermined....

Finally in August 1971, the United States did move decisively to promote the adjustments that seemed

that the Germans will not react by increasing their own rates. They would want to avoid the accusation of feeding a world war of interest rates....

In France, on the other hand, the monetary authorities will undoubtedly not be able to allow the differential between interest rates on the other side of the Atlantic and our own to increase. ... If the German rates do not increase in the immediate period, we can hope to avoid a real escalaton. If they go up, the necessity of defending the Franc-Deutschmark parity will force French monetary authorities to again up the cost of renting money, with all the dangers that this would entail.

"But the most preoccupying consequences are more long term. If a serious recession occurred in America it would spare no one, and least of all the European countries. The danger is clear. But if we take seriously the threat of world inflation ... we must know that we can't bring it down without taking risks.

*From an interview with an official of the West German Bundesbank:*

Personally I think it's a step in the right direction. Inflation must be cut or there will be no dollar stability. The third world? Would it be any better for them if the inflation went on? We must have real interest rate levels above inflation. It's the relation that matters, nothing else. Look at the German example. When we had 8 percent inflation, we had to put up our interest rates above that, and it worked.

*From an interview with a West German banking official:*

We see Volcker as the man who is doing what the Germans have been telling the U.S. to do, though we doubt that the crunch will last—it being an election year. ... The new minimum reserve requirements will put U.S. banks at a competitive disadvantage and prevent U.S. banks from dealing out all those worthless dollars in the world. ... Making money scarce is the most effective way to cure inflation.

*From an interview with a Swiss banking official:*

We're very worried about the U.S. situation. Volcker took drastic steps, and he had to. Now we all have to fight together to support the U.S. currency authorities.

*Romero Kolbeck, head of the Mexican Central Bank, as reported in the Mexican press Oct. 10:*

It is not very encouraging that the advanced countries have decided to grow less next year, because as long as those countries do not transfer resources, at least seven percent of their gross national product, resources for the developing sector countries will be limited. (Kolbeck further explained that Mexico's foreign debt, which is denominated in European currencies and Japanese yen, has increased by 3 to 4 percent as a result of the fluctuations of the dollar. The Mexican peso is pegged to the dollar.)

necessary....

... We have had plain enough warning of the fact that international money, any more than domestic, will not manage itself. It will deliver neither the promised autonomy nor integration if we fail to deal with some of those issues that were unresolved in earlier efforts at more structured reform....

As Fred Hirsch emphasized some years ago, the transition toward a European system could pose difficult problems. I hope we will all be alert to dealing with the complications that the transitional period could present for international cooperation on a wider scale, to protecting the legitimate role of the IMF, and to the implications of decisions within Europe for the monetary system as a whole....

All of this raises questions of governance—if the system is to be managed, who will do it and how. The obvious institutional focus is the IMF, and it plainly

has a full plate of work ahead. I have long felt that, if that work was to proceed with full effectiveness, the effort of the international bureaucracy—however able—and it is very able—needs to be reinforced by more active regular participation by politically responsible officials of member governments. That is, of course, the rationale of the council authorized by the new articles. To a degree, the function has been performed on an interim basis by the advisory council. But it would seem to me useful, more than symbolically, for that body to assume now full legitimacy by transforming itself formally into the council, and renewing the sense of commitment to develop its surveillance function (along with) more or less continuous consultation among the "trilateral" countries: Japan, Europe, and the United States. And the consultation must extend to the highest level. The recent practice of "economic summitry" points that way.