International Nominal Targeting: A Proposal for Policy Coordination

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After some time spent studying the formidable obstacles to international macroeconomic policy coordination, I have begun to think about the more constructive question of defining the necessary characteristics of a coordination plan best suited to overcoming these obstacles. If international coordination agreements are to be *substantive,* they must comprise packages of policy changes that each country would not necessarily be willing to make on its own, but that each believes will be beneficial when enacted jointly. If coordination agreements are to be *enforceable,* the individual authorities must commit to specific "performance criteria," and these criteria must be closely enough related to the policy instruments they control directly that they can be held loosely accountable for deviations. On the other hand, if coordination agreements are to be *successful* at raising economic welfare, the specific criteria that the authorities have committed to must be closely enough related to their ultimate goals—such as output and inflation—that the desirability of having achieved those criteria is not negated by velocity shifts and the other large uncertainties that plague economic relationships.

The current G-7 system of indicators, originally formulated at the Tokyo Economic Summit in May 1986 and supposedly refined at subsequent meetings, lacks some of the characteristics needed to produce substantive, enforceable, successful coordination agreements. I mean this judgment to go far beyond the simple point that the member countries are not yet politically ready to give up the amount of sovereignty needed for full-scale joint optimization. It goes without

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saying that the day of such a degree of political consensus lies far off in the future, if indeed it ever comes. The most we can hope for is to begin in the early 1990s a system in which countries agree to give up just a small amount of sovereignty, hoping to get in return a small joint gain. Then, if coordination is successful on this small scale, the demonstrated record of compliance by the members, and the demonstrated benefits, may engender enough trust in the system to support a greater degree of commitment in subsequent stages if it is desired.

The first reason why the present G-7 indicator system is not as well-suited as it might be to such a plan is that the group does not announce the numbers agreed upon, if indeed it in fact bargains over specific targets for its list of indicators at all.[1] The second reason is that, even if the G-7 were to progress to the point of negotiating and announcing the indicators, there are too many indicators on the list to constitute any serious constraint on policymaking by national authorities. Given that each country has only two or so policy instruments at its disposal—monetary policy and fiscal policy—some indicators will always be moving in such a way as to justify whatever policy settings the country wants. The third reason is that, even if the G-7 continues to winnow down the list of 10 indicators mentioned in the Tokyo Summit (11, if one includes former Treasury Secretary Baker's 1987 suggestion of adding the price of gold and other commodities to the list) to just one indicator, none of them is a good candidate to be that one. All are either too far removed from the policy instruments that authorities have under their direct control and can therefore be held accountable for, or are too far removed from the output and inflation target variables that ultimately matter.

I would like to offer the modest proposal that the G-7 in their future negotiations focus on setting for each member a single target variable: the rate of growth of nominal GNP, or better yet, nominal demand. At the risk of over-glorifying what is a fairly simple and obvious proposal, I have given it a name: INT, for International Nominal Targeting.

Let me begin by noting that one cannot know what kind of coordination is desirable without first knowing the nature of the "externality" that is thought to characterize the noncooperative

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[1] There is no question that the G-7 meetings have produced specific sets of (secret) numbers for their list of indicators. The question is whether they are forecasts/goals that each member government sets independently, or whether a genuine element of bargaining goes into them. The fact that the numbers are not made public, and indeed that their secrecy is carefully guarded, suggests the possibility that there may be little genuine policy coordination going on, but that the members find it politically useful to hold meetings nevertheless; the communiques are sufficiently vague that each member can interpret them to his own advantage. If the meetings were to be true exercises in cooperative policy-setting, the targets should be announced so as to enlist public expectations on the side of attaining the targets.

