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Introduction

William H. Branson, Jacob A. Frenkel, and
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Since the finance ministers and central bank governors of the five largest industrial democracies concluded the Plaza Agreement in New York in September 1985, the theory and practice of international economic policy coordination has become the subject of spirited academic and public policy debate. To some, policy coordination represents a watershed in the way that countries manage increased economic interdependence, and a foundation upon which an improved international monetary system can be constructed. To others, policy coordination constitutes merely a minor extension of the more long-standing process of international economic policy cooperation, and one that carries risks of delaying or otherwise weakening the implementation of macroeconomic and structural policies.

The papers and comments collected in this volume attempt from different vantage points and perspectives to understand: what international policy coordination means today and has meant in the past; under what conditions and circumstances coordination is likely to be beneficial—both to the direct participants and to the rest of the world; what factors most influence the quantitative impact or “effects” of coordination; what obstacles and constraints are most relevant for the exercise of coordination in the current and prospective global economic environment; what methods of coordination are apt to be most or least effective; and, based on the experience of the European Monetary System and of earlier regimes, in what directions the coordination process

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might move in the future, including those associated with greater fixity of exchange rates.

A somewhat more specific guide to the volume's contents can be obtained from a snapshot of the key issues that emerged from the papers and the discussion.

(1) *What does policy coordination mean and what conditions its effects?* As the conference proceeded, it became apparent that coordination meant different things to different participants. In addition, even on identical definitions, there remained a divergence of views on the effects of coordination.

One relevant distinction is between less and more ambitious forms of interaction among policy authorities. The former—which some participants preferred to label “cooperation” rather than “coordination”—encompasses adoption of a common data base and the exchange of information regarding recent developments and policy intentions. William Branson introduced and advocated the use of this distinction. There was a consensus that policy cooperation was beneficial. Douglas Purvis, for example, argued that cooperation was essential when a country changed its medium-term objectives and initiated a dramatic change in policies, and when there was an international crisis, financial or otherwise. Policy coordination was interpreted as going further, to include agreements among countries to adjust policies in light of shared objectives and/or to implement joint policy action. It suffices to say that the potential benefits and costs of this more ambitious interaction were subject to diverse appraisal.

The nature of the theoretical case for policy coordination—as a means of internalizing the externalities associated with international spillovers of national policy decisions—was not at the center of debate. Instead, it was the *practice* of policy coordination that garnered the most attention. One issue was whether a perceived need to coordinate increased or decreased pressures on governments to do the right thing. Supporters of coordination maintained that it was hard to see how peer pressure directed at the dangers of the large U.S. budget deficit could have been anything but helpful over the past few years, and similarly helpful with respect to coordination's contribution to motivating structural reform in Europe and Japan. Those who felt that the public emphasis on coordination could be counterproductive, such as Martin Feldstein, stressed that it could provide a political excuse for inaction by shifting the blame for poor domestic policy performance to other countries. In a similar vein, some participants argued that coordinated firefighting could itself postpone policy action. Stanley Fischer offered the view that by supporting the dollar in 1987, concerted foreign-exchange market intervention probably prevented a precipitous fall in the dollar, which might in turn have forced earlier corrective action on the U.S. fiscal deficit.

A number of participants pointed to the limited size of cross-country policy multipliers as suggesting that both the gains from policy coordination and the incentive to coordinate seriously—especially for a relatively closed economy

like the United States—would be “small.” Others, however, thought this took too narrow an interpretation of the scope and effects of coordination. Fred Bergsten argued that it would be misleading to gauge the effects of, for example, the Plaza Agreement without taking into account the protectionist counterfactual; without Plaza, we could well have gotten a far more protectionist U.S. trade bill than actually ensued. William Branson conjectured that economists adopted a narrow scope for coordination in order to reduce the problem to a size that was manageable with available tools (usually, game theory)—but at a cost of allowing much of the substance to vanish.

Uncertainty about how the world works was yet another factor that gave rise to different views on the feasibility and desirability of coordination. Jeffrey Frankel argued that model uncertainty made it difficult for countries to know which policy changes to ask for and to agree to make. Moreover, because results might turn out to be different from those expected, such uncertainty could lead coordination to reduce welfare rather than increase it. Ralph Bryant felt that one should not exaggerate the degree of our ignorance about the consequences of policy actions. He noted that there was no significant empirical ambiguity about the sign of the spillover effects of fiscal policy actions for the major industrial countries, and that the magnitude of monetary policy spillover effects—whatever the sign—was generally acknowledged to be quite small.

