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

John Williamson

I find the debate in which we are engaged today, which concerns how to organize the G-7 process of policy coordination in the short run, and possibly also, how to institutionalize an international monetary system in the long run, a productive one. I believe it is proving more productive than "fixed versus floating exchange rates" or "monetary versus orthodox theories of the balance of payments," in large part, because the parties are less entrenched in positions encrusted by ideological baggage and more willing to learn, to adapt, and to converge. At least, I believe that to be true of myself, and I find encouraging evidence in this paper that it is also true of Frenkel, Goldstein, and Masson.

Let me start by listing a number of topics on which I endorse the positions espoused in the paper.

Agreed propositions

(1) The proposition that the choice between policy coordination and autonomy should be made on the basis of which can yield the best results, rather than treating either as a priori desirable. I agree with their judgment that, on that criterion, coordination is worth pursuing.

(2) The thesis that the choice between coordination and autonomy is distinct from that between rules and discretion.

(3) Rejection of both the proposition that current imbalances should always and everywhere be eliminated, and the proposition that cur-

rent imbalances are a matter of no consequence.

(4) The lost faith in the belief that speculation can be relied on to be stabilizing. The corollary of this is that the authorities have a duty to develop their independent evaluation of equilibrium real exchange rates; I detect encouraging convergence on this issue.

(5) Rejection of what the authors term "three flawed comer solutions."

(6) The argument that the large margin of error inherent in calculations of equilibrium exchange rates implies a need for wide bands.

(7) The argument that, whilk a commodity price basket may be a useful early warning signal, it should not be a target.

(8) The proposition that the multi-polar world of the future will require a nominal anchor provided collectively by the majbr three (?) countries in the system. (I note, however, that the authors do not yet seem to have any very specific vision of the form that this collective provision might take. They neither endorse nor criticize the "blueprint" proposal to use collective monetary policy to pursue a collective target for the growth of nominal demand [Williamson and Miller 1987], nor do they offer an alternative mechanism for implementing the principle they endorse.)

(9) The proposition that exchange rate commitments should be looser among the G-3 than, for example, within Europe, where many smaller countries may find a relatively rigid exchange rate peg a useful way of linking themselves to the system.

That is a lot of agreement. In contrast, I can find only two hard propositions with which I disagree.

Announcement of the band

The first is that exchange rate bands among the G-3 should be not only wide but also "quiet," that is, kept secret from the public. To support this preference they argue that speculative excesses and serious misalignments are probably the exception rather than the rule; they express the hope that improved macro policy might influence speculative behavior favorably; and they seem to believe that announcements are terribly costly. The latter belief is not stated explicitly but has to be inferred from their analogy to a sprinkler system that is left permanently on. If they really believe announcement to be costly, they owe it to us to explain the nature of those costs rather than to take refuge in analogy. Likewise, one can hope that improved macro policy will improve speculative behavior, but it would be unwise to rely on it. Bubbles and fads are, after all, deviations from the rate justified by the fundamentals, so it is not clear that better fundamentals should be expected to resolve the problem.

I agree that speculative excesses and serious misalignments are probably the exception rather than the rule (although the rise of the dollar in 1989 suggests they are not all that exceptional). I also agree that intervention and changes in monetary policy should be contingent responses to large differences "between the market rate and the consensus official view of the equilibrium rate consistent with fundamentals." But keeping the band secret prevents it from filling two vital roles:

(1) creating Krugman's "bias in the band" which helps to minimize the contingencies which will call for intervention and changes in monetary policy (Krugman 1987) and

(2) improving public policy debate along the lines sought by the U.S. Congress when it included the exchange rate reporting provisions in the Omnibus Trade Act, a quest so far thwarted by the Treasury's obsession with secrecy.

Monetary policy and price stability

My second disagreement with Frenkel and the others concerns their proposition that monetary policy should be focused on achieving price stability. I realize that challenging this proposition in an audience containing many central bankers exposes me to the danger of being misinterpreted as the sort of clown who would tell the Pope that he should not pray, so let me quickly affirm that my disagreement does not stem from any lack of fidelity to the god of price stability. Rather, I wish to argue that price stability should be pursued by macroeconomic policy in total, rather than just by monetary policy.

The trouble is, that if one argues that the monetary authority should concern itself only with price stability, one invites the fiscal authority to adopt a strategy of concerning itself only with real growth, the other half of the assignment urged by Mundell (1971) in his infamous article on the policy mix. If the Mundellian assignment is implemented in a non-Mundellian world where both monetary and fiscal policy influence nominal income which, in turn, determines both output and (the change in) inflation almost regardless of the monetary-fiscal mix that produced that income level, the resulting outcome is entirely predictable: high real interest rates and the rising debt/GNP ratios shown in Table 2 (and rightly deplored by Frenkel-Goldstein-Masson).

I accept that there is a second-best political economy argument for telling central bankers that their prime responsibility is to secure price stability, since otherwise, there may be no counterweight to the Darmans of this world. But in designing guidelines for the G-7, let alone principles on which to base a restored international monetary system, we should not settle for second best. And there is absolutely no doubt that it is possible to expect better macroeconomic outcomes if one can use both the expansionary thrust of fiscal-monetary policy to manage the level of nominal demand and the fiscal-monetary mix to manage, when needed to counter misalignments, the exchange rate. Frenkel and the others acknowledge as much in a footnote. It is much to be regretted that their criticism of the notion of assignment is marred by their endorsement of a rigid assignment of monetary policy to price stability alone.

