To Coordinate or Not to Coordinate?

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To open, it is perhaps worthwhile making some semantic distinctions. Macroeconomic coordination is a strong form of international economic cooperation, which can take many other forms, ranging up from the simple exchange of information among different governments to joint action to achieve a shared objective. Macroeconomic coordination can involve the coordination of targets of economic policy, as in the abortive OECD effort in 1974–75 to coordinate the current account objectives of its member countries following the first oil shock. More recently, we have seen some loose attempts to coordinate exchange rate targets. Or it can involve coordination in setting the instruments of economic policy, as for example the coordinated reduction in interest rates agreed at Chequers in 1967, or coordinated fiscal actions agreed at the Bonn economic summit meeting in 1978. The latter effort also involved trade and energy policies as well as fiscal policies.

Moreover, coordination can be rule-based or process-oriented. The two forms differ sharply in principle but blur in practice. Under rule-based coordination, countries agree on certain basic rules concerning the issue at hand, and are able to act freely and independently within those rules. Process-oriented coordination, in contrast, involves close consultation on actions to be taken shortly before they are taken. In practice, rule-based frameworks, such as the General Agreement on Tariffs and Trade or the original Bretton Woods Agreement, also involve occasional close consultation.

The case for macroeconomic coordination is that completely independent national action is likely to involve a lower level of world welfare

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than could be attained. The case arises formally for two and possibly three reasons. The first is that large nations can influence their own terms of trade—their real exchange rate—and that possibility, if exercised, will lead to suboptimal outcomes from a world perspective. The second is that nations cannot make policy continuously in response to new information. This is especially true of fiscal policy, which in practice is fixed once or at most twice a year. For that reason nations are likely to remain further from where they would like to be in a world of interdependent but independently acting governments. Strictly speaking, what is required here is accurate information on what other governments will do. But since that is contingent, in general, on what our country's government will do, intense exchange of contingent information is hardly different in practice from coordination of actions. The third reason for macroeconomic coordination, more controversial perhaps, is that macroeconomic stabilization is an international public good, which will be undersupplied without coordination among the major national governments.

Stating the case for coordination is not to suggest that it is easy to achieve, or even that if achieved, it will be successful in its aims. At any point in time, governments may well differ in their preferences about which way to push the world economy, each wishing to maximize the help the world economy can give in attaining its immediate domestic objectives. Governments will often disagree on the outlook for the near future, hence on desirable actions to be taken. They will sometimes disagree on the relation between actions and outcomes—on how their economies actually work—and of course even when they agree on the theory they may be wrong, so that coordination fails to achieve expected and desired results.[1]

The pragmatic conclusion I draw from these various considerations is that major countries—the G7 is the currently available forum—should be constantly alert to the possible gains from macroeconomic coordination, and they should try to coordinate their aims and actions to achieve those gains. But we should not expect too much coordinated action to emerge from that process.

That is perhaps a sound conclusion, but it is not a very exciting one. One purpose of conferences such as this is to provoke thought beyond the conventional wisdom. With that in mind, I would like to introduce an old but still important and still unanswered question, put in a contemporary setting. At the present time, is it desirable that the North German mark be depreciated against the South German mark? Or should the New England dollar—the A dollar in your wallet—be appreciated against other U.S. dollars (the B to L dollars in your wallet)?

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[1] For a discussion of these issues see Cooper (1988) and Frankel and Rockett (1988).

Each of these actions has something to be said for it. North Germany is relatively depressed at present, while South Germany is buoyant, yet wages are more or less determined at a national level, so that North German wages are too high relative to South German wages. A depreciation of the North German mark could possibly correct this and stimulate economic activity in the North, while dampening it somewhat in the South.

Similarly, New England at present is booming, with house prices and other prices on non-tradeables rising especially rapidly. The oil and gas regions of the U.S. economy and to a lesser extent the industrial Midwest remain somewhat depressed. Appreciating the New England dollar against other U.S. dollars, and in particular against the Dallas dollar and the Cleveland and Chicago dollars, would redistribute economic activity to some extent in a desirable direction.