(2) *How frequent and how wide should coordination be?* Some participants put forward the case that coordination would be most effective when it was a regular, ongoing process, which some participants labelled cooperation. Jacob Frenkel, Morris Goldstein, and Paul Masson claimed that multiperiod bargaining improved the incentive to fulfill earlier commitments (i.e., increased the role of “reputation” in policy agreements) and expanded the opportunities for policy bargains. Peter Kenen took a different view. He interpreted the postwar experience as suggesting that true coordination was likely only in those unusual cases where there was a clearly perceived need for regime-preserving action. Because the supply of the true coordination was limited, he also preferred coordination via rules or accepted codes-of-conduct (as under the Bretton Woods regime) since these mechanisms required less discretionary coordination. Stanley Fischer found the distinction between policy-optimizing and regime-preserving coordination suggestive but elusive; he queried what regime was being preserved through current efforts at coordination.

Turning to the width or scope of coordination, most participants saw two conflicting considerations at work. On the one hand, improved policy performance might require action on fiscal, structural, and regulatory policies, as well as on monetary and exchange rate policies. On the other hand, negotiation costs across increasing spheres of jurisdiction can rise rapidly with the number of issues under consideration. John Flemming ventured the opinion that the Cooke Committee was successful in getting an agreement on common capital-adequacy standards for commercial banks because its purview was limited and because the preparation was done by specialists. In his view, prospects for

success would have been less favorable if coordination on such financial policy or regulatory issues were handled in a more wide-ranging forum.

(3) *Is it better to coordinate around a single indicator rather than around many?* Jeffrey Frankel argued that the G-7 coordination exercise was flawed. If each country had many indicators to follow but only a few policy instruments, the indicators would almost surely send conflicting signals. National authorities would therefore feel no constraint on their setting of policy instruments. A single indicator would in his view avoid this problem. Among those indicators that provided a nominal anchor, his own choice was for internationally coordinated, nominal-domestic-demand targets (to be pursued by monetary policy). A number of participants took exception to this single-indicator strategy. Ralph Bryant found no convincing need for authorities to focus on a single intermediate variable. He maintained that multiple ultimate targets, the use of a variety of intermediate variables as indicators, and a direct emphasis on the actual instruments of policy did not pose difficult analytical problems. In addition, he felt a nominal-income-targeting strategy paid insufficient attention to coordination between monetary and fiscal policies within a country. Jacob Frenkel, Morris Goldstein, and Paul Masson noted that so long as policy authorities had multiple targets and weighed them differently than their peers do, a multiple-indicator system was probably the only politically feasible one. They also expressed strong reservations about organizing coordination around exchange rate indicators alone. For one thing, exchange rate indicators could send false signals for monetary policy when badly behaved fiscal policies put pressure on exchange rates. Douglas Purvis was prepared to give the G-7 multiple-indicator exercise passing grades if it was seen not as fine-tuning a series of policy targets but rather as putting some structure on the cooperative process of consultation and information exchange.

(4) *Is greater management of exchange rates desirable and, if so, what considerations should guide the identification of equilibrium exchange rates?* A host of questions clustered around this broad issue.

One question was whether greater fixity of exchange rates provided superior insulation against a variety of shocks. This was taken up in three of the conference papers—albeit with alternative underlying theoretical frameworks and, as it turned out, with different findings. Using the IMF's MULTIMOD model (with forward-looking expectations), Jacob Frenkel, Morris Goldstein, and Paul Masson found that policy regimes which performed better in the face of certain kinds of shocks fared worse for others, with no single (exchange rate) regime dominating. A conclusion of Jeffrey Frankel's analysis of shocks was that one has to place a high weight on exchange rate stability itself to demonstrate that a rigid exchange rate rule for monetary policy dominates a rigid nominal GNP rule. Finally, employing a portfolio-balance-type model, Peter Kenen reported that fixed exchange rates are to be preferred to floating rates for a majority of shocks.

A second question is whether the costs of exchange rate misalignment are avoidable and undesirable. Some participants, such as Paul Krugman and Fred Bergsten, thought they were and that authorities should therefore induce nominal rates to move in the direction of the long-run, equilibrium real exchange rate. Some other participants, however, maintained a skeptical view of a more activist role for exchange rate management. Michael Mussa, in particular, argued that it may sometimes be necessary or desirable to countenance exchange rate misalignment in order to allow economic policy to pursue objectives more important than the rapid achievement of current account equilibrium. His case in point was the 1981–85 real appreciation of the dollar. He saw the real appreciation during 1980–82 as an inevitable consequence of tighter U.S. monetary policy which was needed to bring down the U.S. inflation rate. Moreover, the further appreciation during 1983–84 helped, *inter alia*, to contain inflationary pressures that would otherwise have accompanied the strong recovery of the U.S. economy from the 1981–1982 recession.

