

The Coordination of Stabilization Policies Among Countries

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What is Coordination?

Is it really necessary for countries to "coordinate" or "harmonize" their stabilization policies? This rather fundamental question is of interest since there is not too much evidence that countries *actually* coordinate their policies.

What do we mean by "coordination"? Country A may simply adapt or adjust to the policies of Country B, doing whatever it wishes to do from its own point of view. But this is *adaptation* or *adjustment*, not coordination. Alternatively, in choosing its policies Country A may take into account the effects *on* Country B of its (A's) policies. And similarly, Country B may take into account the effects of its policies on A. They bear in mind the effects on each other of their policies *not* because of indirect repercussions through multipliers, and so on, but because they have struck a bargain that each take into account the other's interests. This could more reasonably be described as *coordination*.

A Simple Argument: Coordination not Necessary

It can be argued that if countries make adequate use of the policy instruments available to them, there is no need for coordination of stabilization policies among countries. This argument hinges on a number of assumptions which will be removed below. But it seems useful first to state it quite baldly. For this argument one must define stabilization as being concerned with demand management: a government's stabilization policy aims to keep the country on the optimal point (however defined) of some sort of Phillips curve, or at least to avoid substantial departures from this point.

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The simple argument is as follows. No country need have more unemployment or more underutilized capacity than it wants to, bearing in mind its Phillips curve constraints and trade-off. If Country B deflates and in the first instance, this reduces demand for Country A's products, Country A can use its own fiscal or monetary policy to compensate for the fall in foreign demand. If Country A's import prices rise, and if its elasticity of demand for imports is less than unity, so that demand for its own goods would fall in the first instance (with a constant level of money expenditures), again fiscal or monetary expansion can compensate. The point is obvious. Exchange rate alterations would deal with the balance-of-payments consequences of Country A's stabilization policies.

Similarly, no country need have more price inflation than it wants to, bearing in mind its Phillips curve trade-off. A country can insulate its traded-good price-level from world price inflation by appreciating its currency appropriately. The prices of non-traded goods can be regulated by the level of demand (bearing in mind the Phillips curve again). If incomes expand owing to an improvement in export prices or capital inflow, hence increasing demand for non-traded goods, this can be offset by appropriate deflationary policy.

One can thus imagine countries reacting continually, and atomistically, to events from outside them, including the consequences of other countries' stabilization policies. And if their policies are intelligent and speedy, they will achieve whatever stabilization they wish to achieve given their various *internal* constraints (such as the Phillips curve).

Let us now qualify this approach, to see what case there is for deliberate coordination. Some of the qualifications, especially the first, are no doubt very obvious.

First Qualification: Information and Policy Lags

It takes time to make policy adjustments. Country A needs warning of what B is going to do, and vice versa.

Two things follow. Firstly, there has to be exchange of information about economic trends and policy intentions. This is what OECD is all about, and is what is often meant by "coordination." Each country still considers only its own interests in making its policies, but at least it gives the others warning of policy changes. Secondly, sudden policy changes need to be avoided. Country B's own interests may require it to deflate suddenly, but its obligations to A, as part of a coordination understanding, may cause it to deflate more gradually. In this type of case advance information could not be provided since the policy decision was, presumably, sudden and called (in B's interests) for immediate implementation. Country B thus has to modify its actual policies in the interests of A.

Second Qualification: Policy Rigidities

The exchange rate may be rigid. Let us first look at the effects on prices, and distinguish prices of traded goods from prices of non-traded goods.

With a rigid exchange rate, a country cannot insulate its domestic prices of *traded goods* from world price movements. Each country's price-level depends on the price-level in other countries: inflation can be "imported." The domestic prices of *non-traded goods* depend on the demand for non-traded goods, and hence on the level of aggregate expenditure. With the exchange rate fixed in a world of capital mobility monetary policy may also be ineffective in regulating this level of demand. But fiscal policy could still do the job. A rise in the demand for non-traded goods resulting from increased export incomes or capital inflows could be offset by a deflationary fiscal policy. But if there is, in addition, a rigidity in fiscal policy not even the prices of non-traded goods could be insulated from external shocks.