Since these would be generally desirable things to do, why do we not think about the actions I suggest? The answer is probably that it is totally impractical politically, and runs strongly against the national unity, including a unified currency area, that the Federal Republic of Germany and the United States of America have each established. The proposal is simply too radical, even quixotic.

But I suggest that there is another, more analytical reason for not seriously thinking about these suggested currency changes. To depreciate the North German mark against the South German mark, or to appreciate the Boston dollar against the Cleveland dollar, would jar economic relations within each country badly. It would create a major new source of uncertainty in making contracts and in investing on the strength of future expected demand. Businessmen must worry about the real value of money, but the rate of inflation is likely to change slowly compared with real exchange rates under flexible exchange rates. Changes in exchange rates can wipe out—or double—a 5 percent profit margin in a week. Movements in nominal exchange rates, which as we have learned in recent years do more than simply correct for differential rates of inflation, introduce great uncertainty for prospective investors who are exposed to international—or in the context in which I have raised the question, interregional—trade.

Credibly fixed exchange rates—in effect, one currency—represent an extreme form of rule-based macroeconomic coordination. In the presence of an integrated capital market, permanently fixed exchange rates require a single, fully coordinated monetary policy. The possible cost of moving to a single currency is loss of an instrument of policy, namely local monetary policy (monetary policy remains an instrument for the larger region). The gain is in a reduction in the real uncertainty facing the productive sectors of the economy, uncertainty that is generated by changes in sentiment, from whatever source, in the purely financial sectors of the economy.

If this gain applies to the United States, or to the Federal Republic, why does it not also apply to Western Europe as a whole, or even to Europe, the United States, and Japan taken together? This is the old question of the optimum currency area, first posed by Robert Mundell in 1961. Economists have never answered this important question satisfactorily.

The answer usually runs in terms of whether exchange rate changes are helpful in adjusting an economy to a "fundamental disequilibrium," in the words of the original Bretton Woods Agreement. Clearly they can be. But these gains must be set against the introduction of real exchange rate uncertainty that nominal exchange rate changes introduce. A standard argument for flexible exchange rates is that they reduce real exchange rate uncertainty in the presence of diverse national monetary policies. But even if true, that particular source of uncertainty would disappear under a common currency, such as prevails through the United States.

Nonetheless, it is necessary to assess the loss of an instrument of policy in adjusting to fundamental disequilibrium. The point cannot be developed here at any length. Adjustment within nations involves the movement of labor and capital, plus some cushioning through fiscal transfers from temporarily advantaged regions to temporarily disadvantaged ones. With a common currency, that is, with full coordination of monetary policy, the capital market would develop fully throughout the entire currency area and capital would move readily to any region able and willing to borrow. It is more difficult to envisage extensive labor mobility or fiscal transfers among the industrial democracies, but the European Community has moved toward both fiscal transfers (through the common agricultural policy and the European Fund) and higher labor mobility, supplied mostly, at the margin, by southern Europeans moving to locations of greatest employment opportunity. No doubt these fiscal transfers and labor mobility are not so well developed as they are in the Federal Republic alone, but the gap is certainly closing, and probably rapidly.

The question then is whether adjustment *within* the large and diversified regions of Europe, Japan, and the United States may not be sufficient to reduce the incremental advantages of real exchange rate adjustments among these regions below the incremental costs of the real exchange rate uncertainty that preservation of diverse monetary policies permits and encourages.

In other words, whatever may be appropriate for the immediate future, in the longer run will we not want an extreme form of coordination of monetary policy, namely, a single monetary policy among the major countries, in the interests of eliminating exchange rate uncertainty among major economies? If in the end the answer is negative, we then have to provide the analytical (as distinguished from the political) reasons why each of the 12 Federal Reserve Banks should not be encouraged to frame its own, uncoordinated monetary policy, with floating exchange rates among their diverse regional dollars.

References

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