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UNITED STATES LEADERSHIP AND POSTWAR PROGRESS

Allan H. Meltzer

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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PREFACE

We are pleased to publish *United States Leadership and Postwar Progress* as the forty-second in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

In this paper, Allan H. Meltzer compares worldwide prosperity and stability since 1945 with the record of the period between the world wars. He argues that the years since World War II have been far more successful, and credits this to a regime of rules and institutions established under the influence of the United States. Focusing on political, trade, and monetary affairs, Professor Meltzer examines the beneficial results of international adherence to a system of well-conceived practices and agreements.

Professor Meltzer warns, however, that recent years have seen this venerable framework become increasingly outmoded and ill enforced as the United States has lost the preeminent economic position it enjoyed in earlier years. As a result, he writes, countries have begun to turn aside from established institutions, and to seek new rules of international behavior, often without worldwide consensus on how this should be done. He examines these attempts, both actual and proposed, and compares them with the systems that have until recently served so well.

At a time when it is common for the creation of a "new world order" to be regarded with either unreasoning optimism or despairing skepticism, Professor Meltzer offers a reminder of the vital importance of a functional system of international rules. It will be important to design and adhere to a new, consistent system of rules that provides a framework for prosperity in a more interdependent world. Professor Meltzer's description of how the postwar institutions encouraged unprecedented prosperity and stability provides an example that today's policy makers would do well to emulate.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
April 1993

Allan H. Meltzer

United States Leadership and Postwar Progress

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 Latin America in the postwar years, with the result that nonmarket decision making under authoritarian governments became common.

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 global war. There have been recessions, but no major depression.

There has been remarkable progress in living standards in the democratic market economics, and in the spread of democratic government.

Looking back, we can see that in the postwar era more people in more countries have experienced larger increases in standard 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 that, adjusted for inflation, are three to four times the incomes received by their parents a generation earlier. Western Europe has turned away from false totalitarian promises to embrace the democratic, market system. It, too, enjoyed large increases in standards of living. 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 have 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 Brazil and Mexico, where the decade of the 1980s was burdened by debt and mistaken policies, postwar growth has raised standards of living markedly. In Brazil, for example, real growth of per capita income averaged more than 3½ 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 are 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 outcome 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 widespread rejection of socialist planning. Recognizing the difference in achievement, Communist parties that at times stood on the edge of power have now changed 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 has 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 that may affect the pace of economic development, such as history and culture. Taiwan, Hong Kong, and Singapore together can be compared with the People's Republic of China in the same way that West Germany can be compared with East Germany, or North Korea with 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. The average income of those who left the PRC for Hong Kong is now fifteen to twenty times the average for those who remained behind.

Yet market economies do not always prosper. Argentina and Bolivia are examples of countries that have not shared in the postwar prosperity. Many historical periods have produced poorer results than have the postwar years; the interwar period is an example cited earlier. These differences among 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, or to be curious about the relation between postwar policies and these developments.

The first task in examining this relation is to look at 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 decision 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 gross national product (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 peacekeeping institution was matched to a degree in the postwar era. Political divisions between the totalitarian and democratic countries prevented the United Nations from developing its authorized peacekeeping role. Generally the UN was a relatively ineffective organization. The major difference between prewar and postwar defense or political developments was the organization of defense outside the UN.

There are two important aspects of postwar defense arrangements. 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, not only 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 other places at various times. Even where the United Nations was the nominal organizer of 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.

Not all of these operations were planned or executed wisely or well. Nevertheless, such efforts and the continued relatively large expenditures for defense made the commitment to maintain political stability credible. The costs to the United States 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 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 gave the advantage in military strength and the projection of power to 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; U.S. President Reagan's resolve to rearm in the 1980s, which required in response a commitment of Soviet resources larger than the USSR was willing to squeeze out of its economy; and Soviet President Gorbachev's personality or personal objectives. What matters for present purposes is that the United States' defense spending and its 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 including the gradual extension of Soviet power and U.S. withdrawal that Kissinger feared in the 1970s, or the Euro-communism or "Finlandization" that were prominent concerns at that time.

A public good is defined as a good or service that provides benefits that are not all 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 (though 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 their means straitened and much of their arsenals destroyed. More generally, spending for arms by countries in the Middle East has lowered living standards in these and 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 fully successful. The region offers illustrations of some of the costs of political instability, just as Western Europe or the trading arrangements among East Asian countries provide examples of 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. In the postwar era, a small country—or even one of the larger European countries—could anticipate that U.S. decisions to defend Europe or spend for defense of the free world were independent of the amounts any single European country would spend for its own defense. 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 the United States to bear the main costs of maintaining political stability elsewhere. Some took advantage of these opportunities to take a free ride.

