INTERNATIONAL MANAGEMENT AND DEVELOPMENT INSTITUTE

COOPERATION AND CONFLICT IN MONETARY AND TRADE POLICIES

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Some general remarks

In dealing with the issues raised by our panel discussion, I have chosen to exploit my "comparative advantage" and focus on the macro-economic aspects. I will devote the first part of my remarks to a brief interpretation of the eighties, from which I will draw some useful lessons for the discussion, in the second part, of the prospects for international cooperation.

Interpreting historical experience requires a conceptual framework. I find it useful in this regard to distiguish between cooperation and coordination. Cooperation basically involves information exchange, consultation among authorities, and possibly common assessments of the international repercussions of national policies. Coordination means that policy-makers in a number of countries agree on common objectives and together take joint policy decisions that differ from those they would have taken on their own. Conflict is, in a sense, the opposite of coordination. It may arise from time to time when no consideration is given to the international dimension of national policies. In sum, we can view international cooperation as a continuum ranging from coordination, the highest level of cooperation, to conflict, when cooperation breaks down.

In most situations, simple cooperation is sufficient to guide economic policy: the mutual exchange of information and assessments improves decision-making in each country, and national objectives are mutually consistent or at least in the main not in conflict. In some cases, however, policy coordination becomes both necessary, because indepedent domestic objectives are incompatible, and possible, in that all sides can improve their performance by making policy bargains that sacrifice some goals but entail a smaller loss than would be incurred in the absence of agreement. Clearly, in this framework cooperation is the general condition, while coordination may occur sporadically, usually as the response to potential or actual conflict.

Within this continuum, the situation at any given time will also depend on the rules governing international economic relations and the degree of consensus concerning the causes and possible solutions of current economic problems. For instance, the Bretton Woods regime can by and large be described as a system of (semi)-automatic coordination, since the exchange rate constraint set definite limits to national economic policies and countries were basically willing to respect it. The priority assigned to the exchange rate constraint reflected a basic consensus on the role of macroeconomic policies in ensuring domestic and external stability. Since the advent of free floating in the early seventies, we have witnessed a variety of situations ranging from coordination to conflict. For the most part, however, in this regime the national policy objectives of the major players have not been coordinated, while the burden of reconciling them has been placed on exchange rates. When conflict has arisen, it has often also been clear that the basic consensus on the role of macro-policies was, to say the least, much weakened.

The early eighties: lack of coordination leading to conflict

In the first half of this decade the three leading countries did not coordinate their domestic economic policies in the common pursuit of disinflation. The prevailing conviction was that policies "to put one's own house in order" would also ensure the smooth functioning of the international economy. Advocates of this approach argued that floating exchange rates would grant sufficient "insulation" from international disturbances. Accordingly, the United States adopted a very restrictive monetary policy and an expansionary fiscal stance, while Germany and Japan preferred a restrictive fiscal stance and relatively easier monetary policies. The dollar appreciated sharply. Though all the major industrial countries did manage to bring inflation under control, the fallacy of this approach has been thrown into sharp relief by sustained exchange rate misalignments, the build-up of enormous trade imbalances and the attendant increase in protectionist pressures. It is precisely in the sphere of trade that the threat of conflict has been felt most acutely, to the point of calling into question the entire architecture of the multilateral trade system organized within GATT.

Restoring international cooperation: from the Plaza to the Louvre accord

Recognition that the non-cooperative approach was endangering trade and even the realization of national objetives eventually led to a shift along the continuum, away from conflict and towards coordination. The report by the Group of Ten Deputies issued in June 1985, while recognizing that a return to a system of fixed parities was premature, stressed the need for close and continuing cooperation among the major countries to promote convergence of economic performance and thereby enhance exchange rate stability. It should be noted, however, that coordination was initially limited to two specific episodes and that it was more in the nature of crisis management than a return to continuous collaboration.

The first episode came at the end of February 1985, when the leading central banks conducted massive concerted intervention in the exchange market to halt the appreciation of the dollar. The second was at the end of September, with the Plaza agreement, which was designed to speed up the depreciation of the dollar. Again, the coordinated action was limited in time and scope, with most of the effect being achieved by the announcement of the common goal of bringing the dollar down; interventions in foreign exchange markets were substantial only for a short period; monetary policies also played a role, since interest rates were coming down more rapidly in the United States than elsewhere.

The dollar did turn downwards and a "crash landing" was avoided. The reason for this success was that the common goal was consistent with economic fundamentals, while an easing of monetary policies, which was more pronounced in the United States, was also clearly consistent with national objectives. It was thus possible to produce a lasting change in market participants' expectations.

In the ensuing months the situation reverted to loose cooperation; the dollar continued to depreciate and monetary policies to ease; what was not done, however, was to restore a less unbalanced pattern of fiscal policy. The failure to use this instrument to foster the required redistribution of domestic demand from deficit to surplus countries and the impact effect of the dollar's depreciation on trade values led to a further widening of payments imbalances. Some of the problems deriving from this inability to coordinate fiscal policies were explicitly recognized at the Tokyo Summit in May 1986. This led to the decision to strengthen the procedures for multilateral surveillance, mainly through a more binding system of indicators designed to make national policies more consistent with the needs of external adjustment.