The same issues arise if we are concerned with stabilizing output and employment. If the exchange rate were flexible, a fall in export demand could be offset by depreciation. But when the exchange rate is fixed, demand can be maintained neither through the stimulating effect of a depreciation nor (with capital mobility) through monetary policy. Only fiscal policy can maintain demand.

It seems then that the need for coordination arises when *both* the exchange rate and fiscal policy are rigid. Suppose the exchange rate were rigid but not fiscal policy.

With a flexible fiscal policy it is always possible to stabilize demand for, and hence prices of, non-traded goods. Hence employment and output can be stabilized (apart from short-term effects). But it is not possible to stabilize the general price-level, since the domestic prices of traded goods are at the mercy of world prices. This assumes realistically that a rise in the domestic prices of traded goods cannot actually be offset by a compensating *fall* in the prices of non-traded goods so as to keep the general price-level constant. Furthermore, fiscal policy can maintain internal balance but it cannot, at the same time maintain external balance, since we have only one instrument for two targets. When world prices rise, it may then be necessary to allow the prices of non-traded goods to rise.

Third Qualification: Stabilization Redefined as Real Income Stabilization

Sometimes people do not interpret the concept of stabilization in terms of demand management — in terms of maintaining, for example, a constant rate of unemployment — but rather in terms of maintaining real incomes or expenditures constant. Let us now redefine the concept in this way.

It is true that fluctuations in the rate of unemployment and capacity utilization must certainly lead to fluctuations in real incomes, but the reverse is not true. The rate of unemployment may stay constant and yet real incomes may fluctuate. This can happen if, for example, there are fluctuations in the terms of trade. So the redefinition is significant. We shall suppose now that there are no rigidities in the policy instruments, notably the exchange rate, hence assuming away the complications discussed above.

Country A's terms of trade may deteriorate owing to stabilization policies in Country B. Unless Country A runs a balance-of-payments deficit, it cannot maintain its real expenditures constant. It cannot insulate itself from *real* effects. For example, even with a flexible exchange rate and a flexible fiscal policy, a raw material exporter still finds his real income destabilized by fluctuations in consuming countries. Similarly a raw material importer's real income may be destabilized by fluctuations in demand from competing importers. Here, of course, is the role for exchange reserves: to stabilize expenditures even when incomes are not stable. But I put this aside now. The main point is that countries may wish to coordinate their policies in order to stabilize real expenditures or, at least, take *real* effects on each other into account. For example, a group of raw material importers may seek to avoid simultaneous demand expansion policies.

One can go further. There may be rigidities in real factor prices. Consider the simple case where the average real factor price after tax is rigid downward. One can think here of a rigid real wage and suppose the profit margin to be fixed.

Imagine a country's terms of trade to deteriorate. The *equilibrium* real factor price — that is, the price compatible with continued full employment and external balance — will then fall. But the actual real price may refuse to fall. A devaluation may simply be offset by an appropriate rise in the money wage. Fiscal policy can maintain full employment with a balance-of-payments deficit or it can restore external balance at the cost of unemployment. It cannot do both. In the latter case the destabilization of the real factor price brought about by the terms of trade change in the case where the real price is flexible, is transmuted when the real factor price is rigid into a familiar *employment* destabilization.

Fourth Qualification: Stabilization Redefined as Sectional Income Stabilization

Sometimes the concept of stabilization is thought to refer to stabilization of *sectional* incomes, for example, incomes in the exporting sector, or incomes of consumers of imported goods. The problem now is that a country's sectional incomes may be destabilized by external events which affect the domestic prices of its traded goods.

Let us then suppose that the relative traded goods prices that are externally given to Country A change because of other countries' stabilization policies or lack of them. This relative price change will have

effects on income distribution in Country A. Incomes of particular exporting or import-competing interests may fall. On the lines of the earlier argument this sectional income destabilization may become transmuted into employment destabilization if real factor prices are rigid.

If there were no institutional obstacles and no resource costs to income redistribution, it would always be possible to avoid a fall in anyone's real income or expenditure provided the terms of trade overall have not deteriorated. (If they have then, to some extent, we have discussed the problem in the previous section.) But because of institutional obstacles or resource costs, offsetting income redistribution may not take place. One might regard this failure of income redistribution policy as another kind of policy rigidity.

