

## U.S. MONETARY POLICY IN AN INTEGRATING WORLD: DISCUSSION

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Frank Morris was a good friend, a fellow-navigator in World War II, a fine economist, and a first-rate central banker. I am pleased to participate in this conference honoring him.

First, this interesting and intensively researched paper by Richard Cooper and Jane Little is really mistitled. It goes far beyond the influence of foreign events and institutions on U.S. monetary policy. It deals with the effects of the rest of the world on the entire financial system of the United States. To cite just one example, the repeal of Glass-Steagall was, as the authors note, the result of competition from foreign banks and a more liberal regulatory environment in other countries. Whether the repeal will affect the conduct of monetary policy is not a question that the authors address.

Second, the Federal Reserve's shift away from targeting monetary aggregates to the federal funds rate is attributed by the authors to those same innovations and regulatory changes that were driven by events and institutions abroad. No doubt those influences existed. It would stretch history a bit to attribute the shift away from monetary aggregates completely to external influences, and I do not think that the authors hold that view. I believe that the evolution of the domestic financial system, even in the absence of foreign institutions, would have led to greater instability in the demand for money in its various forms and would have induced the Federal Reserve to abandon those aggregates as intermediate targets for monetary policy.

A third point: On the topic implied by the title of the paper, the authors provide a very useful historical record. Events abroad going back

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many years have had an impact on aggregate demand or prices or both in the United States and have, in consequence, influenced the decisions of the Federal Open Market Committee and the Board of Governors. We are usefully reminded that once there was an Operation Twist, and an actively used swap network, and even capital controls, voluntary or otherwise. Once we got beyond those devices, important external influences on monetary policy remained: Oil shocks, recessions abroad, and international financial crises have all had their influence on Federal Reserve policy. The sizable movements in dollar exchange rates, especially in the 1980s, were to a large extent a product of domestic developments rather than influences from abroad: the Reagan fiscal policy and the Volcker monetary policy.

Fourth, concerning “the legal authority and responsibility” for intervention in foreign exchange markets, the authors state that it “has never been clearly delineated.” According to I.M. Destler and C. Randall Henning, “The legal right of both the Fed and the Treasury to buy and sell foreign currencies is undisputed.”<sup>1</sup> But, they go on to write, “The Treasury has nonetheless maintained its legal right to block Fed intervention on the grounds that the Secretary is the chief financial officer of the U.S. government, the U.S. representative to international financial organizations such as the International Monetary Fund and the World Bank, and the chairman of the National Advisory Council, and on the basis of the President’s constitutional role in foreign policy.”

The Federal Reserve has never tested this legal argument. I well remember a period in the early 1970s when we at the Fed Board wanted to intervene, but Treasury Secretary Schultz would not give his OK.

Fifth, the authors ask us to face the problem of exchange rate movements that run counter to the aims of monetary policy, given that the United States is increasingly exposed to external events and to changes in portfolio preferences around the world. This leads to two proposals—labeled “thoughts”—in the paper. One is that the Fed should consider undertaking open market operations in selected foreign securities, especially those denominated in euros. Second, the Fed should consider switching its focus from the CPI to the finished goods PPI, including a core PPI. The PPI would be a nominal anchor for monetary policy. One can question whether the Federal Reserve should completely ignore what happens to the prices of services. In any event, I presume that the authors are not proposing that the Federal Reserve focus exclusively on the price anchor rather than also on movements in output and employment.

As to open market operations in foreign securities, what Cooper and

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<sup>1</sup> I.M. Destler and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States*, Institute for International Economics, 1989, p. 86.

Little have in mind is that, given the mobility of capital, a shift of funds out of dollars could lead to depreciation and rising prices. That would bring on a tightening of monetary policy that was inimical to the real economy and would also lead to a reversal of the downward movement of the dollar.

In those conditions, open market purchases of foreign securities would tend to offset the upward pressure on the dollar's exchange rates. The question that deserves investigation is as follows: How would such open market purchases of foreign securities affect the domestic economy?

A sixth point: In their conclusion, the authors observe that in earlier years when the U.S. economy was less open, "international work" was handled by one Federal Reserve governor with occasional attention from the Chairman. That was generally true, but I cannot resist pointing out that William McChesney Martin was an exception. Even in the 1960s he always maintained a strong interest in international developments and kept his hand in.

Let me say that Dick Cooper and Jane Little have provided us with an excellent paper. I hope that its proposal for open market operations in foreign securities will be studied and pursued.

We live in an increasingly open economy in a globalizing world. It is reasonable to assume that external influences will become more and more important in the deliberations of Federal Reserve policymakers.