Since the summer of 1986 resistance to further depreciation of the dollar grew in the appreciating-currency countries, where the authorities were increasingly worried about the loss of competitiveness of their exports. The US attitude was less clear, although fears of a resurgence of inflation were spreading.

At their September 1986 meeting, the Group of Seven Finance Ministers declared their conviction that their policies "should help stabilize exchange rates ... so that imbalances can be reduced sufficiently without further significant exchange rate adjustment". This announcement, which was not followed by any action whatsoever, unsettled the markets and thus proved counterproductive .

It was only after a further depreciation of the dollar, and with current account imbalances still widening, that policy makers decided to sit down together again to halt the slide and restore some order to foreign exchange markets. The Louvre accord reached in Paris at the end of February 1987 provided for coordinated changes, clearly detailed for each individual country, not only in monetary but also in fiscal policies.

The Aftermath of the Louvre accord.

Subsequently, Japan did adopt a package of expansionary fiscal measures and the United States took steps to cut the budget deficit. Germany, on the other hand, did not accept the view that a greater fiscal stimulus would be apropriate. The brunt of dollar stabilization fell once again on monetary policy. Heavy intervention in foreign exchange markets led to a sharp acceleration of monetary growth outside the United States. The lack of support from the German authorities, the perception that the US budgetary position would not improve in 1988 and the evidence of still growing trade imbalances, all led market participants to consider the fiscal manoeuvre insufficient. The authorities in the appreciating-currency countries became uneasy about the pace of monetary expansion. The United States appeared increasingly concerned about the lack of progress on the external front, and was not ready to accept a slowdown of domestic demand. After a short period of calm, in May-June 1987, pressure on the dollar resumed.

Towards the end of the summer the markets perceived that cooperation was breaking down and a situation of conflict was emerging, with interest rates in all the major countries creeping upward. This market sentiment unleashed fears of recession in the United States and contributed to the October stock market crash. The Federal Reserve's response gave priority to the stabilization of national financial markets with the explicit abandonment, for the time being, of the objective of a stable dollar, as was made clear in a public statement by Secretary Baker at the beginning of November.

The current debate on coordination

Against this background, there has recently been an upsurge of pronouncements against international coordination and in favour of the pursuit of enlightened self-interest by sovereign nations, notably in the United States. This has been authoritatively argued by Martin Feldstein in a recent article in the Wall Street Journal (November 10, 1987). The United States, he maintains, "should now in a clear but friendly way end the international coordination of macroeconomic policy. We should continue to cooperate with other countries by exchanging information about current and future policy decisions but we should recognize explicitly that Japan and Germany have the right to pursue the monetary and fiscal policies that they believe are in their own best interests". And he goes on to say that the conventional claims about the gains from international coordination are not justified by the degree of interdependence among the leading industrial economies; the expansion of domestic demand in Japan, Germany and the other industrial countries would have a limited impact on trade imbalances. The United States should therefore be prepared to accept a further decline of the dollar to the extent necessary to eliminate the trade deficit. Stabilization of the exchange rate at its current level would require higher interest rates and consequently would heighten the risks of a recession. At the same time Japan and Europe should recognize the inevitability of the dollar decline and provide the required offsetting stimulus to their economies through an increase in domestic absorption.

Objections to this view can be raised on a number of grounds. Let me mention two.

First, while Feldstein and others recognize that a fiscal correction is necessary, there is the attendant risk that in practice exchange rate adjustment may come to be seen as a substitute for required policy changes. Second, lack of supportive policy action may in turn induce a tendency for the exchange rate to overshoot, possibly setting in motion "vicious circles" of inflation and depreciation in the United

States, of deflation and appreciation in Germany and Japan.

One has to recognize, however, that we are confronted here not only with the difficulties of reconciling inconsistent national priorities, but also with basic differences of view about the contribution that can be expected from exchange rates and macro-policies to the correction of trade imbalances.

Why is closer cooperation so difficult?

Although I have objected to the emerging anti-cooperative view of international adjustment, it is clear that there are numerous obstacles in the way of closer cooperation.

Since we are dealing here with sovereign countries and domestic policy objectives are decided upon by national parliaments, it is difficult to bring about mutually compatible policies. The domestic political process is so complicated that international considerations cannot be expected to be more than a small factor in policy-making. Only at times of "crisis" is a common interest in coordinated action more clearly recognized, thus permitting international policy agreements to be reached. In addition, since international cooperation is a "public good", any country participating in it will tend to be more conscious of the costs to itself -- particularly the perceived loss of national sovereignty -- than of the prospective benefits.

There is no shared view nor accepted supranational authority to decide what policies are needed to deal with existing imbalances in the world economy. Empirical evidence from econometric models is not very helpful in this regard since it shows that, while there may be gains from systematic cooperation, these gains are on average not large.