The total costs to be shared among the industrial democracies include much more than the expenditures to support troops in the field, as demonstrated by the demands imposed 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 utility for transfer. Some is secret and cannot be transferred. Without denying that there have been successful technology spin-offs, 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; 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 postwar political order was sustained by two factors: concerns about the intentions and actions of the Soviet Union and the willingness of the United States both to tolerate free riding and to bear a considerable part of the total cost of maintaining stability. Neither factor is any 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 will irritate their neighbors; bigger tyrants will threaten the entire system. Without agreement on collective action, either the system based on freedom and political stability will be weakened or countries will have to bear the enforcement costs individually.

Part of these costs can be avoided by everyone if there is an agreement to share the 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 burden sharing—redistribution of the costs. The decision to shift part of the decision making about Iraq and Kuwait to the UN may have helped to get some of the costs of that operation to be more widely shared. If others bear more of the costs, however, they will want more influence over the decisions. The UN Security Council could agree about Kuwait and Iraq, but the UN is not usually noted for its ability to take decisions quickly or agree about ends and means of settling disputes. Other multinational bodies (the European Commission is an example) would face similar problems of agreeing on political objectives.

Failure of the democratic countries to agree on the ends to be pursued and the means to accomplish them risk the loss of the political stability and economic progress. Yet some nation or group of nations must decide which disputes are threats to international stability and which have costs that should be borne mainly by the parties to the dispute. The former require collective action to enforce stability; the latter do not. Someone must also decide 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% in 1920 to 59% 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 barriers, particularly among developed countries. The embodiment of these rules 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 (1973–1979) had been made, the United States, the European Community, and Japan had reduced tariffs on industrial products to less than 5 percent, on average. Although postwar tariffs have declined substantially, the 5 percent number is not fully informative. There are four reasons.

First, there is considerable dispersion of tariffs for specific 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 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 also used 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, is not subject to GATT rules but is instead covered by much weaker agreements.

Fourth, many developing countries, though members of GATT, are not subject to the same rules as developed countries. The Generalized System of Preferences 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 and encouraging inefficiency in the developing countries.

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, 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 export surpluses, and increase their populations' 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 in and 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 has been 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 member 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 who also try to benefit by preventing the same rules of open access from applying to their potential suppliers. Quotas, subsidies, and many nontariff barriers must be seen as attempts to gain special advantage—to take a 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 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, discriminate against nonmembers, raise prices to consumers and, until they break down, reduce innovation and growth.

A second response has been the use of unilateral action by individual countries and groups and of 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. Such negotiation typically requires one country to incur short-term, visible costs to receive some less visible long-term benefits. Negotiations to get foreign beef, cigarettes, or other products into Japan are examples. In each case there are long-term benefits to consumers from lower prices, but short-term costs to producers.

The third response is multilateral negotiation, which permits all parties to achieve some visible short-term gains to offset losses. The Kennedy and Tokyo rounds and other GATT negotiations 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 for the Uruguay Round will be adopted. Even if agreement is reached, the resulting increase in efficiency and standards of living is likely to be small. Furthermore, 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 each bloc, under enforced rules, but restricts trade with countries outside the bloc. Reduction of trade barriers within the European Community (EC) and approval of a U.S.-Canada agreement 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 them.

To see what this implies, I have grouped countries into hypothetical constructions of these three blocs. The assignments are somewhat 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, however, that changes in the composition of these blocs would not alter my main conclusions about the undesirability of trading blocs as an alternative to more open trading arrangements.

The conjectures do not clearly define membership in the blocs. The European Community is well defined at present, but could expand to include countries now in the European Free Trade Association (EFTA) or in Central and Eastern Europe. I have chosen, however, to include only the twelve current EC members in the EC bloc. 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 easy to envisage.

The membership I used for 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

Altogether, these countries were parties to about two-thirds of the world's trade in the four years 1986–1989.

Table 1 shows average annual trade data for the years 1986–1989, inclusive. The numbers in the table represent half the annual value of the sum of exports plus imports within and between the hypothetical blocs.

TABLE 1 Annual Volume of Trade within and between Conjectured Trading Blocs, 1986–1989 (in billions of U.S. dollars)

	Americas	Asia	EC
Americas	108	144	102
Asia	144	78	70
EC	102	70	289

The table shows that members of two of the three regional blocs conducted more trade outside than among themselves. The exception was the EC, which averaged $289 billion-worth of trade among its members annually, far more than the EC's trade with the other blocs combined. Intra-Asian trade increased markedly during 1986–1989, partly as a result of slow growth in the Americas and partly as a result of substantial Japanese investment in other Asian countries. As the table shows, however, Asia and the Americas were each other's largest trading partners; Asian trade with the Americas was almost twice the volume of intra-Asian trade.

