International Monetary Coordination

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International Monetary Coordination

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For at least a decade the volatility of exchange rates and large international capital movements have led many to conclude that the international monetary system is in disarray. Specific evidence of disarray is hard to come by, however. Two of the most widely discussed problems of the international economy, pollution and the international debt of developing countries, are not closely connected to fluctuations in exchange rates between major currencies. A third problem, trade imbalances, is reduced by exchange-rate changes. Trade and economic activity continue to grow, and inflation in the major industrial countries, despite its recent rise, has been moderate since the early 1980s.

Yet the concern about exchange-rate volatility continues. Governments have responded to these concerns. Since September 1985 governments in the United States, Germany, Japan, and other industrialized countries have intervened, actively at times, to influence exchange rates by buying and selling currencies. Coordinated intervention in exchange markets has been followed by proposals for more explicit policies to coordinate fiscal and monetary actions by governments, to choose indicators showing the need for exchange-rate adjustment, or to establish target zones or bands within which governments would seek to maintain exchange rates.

As these different proposals suggest, coordination has many meanings. At one extreme, governments coordinate by exchanging information about their policies, plans, or interpretations. Exchange of information is now well established. It is no doubt useful for government officials to know how their counterparts in other countries interpret data. At times such as the stock exchange crash of 1987, agreement on the nature of the problem may lead to common action.

 Coordination by Policy Rule

At another extreme, coordination could mean that governments would harmonize their monetary policies by following compatible rules for monetary policy.
growth. The governments of major industrial countries, for example, could agree to maintain domestic price stability—an average inflation rate of zero—and adopt policies clearly related to that goal. If the common policies were expressed by an explicit rule in each country, interested parties would be able to monitor performance and to observe departures from the rule. By following the rule, governments would remove a major cause of exchange-rate fluctuations: international differences in actual or anticipated rates of inflation. Exchange rates would continue to fluctuate in response to international differences in productivity, returns to capital, saving, investment, and the like.

The case for coordination arises because a single country cannot achieve both price stability and exchange-rate stability. If each country acts alone, it can use monetary policy to stabilize domestic prices or to maintain stable exchange rates, but not both. The choice that a country makes depends on its size and its trade arrangements. Small countries like Holland or Belgium, heavily dependent on trade with their neighbor Germany, typically choose exchange-rate stability, fixing their exchange rates to the German mark. Making this choice ensures that prices in Holland or Belgium will generally rise or fall with prices in Germany. Fixed exchange rates reduce swings in domestic demand, output, and employment arising from differences in rates of inflation. Countries with fixed exchange rates, however, lose control of their domestic prices and inflation. If Germany inflates or deflates, Holland and Belgium inflate or deflate, too. If Germany achieves price stability but the United States or Japan does not, Holland, Belgium, and Germany cannot avoid the fluctuations resulting from changes in the exchange rates between the mark, the dollar, and the yen. A credible rule that achieves price stability in the three large countries reduces fluctuations in exchange rates. Thus, coordination by policy rule can provide benefits that countries cannot achieve acting alone.

A system of fixed exchange rates is an alternative type of coordination by policy rule. Countries surrender control of domestic prices and inflation to maintain stability of their exchange rates. This system was popular in the nineteenth and early twentieth centuries and again in the early postwar years. The system is much less common now because the costs of maintaining fixed exchange rates proved to be higher than major countries were willing to pay. The gold standard, a fixed exchange-rate system, imposed severe deflation on much of the world in the 1930s. The Bretton Woods system of the early postwar years, a fixed-rate system based on the U.S. dollar, imposed inflation in the 1960s and 1970s. The system came to an end in 1973 when several major countries chose to let their exchange rates fluctuate against the dollar to regain control of domestic prices and rates of inflation.

Inflation in major industrial countries has been reduced under fluctuating exchange rates, but exchange rates, particularly rates for the dollar, have fluctuated over a wide range. At issue in the search for policy rules is whether exchange-rate fluctuations can be reduced without sacrificing price stability or increasing fluctuations in output and employment.

Some evidence suggests that a coordinated effort to achieve price stability by following a common policy rule would also increase exchange-rate stability. The evidence comes from countries like Germany, Japan, and Switzerland that have used monetary policy in recent years to achieve price stability. Each of these countries, acting alone, has
brought its average inflation rate to about zero. Just as important, because the countries have acted promptly to reduce inflation whenever a recurrence seemed likely, they have earned reputations as low-inflation countries. Although the countries have deviated from the rule on occasion to influence their dollar exchange rates, departures have been neither frequent nor prolonged. The main experiences, in 1978–1979 and in 1986–1987, were followed by increases in inflation, a shift back to less inflationary policies, and a return to price stability or low inflation.