("Nash") equilibrium. The INT proposal presupposes that the motivation for coordination in a given year is that the noncooperative equilibrium is either overly contractionary because of a proclivity toward "beggar thy neighbor" policies—suggesting a need for joint expansion, as under the "locomotive theory"—or overly inflationary—suggesting a need for joint discipline, as in the logic that apparently underlies the European Monetary System. The proposal is not designed to address externalities regarding the mix between monetary and fiscal policies, the level of real interest rates, or exchange rates.[2]

In my major paper for this conference, I address one proposal aimed at reducing excessive exchange rate variability, the "Tobin tax" on foreign exchange transactions. In my view, a more promising route if one wishes to try to stabilize exchange rates would be a supranational bank, sometimes called a "Hosomi Fund," which could intervene in the foreign exchange markets, without national central banks surrendering their own rights to operate in the markets. In each case—International Nominal Targeting and the Hosomi Fund—a key element of the proposal as I see it is that it could begin on a very small scale so that the members would at first be sacrificing very little policymaking sovereignty, could then build up trust and confidence in the institution slowly, and might thus progress to higher degrees of commitment and coordination if they so desired. I spell out both proposals at somewhat greater length in a paper for an NBER/IMF conference on international policy coordination.[3]

The argument for nominal GNP targeting in a closed-economy context has been made well by others. Nominal GNP targeting has the advantage that all nominal anchors do: by pre-committing to a rate of growth for some nominal magnitude, monetary authorities can reduce inflationary expectations and thus, in long-run equilibrium, attain a lower level of inflation for a given level of real output. But nominal GNP dominates the other nominal anchors that have been proposed. It is clear by now that following the monetarist prescription of setting rigid

[2] In particular, the proposal is not designed to address the major macroeconomic disequilibrium of the 1980s: the U.S. structural budget deficit and consequent trade deficit. I continue to believe that these deficits represent a unilateral failure of U.S. policymaking, rather than an international "coordination failure." Neither the INT nor any other proposals for coordination should be allowed to distract attention from the need for a U.S. fiscal correction in 1989, which exists independently of any arguments for German or Japanese expansion. Results in Frankel and Rockett (1988) show that the potential gains from international coordination are generally less than the gains from the United States discovering that it has been using the wrong model, and unilaterally adjusting its policies accordingly.

[3] See Frankel (1989). The paper also gives references to relevant work by others, such as the Miller-Williamson "blueprint." Ten proposals for world monetary reform are reviewed in Dornbusch and Frankel (1988).

targets for M1 would have been disastrous in the 1980s, because of large velocity shifts: the 1981–82 U.S. recession would have lasted another five years. Choosing the price of gold or the price of foreign exchange as the nominal anchor has analogous problems. In each case, large shifts occur in the behavioral relationships that tie the nominal magnitude in question to the economic variables that we ultimately care about, such as real output and inflation. Committing to any one of the three—money, the price of gold, or the exchange rate—as the nominal anchor would mean allowing these shifts to be transferred into undesirable changes in output and inflation. As a further consequence, strong political demands would inevitably arise for government policy to offset, for example, a large recession that resulted needlessly from such a shift, which means that the commitment would not be very credible from the beginning.

In my view, the argument for choosing nominal GNP as the target variable is even stronger in the context of international coordination than in domestic policymaking. The reason is that such an approach is the one most likely to be able to overcome the daunting obstacles to successful coordination that a number of economists have begun to point out in the last few years. Those obstacles are of three sorts: uncertainty, enforcement, and time-consistent inflation-fighting credibility.

Uncertainty is itself of three kinds: uncertainty regarding the current and future position of the economy (the "baseline"), uncertainty regarding the desirable goals (such as full employment), and uncertainty regarding the effects on the target variables of changes in those policy instruments that the policymakers directly control ("model uncertainty"). Uncertainty regarding transmission of monetary policy internationally is much worse than domestically: whereas we generally agree at least on the sign of a monetary expansion's effect on domestic output and inflation, the leading econometric models disagree completely on the sign of the effects in the international case. So Germany could respond to U.S. requests for faster money growth (on the theory that faster growth in German income will result in more imports from the United States), and yet the U.S. trade balance and output might subsequently fall rather than rise (in response to a depreciation of the mark against the dollar). I have shown (Frankel and Rockett 1988) that in the presence of such uncertainties, policy coordination as usually thought of—where policymakers bargain over money supplies and fiscal policies—can turn out to reduce economic welfare as easily as to raise it.

