The Requirements for Successful International Macroeconomic Cooperation

*Helmut Schlesinger**

To start with, the question "To coordinate or not to coordinate?" arises in light of the fact that in recent years the susceptibility of national economies to external influences has increased. For one thing, right up to the present time world trade has been growing faster than global GNP. For another—and a far swifter development—the integration of national financial markets has been making ever-greater headway. With the dismantling of controls on capital movements, the introduction of sophisticated communications techniques, and the advent of the financial innovations these techniques make possible, the mobility of capital has been greatly augmented and the "global village" has become reality. Financial news—good news and bad news, genuine news and false news—spreads today no less quickly than news did in the villages of our ancestors.

The Federal Republic of Germany has participated in a special way in this growing interdependence of the world economy. Despite its comparatively small size, my country's exports in 1987 were higher than those of the United States or Japan, although this admittedly owed something to the fact that we still regard as exports our deliveries to other countries of the European Economic Community, which one day will only be deliveries within the single internal market. At all events, economic growth in Germany hinges crucially on developments in world markets and on the competitiveness of German industry. In addition, the deutsche mark continues to be a major international reserve and investment currency. Hence, interest rate movements in the German capital market and the exchange rate of our currency reflect not

*Deputy Governor, Deutsche Bundesbank.

only domestic economic influences but also trends in international financial markets and fluctuations in the currency preferences of international investors. But even such an enormous economic area as the United States increasingly feels the effects of international interrelationships, the pressure of foreign competition on domestic and foreign markets, the impact of exchange rate changes on global competitive conditions, and their repercussions on national financial markets.

The high degree of interdependence of the goods and financial markets throughout the world causes disturbances on specific markets to spread very quickly to other countries. The oil price shocks, the overshooting of the dollar rate in one direction or the other, the debt problems facing many developing countries, and the stock market crash in the fall of 1987 are examples of how strong global interdependence has become. The same is true of national economic policy measures. When making their decisions, economic policymakers must make allowance for influences from abroad and the effects of measures taken abroad. They also ought to pay regard to the repercussions of their own actions on partner countries. They are not obliged to do so, and they often fail to do so. But such "lone wolf" approaches to economic policy are apt to come up against limits—the more so, the smaller the country. "Le cavalier seul" is a common French expression for a lone ranger. But many "lone ranger" expeditions have become proverbial for the early end they have met.

In view of the clear loss of autonomy by national economic policy, the calls for closer international cooperation are perfectly understandable. For example, if—as at the moment—external disequilibria are difficult to remedy by means of isolated measures because of possible adverse "spillover effects," international accords are an obvious step to take. Without any doubt, some of the arguments adduced in the literature in favor of international cooperation are quite convincing at first sight. What has been referred to as the "theater syndrome"—an attempt by some of the audience to improve their view by standing up—implies in the end, when all are standing up, that all are worse off. This strengthens the expectation that a cooperative approach is preferable to a "non-cooperative equilibrium." In particular, international cooperation is expected to bring about greater consistency in the objectives and measures of economic policy in individual countries, so that self-generated disruptions of the world economy can be avoided. By stabilizing expectations, it is claimed, international cooperation would provide a "public good," with the aid of which the unavoidable swings in economic activity could be diminished in scale or shortened in duration.

On closer inspection, however, the advantages of coordination are by no means so unmistakable. They are difficult to demonstrate empirically. Rather like Stanley Fischer, Horne and Masson (1988) conclude in an IMF staff paper that the gains deriving from cooperation are fairly small: "Although the theoretical case in favor of policy coordination may be strong, there are real-world problems that may limit its practical possibilities (p. 284)." It appears that the success of a cooperative strategy depends on a number of conditions that are not necessarily fulfilled in economic reality:

- First, the economic policymakers must have clear and consistent ideas about the transmission mechanisms of their decisions. Jeffrey Frankel has just pointed out that cooperation may even lead to worse results than isolated national action if the cooperation process is based on a misspecified macroeconomic model or the participants hold differing views. Let us suppose, for instance, that one country believes that changes in its national interest rate level have no effect on the exchange rates of its national currency, while its partner countries are convinced that these changes are operating in the wrong direction. How can cooperation be possible in such a case?
- Second, all parties to the cooperative process will therefore be required to keep to the "rules of the game," and in the same way. The question that arises in this context concerns the sanctions to be imposed if a country deviates—no matter for what reasons—from the internationally agreed economic policy stance. "Peer pressure" or "reputational considerations" are conceivable, but can be applied only within limits. A country's feeling of sovereignty must not be disregarded. Nor may the impression be given that adjustment burdens are being passed on to others by means of the coordination. This applies not least to the one "big shot" in the boat and its attitude with respect to all the other lesser lights.
- Third, the joint economic policy objectives must actually be attainable using the available economic policy instruments. Besides the final targets (price stability and economic growth), intermediate targets—such as the stabilization of (real) exchange rates—may be helpful in the short run. But if the cooperative approach is spelled out in overmuch detail, there is a danger that attainability by means of economic policy measures might be overrated.

In the light of such uncertainties regarding international cooperation, it is not surprising that quite recently a number of skeptics have been raising their voices more loudly and warning against illusions about the possibilities inherent in cooperation. As you will know, Martin Feldstein goes so far as to recommend the United States bid a fond farewell to the strategy of international coordination of macroeconomic policy. Without any doubt, coordination cannot be a substitute for necessary economic policy action at home. Even so, in my view there is no alternative to it, if a further disintegration of the world economy is to be prevented. James Tobin expressed himself very clearly on this point in a recent essay (1988, p. 77):

> Coordination of macroeconomic policy is certainly not easy; maybe it is impossible. But, in its absence, I suspect nationalistic solutions will be sought: trade barriers, capital controls, and dual exchange rate systems. Wars among nations with those weapons are likely to be mutually destructive. Eventually, they too would evoke agitation for international coordination.

The most important thing seems to me to be that the concrete blueprint of international cooperation not be overburdened with unrealistic expectations. A danger exists that responsible policymakers may overestimate their own possibilities and underestimate or even disregard obvious economic relationships. Let me enumerate a few basic principles that appear to me to be essential in the cooperation process (without wishing to make any claim to completeness):

- First, international cooperation should be confined to a broad adjustment of economic policies, the detailed implementation of which should remain the responsibility of the respective countries. Attempts at "fine-tuning" already founder frequently at the national level; in an international context the problems would be exacerbated. Correspondingly, historical experience of international overall control of economic policy is not particularly encouraging. The economic summit meeting in Bonn in 1978 may serve as one unfavourable example of this.
- Second, the international coordination of economic policies is likely to promise particular success when unmistakable disequilibria are to be rectified. For one thing, a coincidence of national interests and global economic requirements can no doubt be achieved relatively easily in such circumstances. For another, the necessary economic policy actions are easier to identify, despite the above-mentioned uncertainties with respect to the model. We may take as an example the Plaza Agreement of 1985, when all those concerned agreed that the envisaged measures were in everybody's interest.

  This should not be taken to imply that efforts at economic policy coordination only make sense when "the cat is already among the pigeons." However, permanent macroeconomic coordination extending beyond special occasions would, in the long run, impose too great a strain on the cooperation process. Signs of "wear and tear" and a loss of credibility might be the consequences. "In normal circumstances"—that is, given a reasonable degree of economic convergence—mutual information and consultation in the context of a "multilateral surveillance" procedure should suffice, without any formal coordination of concrete economic policy measures being necessary. Under these conditions, allegiance to a definite policy stance is not to be recommended, if only because national interests not infrequently diverge. It is, however, an illusion to believe that, for the sake of cooperation, a country would act for any length of time contrary to its own best interests. In Europe, and more precisely within the European Economic Community, we have had enough experience that goes to show that a determination to act in concert must not be overstrained.