Have the exchange rates for these countries been less variable? A comparison of the exchange rates for the German mark and the Japanese yen illustrates that much of the variability arises from fluctuations in the dollar. Figure 1 shows that the direct exchange rate of the mark for the yen has been far less variable than the dollar exchange rate of either currency. The credible commitment to price stability appears to reduce exchange-rate variability.

An additional advantage of following a common rule is that the benefits of coordination are achieved at low cost. A rule for price stability does not require a large bureaucracy, frequent meetings, or interference in the domestic economies of other countries. If the rule is simple and clear, market participants can observe when a country deviates from the rule. By shifting assets from countries that inflate to countries that follow the rule, market participants would impose costs on countries that do not follow the rule. Exchange rates would fall, and interest rates would rise in countries that inflate to reflect the actual or anticipated departure from price stability.

Coordination by Activist Policy

Most proposals for international coordination envisage much more government intervention than is required by rule-based policy coordination. Suppose that country A is headed toward recession or has a current account deficit, while country B has inflation and a current account surplus. Coordination consists of an agreement on a mixture of monetary and fiscal actions by each country that is intended to move both countries toward a position of growth with low inflation and with current accounts nearer to balance.

The hidden presumption in a proposal of this type is that policy makers or their advisers know the combination of actions that is consistent with equilibrium in both countries, or in some cases several. Coordination of this kind attempts to adjust economies using forecasts and judgment in much the same way (but on a larger scale) as the efforts in the 1970s to control inflation by managing Phillips curves. These curves were supposed to show the trade-off between inflation and unemployment. Then, the belief was that economists could design a combination of policies that would reduce unemployment without much increase in inflation. The economy was supposed to benefit by moving to a more satisfactory position. The earlier policies failed mainly because they substituted what economists would like to believe they know for what they actually know. What economists do know does not include the detailed knowledge required to design short-term changes in monetary and fiscal actions that reduce variability. In fact, there is not much evidence that economists can forecast output, prices, or current account balances with sufficient accuracy to design policy mixtures that reduce variability on average.

Consider the problem of choosing actions to coordinate the responses in two (or more) economies. The timing of responses to policy actions is different in different countries. Wage rates adjust to prices more rapidly in Japan than in the United States or Europe. Labor markets in the United States are commonly believed to be less flexible than in Japan but more flexible than in Europe. Countries produce different products. For these reasons, expansions and contractions can give rise to short-term changes in relative prices and output. These differences stimulate capital flows and changes in exchange rates. Efforts to offset these movements by changing the policy combination in two or more countries are not likely to be more successful than the earlier efforts in the 1970s, which were confined to a single country. Coordinated policy action requires far more knowledge than economists can claim reliably. And estimates of the effect of coordinated actions on exchange rates must fail because no one has developed a theory capable of accurately predicting movements in exchange rates.

Similarly, countries will reduce stability if they attempt to coordinate changes in aggregate demand.

‘‘The inability to forecast accurately the responses of output, exchange rates, prices, and other variables to policy changes means that efforts to coordinate policies are likely to increase variability and uncertainty.’’
or changes in the demand for money. Short-term changes in aggregate demand include large random movements that obscure underlying trends. For this reason, economists have difficulty predicting whether observed changes will persist, reverse, or cumulate. The record of economic forecasting shows that these forecasts are the best available. Nevertheless, they cannot reliably predict whether the economy will be in a boom or a recession a quarter or a year ahead.

The inability to forecast accurately the responses of output, exchange rates, prices, and other variables to policy changes means that efforts to coordinate policies are likely to increase variability and uncertainty. Coordination of discretionary policy actions will have unintended consequences, including inflation and recessions, that could have been avoided by following policies to achieve long-term stability.

Recent experience illustrates the problem. Prominent economists predicted that the dollar would fall after the 1988 election. Several urged more expansive policies for Germany and Japan in 1989 and more restrictive policies for the United States. Midway through the year, the dollar has risen. The U.S. economy has slowed, and Europe and Japan are experiencing inflation. Moreover, the inflation in Germany and Japan is not happenstance. It is the result of a previous attempt to coordinate policies in 1986 and 1987.