Assignment

Ironically, on several occasions Frenkel-Goldstein-Masson complain about the assignment in the Williamson and Miller (1987) "blueprint." I am beginning to think that we may have made a tactical error in describing our proposals that way, since that language seems to have spawned a number of misconceptions. I increasingly suspect that many of our differences are cosmetic rather than substantive.

The reason for choosing the language of assignment to describe a part of our proposals was to emphasize the truth of the argument developed by Robert Solomon in his comment on the Frenkel-Goldstein-Masson paper. Specifically, once one has agreed that there are limits to the exchange rate misalignments that policy should tolerate, there is no option but to be willing to change interest rate differentials in order to manage exchange rates, since unsterilized intervention is the one policy instrument that can be relied on to work. (Frenkel and the others acknowledge this explicitly, and seem willing to go along with the implications, even though they clearly hope that the occasion to resort to exchange rate oriented monetary policy will arise only rarely.) And once one has agreed that monetary policy may have to be used to manage the exchange rate, one has to face the possible need for a second instrument to achieve an intermediate target for the growth in nominal domestic demand. Fiscal policy fits the bill. So we summarized a part of our proposals as assigning interest differentials to achieving exchange rate targets and fiscal policy to achieving the target growth rate of domestic demand.

As noted above, however, our presentation seems to have nurtured a whole range of misconceptions. Let me spell these out.

(1) One misconception is that the blueprint assigns monetary policy to external balance and fiscal policy to internal balance. This is just not so. We summarized our proposals as assigning international differences in monetary policy to an intermediate target, the exchange rate, and fiscal policy to another intermediate target, the growth of nominal domestic demand. Thus the Frenkel-Goldstein-Masson summary misrepresents our summary in two crucial respects. First, it fails to note that at the world level, monetary policy is assigned as they would wish, to the control of a relevant nominal magnitude; it is only international differences in monetary policy that are assigned to exchange rate management. Second, we did not assign the two policy instruments.to the two objectives of internal and external balance, but to the two intermediate targets of exchange rates and demand growth; those two intermediate targets are, of course, calibrated to pursue internal balance (continuously) and external balance (in the medium run), but to omit mentioning the intermediate targets obscures the essential logic of the proposal, which is to limit random deviations of exchange rates from the level appropriate to medium-run needs.

(2) Another misconception is that the blueprint implies treating all incipient changes in payment imbalances the same way, as "bad." Not so. The derivation of current balance targets is indeed an imprecise science, but it rests on the same factors that Frenkel and the others consider in discussing whether or not a shock (such as an investment boom) should be financed or adjusted. If an investment boom is big enough to be discernible to the authorities, they can argue with their G-7 peers that this creates a need to appreciate the exchange rate target and allow a correspondingly larger expansion of domestic demand. And if it is not big enough to be discernible to the authorities or convincing to their peers, then the appreciation

needed for the deficit to be financed rather than adjusted away can surely be accommodated within the band.

(3) A third misconception—for which, however, I fear Marcus Miller and I must bear some responsibility, since we omitted the implications of the wide band from our summary of the assignment—is that the blueprint leaves little scope for monetary policy to contribute to the management of domestic demand. In fact, if badly behaved foreign exchange markets are the exception rather than the rule, a country in a cyclically typical situation will normally'be able to use monetary policy for that purpose. And even countries out of line with the world conjuncture will normally be able to get substantial domestic leverage by allowing their exchange rates to leave the center of the band. (Perhaps recognition of this under-emphasized feature of the blueprint will make it more palatable to Frenkel and the others?)

(4) A fourth misconception apparently provoked by our casting the blueprint in terms of assignment is that the whole proposal is heavily dependent on frequent changes in tax rates. My own view is that, under normal circumstances, it will be quite sufficient if the annual budgetary process pays proper attention to the budget's implications for aggregate demand as well as to the allocative and distributive objectives that provide the rationale for having a budget at all. I cannot understand the objections to fiscal flexibility of Frenkel-Goldstein-Masson. In what way is long-run efficiency compromised by ensuring that the cyclically-adjusted deficit is appropriate to the state of the cycle? Why does it matter that the impact of a fiscal change depends on the form of that change? And why do the "delays and difficulties associated with correcting the large U.S. federal budget deficit undercut the case[3]'—rather than underscore the need—"for greater flexibility of fiscal policy?"

On reflection, I have decided that the guideline for fiscal policy embodied in the blueprint cbuld be materially improved by incorporating as a medium-run rule the fiscal thrust of the "reverse assignment." That is, each country would be asked to identify the medium-run fiscal stance compatible with its current account target, a sustainable debt position, and a normal real interest rate. It would then choose a medium-run (say, five-year) path for adjusting its fiscal deficit toward the target position. Deviations from that target path might then be allowed in the interest of stabilizing demand. One hopes this reformulation will help the process of convergence.

Conclusion

This paper contains many constructive propositions about how to organize macroeconomic policy coordination among the industrial countries. Perhaps its principal defect is that the authors are too timid; they allow their analysis to be unduly constrained by the positions that the G-7 authorities are presently prepared to endorse. In seeking ways to urge these governments forward toward more effective policy coordination, I would suggest that they think less about assignment and more about the choice of intermediate targets.

References

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