The ability of economists to identify the equilibrium real exchange rate also elicited considerable discussion. Those who argued that official estimates of equilibrium rates would be subject to substantial margins of error stressed the difficulty of defining a sustainable current account position as well as the daunting general equilibrium nature of the exercise. The other camp pointed to the successful operation of the European Monetary System and to the larger misalignments that might occur in irrational and unmanaged foreign-exchange markets. After appraising all the evidence on where the dollar needed to go to reach equilibrium, Paul Krugman concluded with a definite “don’t know.”

Yet another related question was whether equilibrium real exchange rates would be subject to sizable secular trends because of persistent intercountry differences in income elasticities for exports and imports. For example, did the oft-observed higher ratio of export-to-import income elasticity for Japan, relative to the United States, imply a steadily depreciating dollar for equilibrium? Paul Krugman’s answer was no—because there was a systematic offset in growth rates: Japan, on average, grows faster than the United States. What counted was the *product* of income elasticities and growth rates—and this product had been relatively stable over time. Moreover, Krugman argued that this stability was consistent with a specialization among industrial countries that reflected increasing returns rather than comparative advantage. Many participants felt that the determinants of the paths of long-run equilibrium real exchange rates was a fruitful area for further study.

The ramifications of uncertainty associated with highly variable floating exchange rates also entered the discussion of exchange rate management. Richard Cooper offered the view that any exchange rate system under which firm profitability was influenced much more by exchange swings than by longer-run cost considerations would prove unacceptable to business interests and would eventually be replaced. The surest way to reduce exchange rate

uncertainty was to reduce the number of exchange rates in the world. Larger common currency areas would of course require a high degree of monetary policy coordination within each area. Yet if different regional interests could be accommodated within the Federal Reserve's Open Market Committee, why could they not also in, say, a European central bank? Among the questions raised by participants who were not convinced by Cooper's scenario was how real economic shocks would be handled once the nominal exchange rate was no longer a policy instrument; would labor mobility, or the tax and transfer system, or capital mobility take on an expanded role?

(5) *Has recent experience with (sterilized) foreign-exchange market intervention altered earlier views about its effectiveness?* Most participants seemed to be in general agreement with the main conclusions of Maurice Obstfeld's examination of experience with intervention over the 1985–87 period. He found that: monetary and fiscal actions—not sterilized intervention—had been the dominant determinant of broad exchange rate movements; the scale of intervention had been too small to have significant portfolio effects; the “signalling effect” of intervention had been effective only when backed up by action on policy fundamentals; and the most effective intervention operations had been “concerted” ones. John Flemming was uncomfortable with the notion that bonds in different currencies were perfect substitutes since it would imply that portfolios would typically be undiversified. Shuntaro Namba cited econometric work at the Bank of Japan which suggested that sterilized intervention could affect risk premiums but also that these effects had weakened recently. Hans Genberg was skeptical about the quantitative significance of central banks putting their money where their mouths were and put forward the view that intervention operations may merely serve as a “placebo” for public opinion. Martin Feldstein doubted that either concerted intervention or the policy coordination process more generally had contributed much to the 1985–87 fall of the dollar.

(6) *Can the European Monetary System (EMS) be exported?* A short answer—to judge from the study by Francesco Giavazzi and Alberto Giovannini—is no. They argued that the incentives which countries have to belong to the EMS (and to its exchange rate mechanism)—namely, the high degree of trade interdependence and the more comprehensive design of regional integration of which the EMS is just an element—are not present among the United States, Europe, and Japan. In addition, they see the operation of the EMS as an (imperfect) greater deutsche mark area, where the Federal Republic of Germany practices (near) monetary policy independence. The institution of fixed (but adjustable) exchange rates per se cannot in their view induce international monetary cooperation. While endorsing their main conclusions, Wolfgang Rieke pointed out that the Bundesbank's policy independence can be limited by external imbalances; in fact, he conjectured that the potential inflationary consequences for surplus countries may be more than the corresponding constraining effects on deficit countries arising from reserve losses

through intervention. He also reiterated the view that common decision-making in the area of monetary policy (à la European central bank) would cause unease unless price stability was fully accepted as a priority objective. Richard Marston acknowledged the role that trade interdependence can play in motivating measures to reduce exchange rate variability but emphasized that it was only part of the story. Canada, for example, has over 80 percent of its trade with the United States but has allowed its exchange rate vis-à-vis the United States to vary substantially—probably in order to insulate itself from disturbances originating in its main trading partner.

