Commentary on 'International Dimensions of Monetary Policy: Coordination Versus Autonomy'

Robert Solomon

The paper of Frenkel, Goldstein, and Masson (FGM) addresses the key policy problems that confront the industrial countries as they enter the last decade of the twentieth century.

Out of their experience as theorists, analysts, and policy advisers, the three authors offer a number of judgments about the management of policy instruments among countries with varying degrees of mutual interdependence.

I find myself in whole-hearted agreement with most of the judgments that are put forth in the paper. I shall, therefore, confine my comments mainly to one topic, among the many that are covered, on which I differ with the authors. That is the role of fiscal policy in macroeconomic management and, therefore, also in policy coordination.

I shall not discuss what FGM have to say about exchange rate guidelines in the plausible belief that John Williamson will focus on that subject.

Underlying the paper's judgments about policy strategies and policy instruments is the authors' rejection of three so-called corner solutions. They provide persuasive arguments against the independent pursuit of policy objectives as advocated by Feldstein (1988) and others who oppose policy coordination. FGM point out, correctly, that policy coordination is not at all inconsistent with the pursuit by countries of "their own best interests."

The second comer solution that the authors reject is a regime of fixed (and even adjustable) exchange rates à la Bretton Woods, the

EMS, or target zones. Among the reasons is that such a regime would divert monetary policy from its primary role of promoting "internal. balance" (the term that has come down to us from James Meade meaning adequate growth with relatively stable prices).

The third comer solution is "sand in the wheels" of capital mobility as advocated by Tobin (1978) and others—that is, restrictions of one sort or another on international capital flows.

While opposing a return to Bretton Woods, FGM would not leave exchange rates and current account positions solely to determination by market forces. Although they believe that monetary policy should be aimed at internal balance in general and price stability in particular, they see the need for some exchange rate management.' This is so because exchange rates can misbehave. Speculative bubbles can occur. So can misalignments. When large differences exist between market exchange rates and the "consensus official view of the equilibrium rate," FGM advocate coordinated adjustments of monetary policies. Thus they would, at such times, divert monetary policy from its domestic goals.

This leads them to consider policy instruments that could complement monetary policy. With two objectives—internal balance and some management of exchange rates—two instruments are also needed.

Regarding sterilized intervention in foreign exchange markets, they arrive at the sensible mainstream view that it is not powerful enough to be a full-fledged second instrument, but it can be helpful at times, especially if it is carried out in a "concerted, coordinated way."

The discussion of fiscal policy is, in my opinion, the least satisfactory part of the paper, for the following reasons.

First, FGM observe that fiscal policy is less flexible than monetary policy. True; the dials on fiscal policy can be reset less frequently than those on monetary policy. But what matters is not the flexibility of instrument setting but the flexibility of impact on target variables. After all, some well-known monetary theorists insist that monetary policy acts with a lag of one and one-half to two years. The lags of fiscal policy's impact could be shorter.

Second, the point is not to compare fiscal policy with monetary policy but to ascertain whether fiscal policy can be used as a second instrument to complement monetary policy—either to help maintain internal balance when monetary policy is aimed at the exchange rate or to act on the external balance while monetary policy deals with internal balance..

Third, instead of judging fiscal pqlicy in this way, FGM put forward the normative proposition that fiscal policy should be "guided by considerations of long-term efficiency, resource allocation, income distribution, and economic growth rather than by short-term considerations of demand management and fine tuning." They take this position, in part, because they are concerned about the widespread increase in the ratio of debt to GDP in the industrial countries.

I would argue that fiscal policy can be used as an instrument of demand management while fiscal discipline is respected over time. In principle, it can be flexed around any desired average level of fiscal restraint.

FGM also characterize fiscal policy as a "more disaggregated instrument" than monetary policy. Since either taxes or expenditures can be altered, choices exist among types of expenditures and tax rates and so on. Why is this a disadvantage? Once again, the relevant comparison is not with monetary policy. The question is, is fiscal policy usable as a second instrument?

My view is that we should not allow a decade's misuse of fiscal policy—primarily by the United States, but also by some other industrial countries earlier in the 1980s—to give that policy a bad name.

Let me sum up in four propositions:

1. Nations need to use their macroeconomic policies in a coordinated way in order to maintain adequate growth and stable prices.

2. Nations also need to influence exchange rates at times. Thus they require at least two policy instruments.

3. At present, there is only one active policy instrument—namely, monetary policy.

4. It is desirable, therefore, that fiscal policy become usable for demand management purposes.

Since everything is up-to-date in Kansas City, perhaps our hosts would like to sponsor a symposium on how to reform and improve fiscal policy.

I am old enough to recall the period in the 1950s when we recognized the postwar "revival of monetary policy." As a title for the Kansas City Fed's symposium, I would suggest "The Revival of Fiscal Policy."

References

Feldstein, Martin. "Distinguished Lecture on Economics in Government: Thinking About International Economic Coordination," *Journal of* Economic Perspectives, vol. 2, Spring 1988, pp. 11-43.

Tobin, James. "A Proposal for International Monetary Reform," *Eastern* Economic *Journal*, vol. 4, July/October 1978, pp. 153-9.