Enforcement of a coordination agreement can be difficult in the best of circumstances, but it is greatly complicated by the existence of uncertainty. In some years, some countries will lose by the agreement, for example because their economies turn out to be operating at a higher (or lower) level of capacity than they thought they would be when they

entered into the agreement, so that more (or less) stimulus coming from trading partners now turns out to be bad rather than good. In such years, the temptation to abrogate the agreement will be especially strong.

Cooperative setting of nominal GNP (or demand) targets on a year-by-year basis provides the best chance of overcoming these two obstacles to coordination, because it combines the necessary characteristics of a coordination plan that I mentioned at the outset. Nominal GNP constitutes a specific "performance criterion" closely enough related to the policy instruments that national monetary authorities control directly, that they can be held loosely accountable for it. At the same time, nominal GNP is closely enough related to the ultimate goals, output and the price level, that the desirability of having achieved the target will not be negated by velocity shifts or other uncertainties.

Cooperative setting of nominal GNP targets on a longer-term basis also provides the best chance of overcoming the third obstacle to successful coordination. This is the problem pointed out by Ken Rogoff (1985): if governments set up the machinery for joint policy-setting period by period, it will likely turn out to entail expansion to reduce unemployment, and thereby in the long run will undermine the governments' inflation-fighting credibility. The need for time-consistent inflation-fighting credibility points to some commitment on a global scale to a nominal anchor; just as on a national scale, nominal GNP seems the best choice to be that nominal anchor.

My specific proposal is as follows. At each G-7 meeting, the national authorities would (a) commit themselves, without any obsessive degree of firmness, to target rates of growth, or ranges, for their countries' levels of nominal demand for five years into the future, and (b) commit themselves, with somewhat greater firmness, to targets for the coming year.[4] In the first stage, that is, the early 1990s, there would be no explicit enforcement mechanism. But the targets would be publicly announced, and if a country's rate of growth of nominal demand turned out to err significantly in one direction or the other, the fact would be noted disapprovingly at the next G-7 meeting. This cannot happen under the current system. Aside from the fact that the targets for the current 11 indicators are secret, can one imagine the G-7 admonishing a member because his country's real growth rate turned out to be higher

[4] There is a reason for choosing nominal demand (defined as GNP minus the balance on goods and services) as the target variable in place of nominal GNP, even though the latter is a more familiar concept. In the event of a recession, countries need to be discouraged from the temptation to accomplish their expansion of output through net foreign demand—for example, through protectionist trade measures—as opposed to domestic demand.

than targeted? (or because its inflation rate turned out to be lower than targeted?)

I would prefer to leave to each country the specific means of attaining the nominal demand target to which it has committed itself. But perhaps a proposal for reform is obligated to be specific. In that case, my favored instrument would be monetary policy. One could follow Bennett McCallum (1988), who has suggested a specific monetary feedback rule in a closed-economy context: for each 1 percent that nominal GNP deviates from its target in a given quarter, the monetary base is expanded an additional 0.25 percent over the subsequent quarter. He suggests setting a trend growth rate in the target of 3 percent per year, and subtracting from this the average growth rate of base velocity over the preceding four years. I would accept the 3 percent trend as a target average at the five-year horizon. But the international cooperative policy-setting process would involve somewhat higher targets in some years or for some countries, and somewhat lower targets in other years or for other countries (without being allowed to degenerate into unprincipled "fine-tuning"). To constrain the target to 3 percent for all countries right from the start would doom the proposal to the same sort of political irrelevance as a return to the gold standard and all the other impractical proposals for world monetary reform that one hears.

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