Furthermore, these results are based on the assumption that the authorities in the different countries "all use the same model", or in other words hold broadly similar views on the functioning of the world economy. If this condition is not satisfied, it is easy to show that it is far from certain that the gains from cooperation will be achieved or even recognized. Moreover, in certain circumstances the credibility effect of announcing coordination may be counter-productive on other fronts. For instance, the announcement that exchange rates will be stabilized, without adequate support from fiscal action, may convince private agents that monetary aggregates will run out of control and lead to a resurgence of inflationary expectations.

Are there realistic prospects for improved cooperation now?

In general terms, coordination is viable and useful insofar as it enables the countries concerned to make gains that they would not achieve by acting separately. Furthermore, these gains must be visible and exceed the cost of sacrificing domestic objectives, so that a deal is possible. I believe that this is true in the present situation, in which the world economy confronts the simultaneous objectives of adjusting large external imbalances and avoiding the twin dangers of inflation and recession. Clearly, however, we must take a realistic view of the scope for coordination and of the possible gains. We must recognize that external imbalances will persist for a long time, regardless of the policy approach adopted, and that their correction will be neither painless nor smooth.

It is also clear that the sheer size of the divergences in "fundamentals" in the leading countries is not consistent with a return to fixed exchange rates. Exchange stabilization agreements can only be seen as "holding" operations. They are necessary because the effects of exchange rate changes on trade flows are powerful but slow to come about, so that exchange rates have a tendency to overshoot.

This view of stabilization operations is also consistent with another important lesson of recent experience: with divergent "fundamentals" countries will only be willing and able to adhere to exchange rate stabilization agreements for limited periods, that is for the time that it takes for fundamental inconsistencies to show up in conflicts with domestic objectives. The clearest example is the stock market crash putting an end to the Louvre accord, but others could be mentioned. This is not to say, however, that no constraint on national policy should be involved in stabilization agreements: indeed, these will be useful only if they succeed in gradually bending domestic policies and priorities to the requirements of international adjustment. A difficult middle way will have to be found here between discipline and flexibility; the policy judgements will have to be made on the basis of conditions in foreign exchange markets, domestic developments, and the progress made on the external front in the leading countries.

This realistic view of cooperation should also be reflected in public statements. It is essential to avoid creating excessive expectations, notably any implication that cooperation is either "everything for ever" or nothing. By the same token, however, the public airing of disagreements should also be avoided.

A further feature of any cooperative strategy is that it should not continue to rely only upon the three leading actors. Other groups of countries should participate in the concerted efforts for adjustment. The size of the external surpluses accumulated by the Asian NICs and, in particular, the role of restrictive trade practices and "competitive" management of their exchange rates in generating these surpluses single out this group as one deserving special attention in identifying the requirements for adjustment.

Turning to the contents of coordination, any strategy will, of course, have to be based on the correction of the savings-investment imbalances in the leading countries. Since the room for manoeuvre on the monetary side is limited, fiscal policy will have to contribute more, both in the United States and in Germany. The role of Germany is crucial because its cautious fiscal posture greatly influences the other European countries participating in the exchange rate mechanism of the EMS. A more courageous growth-oriented approach in Germany, aiming at exploiting in full the potential of the economy, would therefore help set in motion a virtuous mechanism permitting Europe as a whole to contribute to worldwide growth and adjustment.

Europe must realize that it cannot expect the United States or Japan to help much in pulling it out of the present predicament of slow growth and high unemployment, since trade interdependencies between the two areas are small. Indeed, while Europe has quite a lot to lose from a lower dollar it does not have much to offer to the United States in exchange for participation in the dollar stabilization effort.

Japan finds itself in quite a different position, in view of its high interdependence with the United States. Since the US deficit and debtor position and the Japanese surplus and creditor position are, to a considerable extent, mirror images of each other, the benefits from cooperation between the two are greater and more evident to national authorities in both countries.

Would the United States have an incentive to cooperate in a coordinated strategy?

The proposed fiscal policy correction has so far proved politically difficult to implement. On the other hand, if the Federal government does not reduce its net absorption, the external deficit is bound to be adjusted by a decline in investment or a surge in private savings in response to higher real interest rates or a further slide in equity prices.

Finally, the discussion on international policy coordination is often confined to the macroeconomic sphere. This is an oversimplification since there is at least one other area of policy where collective action is relevant, i.e. trade policies.

The "gains" from coordination might prove larger if the scope for coordination were broadened to the trade arena or, for that matter, defense and foreign policy, because the range of possible policy bargains and improvements would thus be broadened. Trade and macroeconomic policies cannot be divorced since the viability of a free-trade system depends on a reasonable configuration of exchange rates.

The prevention of a protectionist backlash should be a chief imperative of international cooperation; it is clear from recent experience that trade-restrictive legislation is fostered by the persistence and exacerbation of external imbalances and exchange rate misalignments. When discussing whether payments imbalances are "sustainable" or not, we should not belittle this element of "political sustainability" represented by an increase in protectionism. There is an urgent need to insulate trade policy from the effects of persistent macroeconomic imbalances.