These data suggest the importance of open trade among regional blocs. For the United States or Japan, a bloc within Asia or the Americas would be an inferior substitute for open trade. Detailed statistics from 1986–1989 reinforce the conclusion drawn from the aggregates: Canada-U.S. trade was more than $70 billion of the $108 billion annual average for intra-American trade; Japan-U.S. trade averaged $63 billion, 80 percent of total annual intra-Asian trade and 125 percent of Japan's trade with its Asian partners. It would not be in the interest of either Japan or the United States to develop trade within a regional bloc as a substitute for open, international trade. Even for the EC, trade with the Americas—particularly the United States—was 7 to 8 percent of total trade and nearly 20 percent of trade outside the EC in 1986–1989. A significant reduction in open 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, and hence the composition of output, would be altered.

Western Europe and Japan buy from and sell to the United States a different mix of goods and services than does Latin America. Moreover, Latin America cannot supply consumer durables and autos to the United States 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 Asian 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' comparative advantage.

Further, the United States and the principal countries in the Americas are, taken together, 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 projected cost to 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 also 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 factors raising postwar living standards in the market economies. Unilateral action, including action by the United States in response to perceived and actual trade 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. Both the Canada-U.S. agreement and the EC treaty recognize the need for a supranational authority to settle disputes.

Monetary Stability

The postwar years, particularly the 1970s, were years of widespread, persistent inflation. Although disinflation in the 1980s lowered inflation in the developed countries, inflation nevertheless continued in most of these countries. High inflation became the norm in many developing countries, including Argentina, Brazil, Peru, and Yugoslavia, while countries such as Israel and Mexico restrained their high rates of inflation but failed to achieve price stability.

Although the postwar record did not reach the desirable goal of price stability, major countries have fared substantially better than they did in the interwar years. Market economies avoided both the 1920s' hyperinflation in Germany and Austria and the 1930s' severe deflation and unemployment around the world.

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. Member countries agreed to maintain fixed exchange rates against the dollar, so their rates of inflation depended on U.S. inflation. When U.S. inflation rose after the middle-1960s, and until the Bretton Woods system ended in 1973, the system transmitted U.S. inflation to the rest of the world.

In the years since 1973, the major currencies—the dollar, mark, and yen—have fluctuated in value against each other. Many countries have chosen to tie 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 member countries as a first step toward introduction of a common currency. Other countries have tied their currency 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 mark and, to avoid repeated devaluation, have brought their rates of inflation close to the German rate. Countries with fluctuating rates, such as Japan in the 1970s and the United States and the United Kingdom in the early 1980s, also succeeded in lowering their rates of inflation.

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, following periods of sustained disinflation, unemployment has declined more rapidly in countries with fluctuating exchange rages. 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, similar to the trading blocs. The conjecture gains some plausibility from the proposed development of a single currency for the European Monetary System by the end of the 1990s. The demand for the new currency, if it comes into use, would lower the demand for other reserve currencies, principally marks and dollars. If the Europeans fail to agree on a common currency, the 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 the world's official reserves were in dollars; the 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. Perhaps more relevant for the idea of a currency bloc is the yen's share of the reserves held by principal Asian countries—20 to 30 percent. The Asian countries, however, continued to hold most of their reserves in dollars.

In the years 1988 and 1989, 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 currencies shared the remainder. The dominance of the dollar as a unit of account for equity-related bonds was more striking; more than 70 percent of the issues were dollar-denominated. The major competitors were not the mark and European Currency Unit, 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. As long as the United States continues as a principal trading partner for many countries in Asia, Latin America, Europe, and North America, the dollar will remain a medium of exchange, 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. 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 that of early 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 its position 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; their actions do not affect world prices. They can achieve domestic price stability in an inflationary world 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, a source of variability in fluctuating rates among the dollar, mark, and yen would be removed. These countries, with fluctuating rates, would 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. Price levels in these smaller countries would remain relatively stable, reflecting the price stability of the major economies. Since their exchange rates would now be 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 the rules and institutions that sustain stability and provide opportunities to increase standards of living in a peaceful (or relatively more peaceful) world. I have argued that the postwar rise of living standards, compared with living standards in the interwar and other periods, owes much to the political, trade, and monetary stability achieved under U.S. leadership.

The postwar rules for political, trade, and monetary stability were not ideal. Nor was the implementation ideal. 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.

The 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 similarly falling transport costs and earlier 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, less able to impose the rules of the trade and monetary system on others, and less willing to follow the rules. 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, political, and monetary stability are required, I believe, if living standards are to rise in the future at the rates of the past forty (or even twenty) years. Each will affect resource use and economic efficiency. All affect the distance that people are able to 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. Doing so 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.

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