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II Monetary and Fiscal Policy Coordination

International capital mobility first became a serious problem for macroeconomic policy making in the mid-1960s, with the emergence of the Eurodollar market in London. Governments tried to reduce capital flows that threatened fixed exchange rates and macroeconomic policy making autonomy by tightening capital controls, but by the early 1970s it was apparent that this strategy could not succeed without controls so strict that they would interfere with desirable trade financing and foreign direct investment. Instead, most governments chose to let their exchange rates fluctuate, hoping that flexible exchange rates would adjust gradually to accommodate differences in macroeconomic policies in different countries. This faith in the automatic equilibrating tendencies of private markets underestimated how volatile flexible exchange rates would be in the new context of open capital markets. The 1970s therefore were characterized by severe exchange rate volatility and substantial international payments imbalances, as well as slow growth and rising unemployment in many ACCs.

Macroeconomic policy coordination as a response to these problems first became an important issue at the G7 level in the late 1970s, when the US persuaded Germany and Japan to reflate their economies as part of the "locomotive strategy" for pulling the world economy out of the stagflation caused by the OPEC oil shock (the key deal was reached at the Bonn Summit of 1978). Policy coordination lapsed in the early 1980s as the US and other conservative G7 governments focused on fighting inflation. But Reaganomics (tight monetary policy combined with huge budget deficits created by military spending and tax cuts) generated huge imbalances, most notably an overvalued dollar and a growing US trade deficit. Consequently, in 1985 the US joined with other G5 countries in coordinated intervention (announced in the September 1985 Plaza Accord) to bring the dollar down. By 1987 the US had persuaded the reluctant Japanese and German governments to reflate in return for American commitments to reduce its budget deficit and to cooperate in stabilizing currencies. The key bargain was struck in the Louvre accord of February 1987, though it was not until the October 1987 stock market crash that coordinated reflation began in earnest. But Japanese and West German reflation had the perverse impact of making it easier for the United States to avoid serious efforts to reduce its budget deficit.¹¹

Capital continued to become more mobile during the 1980s, as private international market linkages flourished and official barriers between the financial capital markets of the industrialized countries were largely eliminated. Foreign exchange markets experienced spectacular growth, to the point that daily foreign exchange trading (estimated at \$1.49 trillion in April 1998) now greatly exceeds the combined foreign exchange reserves of the industrialized countries (approximately \$770 billion in April 1998).¹² These markets impose stricter constraints on national policy-making autonomy than those imposed by the Bretton Woods system's fixed exchange rate rules, and they have been extremely unstable.

International macroeconomic problems in the 1990s have stimulated discussion of two broad alternatives. The first would bring government policies more into conformity with market preferences, while the second favours active macroeconomic policy coordination to address world

economic problems. The G7 moved clearly in the first of these directions in the 1990s. The rhetorical tide turned strongly against discretionary macroeconomic management. G7 communiqués rejected counter-cyclical Keynesian demand management in favour of price stability and reducing budget deficits. Central bankers meeting at the G7 reinforced each others' determination to keep interest rates up to prevent the emergence of inflationary pressures, while finance ministers encouraged their counterparts' efforts to cut spending and shrink deficits. As discussed earlier, ideological convergence was accompanied by actual convergence of monetary and fiscal policies. Inflation rates fell sharply, and fiscal deficits shrank even in the face of lingering recession and high unemployment in most G7 countries.

Nevertheless, orthodox rhetoric and international market constraints did not prevent the G7 from occasionally attempting to coordinate macroeconomic policies. In particular, American efforts in the G7 made Japanese policy less restrictive in the early 1990s, though not enough so to avoid prolonged stagnation or to meet American demands. The German government rejected similar American calls for lower interest rates (high post-reunification interest rates were slowing European and world growth), both because it put a higher priority on containing inflation and because it no longer trusted Washington to fulfill any commitments it might make.¹³ G7 leaders could not avoid the issues of slow growth and high unemployment at their summit meetings in the 1990s, since unemployment was near historical highs in most G7 countries. In response to calls for a coordinated G7 growth strategy to combat these problems, the 1993 Tokyo Summit initiated a series of special ministerial meetings on the subject. The G7 finance ministers explicitly rejected a Keynesian macroeconomic response to these problems. Macroeconomic policy, they argued, should emphasize price stability and fiscal consolidation. High unemployment should be addressed by deregulation to make labour markets more flexible.¹⁴

Despite the consistent rejection of the idea of coordinated macroeconomic stimulus, global demand stimulus was in fact generated by the US. The US economy grew faster than its G7 counterparts in part because the US Federal Reserve was more tolerant of inflation, and kept interest rates low even when growth was strong. Rapid US growth generated strong demand for imports which helped offset the global deflationary impact of Japanese recession and Bundesbank-led deflation in continental Europe. Americans had become "the consumers of last resort in a world of excess savings".¹⁵ But the US will probably become less able to perform this role in the future. Foreign investors have been willing to keep lending to US in part because of recession in Japan and other East Asian countries, but these economies will eventually recover. The US ability to borrow at low cost from abroad has also depended on the US dollar's status as the key world currency, but the creation of the Euro may reduce the attractiveness of US dollar holdings for both central banks and private investors. If the Euro gains acceptance as an alternative reserve and transactions currency, the ability of the US to benefit from the international seigniorage effect of providing key global currency will sharply diminish, and the world economy may find itself awash in surplus dollars. If this occurs, the US will no longer be able to serve as the driving force for world economic growth. If other G7 countries (especially in Europe) persist with their current deflationary approaches, global deflation will become a real possibility.