(7) *Do we need greater international coordination of financial policy?* Here, financial policy refers to policies governing international and domestic transactions, markets, and institutions, including the taxation of transactions or the returns to capital. The case for more coordination was laid out by David Folkerts-Landau. He argued that the ongoing, largely uncoordinated restructuring of financial markets can be unstable because of perverse incentives for risk taking by financial institutions. At the same time that private market participants were exploiting the greater opportunities for arbitraging regulatory and fiscal differences across domestic and international jurisdictions, financial authorities did not reduce—in fact, they significantly extended—implicit and explicit liquidity and solvency guarantees to these participants. Francesco Papadia notes that the implicit “competition in laxity by supervisory authorities” is a particular risk for Europe of 1990. Folkerts-Landau concludes that, if globalization and liberalization of financial markets is not to produce suboptimal prudential regulation, or suboptimal allocation and pricing of risk, greater coordination of financial policy is required. Many participants found this line of argument appealing but nevertheless harbored some reservations. Papadia argued that coordination would be clearly welfare improving only if the regulation were due to market failure. Others were concerned about the feasibility of implementing such coordination on a universal basis when there was always an incentive for one location not to impose the regulation in order to capture a larger share of the world’s business. A third concern was how to ensure that efforts at eliminating “over-insurance” for financial institutions did not tie the hands of authorities in coordinating their response to an incipient financial crisis.

(8) *Does the existence of large multinational corporations (MNCs) affect the behavior of exchange rates and capital flows?* Kenneth Froot approached this question by looking both at the financial innovations used by MNCs and at their investment decisions. Adopting a Modigliani-Miller-type argument, he maintained that firm financing techniques are basically a “veil” and that investors will not pay the firm to do anything they can do for themselves. He also found some evidence of a positive relationship between excess volatility of asset prices and trading volume (i.e., “noise trading”) at very high frequencies and at short horizons. However, MNCs—as opposed to banks—have been responsible for a dramatic rise in currency trading at longer horizons, where speculation appears

to be stabilizing. Foreign direct investment is, in his view, less sensitive to exchange rate uncertainty than are trade flows. A more powerful instrument that influences foreign investment by MNCs is corporate tax codes. Froot illustrated how change in U.S. corporate tax provisions affected U.S. direct investment inflows and outflows in the 1980s—albeit not enough to explain coincident swings in the dollar. Geoffrey Carliner supported Froot's conclusion that MNCs do not increase exchange rate fluctuations. Since foreign direct investment by MNCs is dwarfed by international flows of portfolio capital, Carliner argued that actions of financial institutions—not MNCs—need to be placed at center stage in any institutional actor story of destabilizing capital flows. He also made a plea for giving more attention to international coordination of tax policies since international tax competition can produce suboptimal outcomes. John Flemming too agreed with the basic thrust of Froot's analysis. He noted that an implication of exchange rate instability militating more strongly against trade than against foreign direct investment is that much of undeterred investment displaces deterred trade. He also took issue with the notion that MNCs could contribute to closer adherence to purchasing power parity on two counts: (a) MNCs are not immune to the costs of adjustment of switching production from one source to another; and (b) to the extent that MNCs have market power, they may be well placed to practice price discrimination between different markets.

(9) *Are data on current account positions and international indebtedness adequate as indicators of the need for policy adjustment?* This issue was examined by Lois Stekler, with particular emphasis on the quality of U.S. data. To be sure, her work indicated a number of areas where the existing data are flawed, ranging from large discrepancies between U.S. and Japanese data on purchases of U.S. securities by Japanese residents, to outdated (World War II) benchmark surveys of U.S. portfolio assets abroad, to the effect of securitization of capital flows on shifting transactions from an on-balance to off-balance-sheet basis. In the end, however, she concluded that the shift of the U.S. current account from near balance in the first three years of the 1980s to a deficit of around \$150 billion cannot be accounted for by errors and omissions, and that publicly available data also indicate correctly the direction and rough order of magnitude of the U.S. net international investment position.