The inaccuracy of forecasts and the problems arising from the use of forecasts to guide policy are now more widely recognized. Instead of basing coordinated actions on forecasts, governments of the major industrial countries have supported the use of indicators of economic activity such as the gross national product (GNP), inflation, the trade deficit or surplus, and the fiscal deficit or surplus. There are two major problems with this approach. First, economists lack the ability to translate movements of these (or other) indicators into correct exchange-rate changes. Hence, there is no reason to believe that, on average, reliance on indicators will increase stability. Second, the indicators often do not point in the same direction. Some may suggest expansion or inflation; others, contraction. Weighting the indicators according to their importance requires more detailed knowledge about the economy than economists currently have.

An alternative proposal for coordinated action calls for the use of target zones for exchange rates. Under this proposal, countries would agree to change policies to keep exchange rates within a given band or appropriate range. An agreement of this kind presupposes that the correct exchange rate is easily determined and likely to remain within the band. Unfortunately, economic analysis does not tell us the correct price or exchange rate. It tells us that, left alone, markets do a good job of using available information to find the correct price and of changing it when underlying conditions change.

Proposals for discretionary coordination, indicators, or target zones may reflect a common error. The fact that exchange rates are highly variable is not evidence that the fluctuations are more costly than alternative arrangements. Exchange-rate changes are, at least in part, substitutes for adjustments of wages, prices, output, and employment. For Germany and Japan, with relatively stable, noninflationary policies, the variability of output, employment, and prices has been lower under fluctuating exchange rates than under the fixed-rate

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The AEI Economist is a monthly report intended to clarify current issues of economic policy in an objective manner. It is edited and often written by Herbert Stein, senior fellow of the American Enterprise Institute and A. Willis Robertson Professor of Economics Emeritus at the University of Virginia.

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system in effect before 1971. These economies have been more stable, when judged by these variables, under fluctuating exchange rates. Variability of output and prices in the United States has remained about the same under fixed and fluctuating exchange rates.

Despite variability and the gains from reducing excessive variability, this evidence suggests that fluctuating exchange rates have not been costly and may have been beneficial. The evidence from these few large countries should be supplemented by analyses of many countries before we draw general conclusions. Nevertheless, it is instructive to find that increased variability of exchange rates can be accompanied by lower, or unchanged, variability of principal measures of economic well-being.

A Modest Proposal

Markets coordinate responses by adjusting prices. Fluctuating exchange rates are a means of letting prices coordinate responses to differences among countries. A valid case for international policy coordination cannot be based on policy makers’ abilities to coordinate better than markets because there is simply no evidence that this is so. The case for coordination depends on finding net benefits to society that can be achieved on favorable terms.

We noted earlier that the principal benefits from coordination of monetary policy can be achieved if major countries adopt a common rule. Two of the three major countries, Germany and Japan, though not unalterably committed to a rule-based policy, have generally followed stable, predictable policies to achieve price stability. Departures have been infrequent and have usually been made at the urging of the United States.

In 1978–1979 the United States favored coordinated action to expand spending and output. Countries that joined in this coordinated effort subsequently experienced increased inflation. This inflation brought the effort to coordinate expansion to an end and was followed by anti-inflationary policies and severe recessions in the early 1980s.

Again in 1988–1989, earlier efforts to coordinate expansion in Germany, Japan, and other countries outside the United States were followed by renewed

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inflation in many of the cooperating countries. This experience appears to have reduced current interest in coordinated action.

Our modest proposal seeks to gain the main benefits of coordination without incurring the costs just described. We believe that the benefits sought by advocates of activist coordination can be achieved best by rule-based coordination. If the United States would choose to join Germany and Japan in dedicating monetary policy to the maintenance of price stability, all three countries would have a common goal and a common policy rule. Citizens of each country would benefit from price stability and from the reduced variability of exchange rates. The three countries would be senior partners in a club of financial stability. Smaller countries would have the opportunity to fix their exchange rates to countries with stable prices, so their prices and exchange rates would be more stable as well. They could choose to be members of the club.

Countries would remain free to depart from the stabilizing policy, but if they did so frequently, confidence in their commitment to price stability would decline. Unwillingness by the United States to achieve price stability, for example, would restore the present, less than fully satisfactory arrangements. That would put an end to the club of financial stability.