The international financial crises of 1997-98 forced a reluctant G7 to consider more seriously the option of coordinated reflation to avoid a global recession, discourage EMEs from tightening controls on international capital flows, and contain a crisis that threatened the stability of western financial institutions. The US relaxed its own monetary policy (despite rapid domestic economic growth) out of concern that higher US rates would worsen Asian economic problems, and called for coordinated interest rate cuts and fiscal stimulus by the G7. The Japanese government did move slowly to introduce fiscal stimulus (having already cut interest rates to near zero), but the Bundesbank in Germany rejected the idea of monetary stimulus. The Bundesbank's President declared that with domestic demand reviving, there was no reason for Europe to lower interest rates just to help troubled EMEs. Many European financial leaders shared this view, taking great satisfaction from the fact that the imminent introduction of the single currency seemed to have sheltered EU financial markets from global turmoil (though the Bundesbank did lead a coordinated round of modest interest rate reductions in December 1998, just prior to the introduction of the single currency). Thus, the G7 was unable to adopt any coordinated macroeconomic policy measures at meetings in September-October 1998, at the height of international concern.

Overall, there has been little active macroeconomic policy coordination among the G7 countries in the 1990s. The G7 and conservative commentators have argued that there is no alternative to orthodox policies, pointing to the stagflation of the 1970s as evidence of the unworkability of traditional monetary and fiscal tools for stimulating growth and employment. International market constraints are undoubtedly tighter than in earlier periods; nevertheless, the global stimulative impact of US macroeconomic policy choices shows that demand stimulus can still be effective. Constant invocations of international market pressures are part of a strategy to persuade publics of the inevitability of macroeconomic austerity, not a description of objective reality. Political dynamics are the key to the weaknesses of G7 action. Effective policy coordination in a context of capital mobility must involve monetary and fiscal policies, yet these have always been among the most difficult policies to coordinate internationally. Taxing, spending, and control of the money supply have long been thought of as core elements of national sovereignty. Different national preferences also pose a substantial obstacle to policy coordination. Recent finance ministers' communiques often paper over unresolved differences in policy priorities by repeating "the three-word formula 'sustained non-inflationary growth'. 'Sustained' is the code word for Japanese resistance to further stimulus to reduce Japan's current account surpluses; 'non-inflationary' is the code word for German resistance to cutting interest rates; and 'growth' is the objective pushed by the Americans".¹⁶

Macroeconomic policy coordination was also blocked by the domestic paralysis of fiscal policy in the three leading countries. Budget battles between Congress and the administration impeded deficit reduction and blocked the implementation of American commitments regarding *fiscal restraint before the mid 1990s, making foreign governments (especially Germany) unwilling to coordinate policies with the United States*. The pressure of reunification-induced deficits and the Maastricht criteria undermined fiscal flexibility in Germany, while weak political leadership and bureaucratic opposition to deficit spending impeded fiscal policy adjustments in Japan. Active

monetary policy coordination was impeded by the growing consensus in favour of price stability as the only target for monetary policy, and by the determination of many central banks to assert their independence from political authorities. The Bundesbank's stand on these issues was particularly strong as it tried to ensure that the introduction of a single currency in Europe was not accompanied by any reduction in anti-inflationary zeal. The weakness of G7 policy coordination also reflects the preoccupation of Germany, France, and Italy with monetary, fiscal, and exchange rate coordination within the EU.

Limited active policy coordination in the 1990s does not mean that the G7 is incapable of addressing international macroeconomic adjustment problems. During the 1980s, the G7 proved much more effective at responding to crises than at coordinating international macroeconomic adjustment policies to prevent crises from emerging, because crises posed the potential losses from non-coordination in a particularly stark fashion.¹⁷ Coordinated monetary relaxation in response to the October 1987 stock market crash is an example of this type of policy coordination. During the 1990s, the G7 countries have not yet faced crises in their relations with each other that are of the same magnitude as those faced in the 1980s, and this helps to account for the lesser extent of active macroeconomic policy coordination in the 1990s. The slow growth and high unemployment that have plagued most G7 countries in the 1990s are common national problems, not primarily international payments problems. The key international macroeconomic adjustment problem of the 1980s — Reaganomics and the US budget and trade deficits — *diminished in the 1990s as budget measures and strong economic growth eliminated the budget deficit*. Japan's economic slowdown in 1998, in the broader context of an East Asian financial crisis, has the potential to trigger serious problems within the G7, but at the time of writing neither the US nor the European G7 countries have been seriously affected by the East Asian slowdown. Consequently, none has seen a need to alter its own monetary and fiscal policies to assist Japan.¹⁸ If the problems do spread, past history suggests that policy coordination is a likely response.