- Third, an envisaged closer coordination of economic policy must not be confined to monetary policy but must be extended to include the other economic policy areas as well. It is true that fiscal and structural policy are comparatively inflexible (not least because they affect firmly entrenched interests and require protracted parliamentary deliberations), yet an unsatisfactory policy mix and structural distortions are often the cause of economic disequilibria. As it is, monetary policy is often overburdened when it is expected, on its own, to stabilize exchange rates, keep inflation rates low, and maximize the rate of economic growth. It may easily happen here that economically inconsistent objectives are set, and their achievement perhaps even promised by politicians, even though in this combination they are not attainable at all.
- Fourth, mechanistic rules and automatically operating economic policy mechanisms should be avoided in the cooperation process. So-called "objective indicators," which are the focus of so much attention today, are no doubt a necessary instrument of analysis, but no unambiguous instructions for action can be derived from them. "Target zones" with their obligatory interventions may considerable impede a stability-oriented monetary policy without actually stabilizing exchange rate expectations in the final analysis. In this context, I do not intend to be unfair to various authors who understand "target zones" to mean wide margins of fluctuation for exchange rates and who envisage an adjustment of these margins to inflation differentials, that is, in principle are thinking of stable real exchange rates. Politically, such shifts in the exchange band, especially when the top or bottom end of the band has already been reached, arouse strong resistance; this fact is borne out by experience of the regionally limited exchange rate system of the European Monetary System (EMS).

National economic policy must remain sufficiently flexible. It is unrealistic to suggest that in democratically governed countries economic policy decisions should be taken as soon as particular indicators point to certain maladjustments. Decisions will always depend on a comprehensive general appraisal of the prevailing economic conditions and an overall consensus on the necessary measures, particularly in the field of fiscal policy.

- Fifth, economic policy cooperation should be underpinned by market mechanisms. Under a free market system, coordination is effected primarily through market processes, that is, above all through price adjustments. Thus, not only the prices of goods but also those of capital (interest rates) or of currencies (exchange rates) must be able to respond adequately to changed scarcity conditions. Furthermore, in the event of adjustable exchange rates, the problem of asymmetry in economic policy adjustment, which is so often deplored today, would be largely defused. While, under conditions of fixed exchange rates, most deficit countries are induced to adopt unilateral economic policy measures relatively quickly, owing to their losses of reserves, under a regime of floating exchange rates the surplus countries likewise bear part of the real adjustment burden, owing to the deterioration of their international competitiveness caused by the appreciation of their currencies.

Relative to the expectations, which are sometimes set fairly high, the framework outlined here for the international coordination of economic policy admittedly appears to be rather more modest. Even so, cooperation among the major industrial countries remains very important; it has now developed into an integral part of the world economic system. The Deutsche Bundesbank, too, has always played its part in international cooperation (and the experience gained in the process has been incorporated into the five points raised above). The Bundesbank has endorsed the various accords reached by the Group of Seven, from the Plaza to Louvre II, and has participated time and again in the concerted efforts to stabilize exchange rates, right up to the present. Within Europe, cooperation among the central banks is particularly close on account of the regulations governing the EMS. The Bundesbank has belonged to this narrower margins arrangement from the very beginning in 1973, doing so without any break at all, which can be said of only three other central banks. Moreover, we, the Bundesbank, have so far made the largest active financial contributions—ones resulting from our commitments and ones going beyond that level. (I say this because the impression has arisen among the public at large that we are the chief brakemen on monetary policy developments in Europe.)

However, I do believe that national policy objectives are not in all cases suitable as objects for exchanging in the international cooperation process. Slightly less monetary stability, for example, would promote neither economic growth nor exchange rate stability. The declarations of the global economic summits therefore rightly state that the supreme goal is "non-inflationary growth"—a form of words that is interesting, because some participants nevertheless continue to speak of growth with low inflation rates. International cooperation can do a great deal to ensure that these "correct" words are followed by matching policy actions, although the degree and depth of the coordination of the individual national economic policies must be kept in line with the prevailing circumstances. To sum up, I should like to associate myself with the conclusions that Norman Fieleke recently reached in an article on "Policy Coordination" (pp. 34–35):

> Coordination is not an absolute good or bad or even a matter of principle; it is a method to be chosen or rejected depending on the circumstances. . . . The issue is not one of decentralized isolation versus full coordination at all times, but of adaptation to the situation. . . . At a minimum, governments should share current information on policy measures, and all may profit from frequent discussion and debate in the various international forums.

References

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