It has to be stressed that we are here concerned with *relative* price changes in the traded goods sector, since a *general* change in the price-level of traded goods can always be offset by exchange rate adjustment. It might also be noted that tariffs, and especially variable levies, can insulate particular domestic-traded goods prices from changes in world prices. Tariffs are, as is well-known, the second-best (or worse) means of redistributing domestic incomes.

It follows that when there is a desire to stabilize sectional incomes and when adequate domestic redistribution policies are costly or not available, countries may wish to coordinate their economic policies to reduce such redistributive effects.

Summary So Far

The simple argument that there is no need for so-called coordination of economic policies must thus be qualified for a number of reasons:

- (a) It takes time to make policy adjustments; hence information has to be exchanged and sudden changes must be avoided.
- (b) There may be policy rigidities, notably in the exchange rate.
- (c) Stabilization policy may require stabilization of real incomes, whether in total or sectionally; or real factor prices may be rigid.

Thus some policy coordination may be needed or desirable. It becomes essential if countries wish to lock their exchange rates. Since 1971 we have seen a grand un-locking of rates, so that the need for coordination has been reduced. But if there are renewed moves towards a pseudo exchange rate union in the EEC, the need for coordination in the EEC will certainly arise.

Note on Incompatible Exchange Rate or Balance-of-Payments Objectives

Countries may have price-level targets, they may have exchange rate targets, or they may have quantitative balance-of-payments targets. In a world of flexible rates price-level targets can be made compatible by exchange rate variation. This has been a main theme so far. Let us now

look at the question of incompatible exchange rate or balance-of-payments targets.

(a) *Exchange Rate Targets*

Exchange rate targets are thoroughly irrational when they are independent of relative price levels. Nevertheless, countries do have them, at least in the short run. The rigid exchange rate situation discussed above is a special case of an exchange rate target.

A problem certainly arises when exchange rate targets are not compatible. This can arise whenever exchange rates are seen in relative terms — as one currency expressed in terms of another — rather than in terms of gold or SDRs. If countries have flexible rates and focus on stabilization of prices, employment and output, avoiding payments imbalances, there is no need for “coordination” other than for the reasons already discussed. But if Country A devalues in terms of SDRs and this is followed by B devaluing to restore the original exchange rate relationship, then the exchange rate is not really an instrument of policy available unilaterally to Country A. A need for coordination between countries arises. But this is coordination of exchange rate policy rather than stabilization policy.

(b) *Balance-of-Payments Targets*

Finally, countries may have incompatible balance-of-payments targets. This is a matter of great current interest. If countries behave atomistically, such incompatibility will again create a disequilibrium situation.

Suppose that Country A — which we can think of as the United States — starts off by expanding aggregate demand and, at a given exchange rate, runs a deficit. Country B (Europe) thus runs a surplus. Now consider four possible responses. Only Response IV gives rise to the need for coordination among countries.

Response I. Country B is happy to run a surplus. It reduces absorption so that the excess of income over absorption is equal to the surplus. The balance-of-payments targets of the two countries are thus compatible. This may be said to describe broadly the world situation for a period up to 1971.

Response II. Country B does not want the surplus, so it appreciates its currency. The crucial issue now is whether Country A accepts this. Let us suppose that Country A did not have a balance-of-payments target at all, but just had a rigid exchange rate combined with a full employment target. In that case it will accept the elimination of the payments imbalance.

Some people would argue that if Europe (B) had really not wanted its surplus in, say, 1969, the United States (A) would have responded in this way, having only exchange rate (gold price) and full employment targets, but not a balance-of-payments target. Failure of Europe to appreciate its exchange rates sufficiently suggests that really Europe was happy to run

the surplus. But some Europeans might have argued (unconvincingly to me) that *if* they had appreciated sufficiently the following response would have ensued instead.

Response III. Again, Country B does not want the surplus, and again it appreciates. But this time Country A does not accept this. It wants to “live beyond its means” and thus wants its deficit. The balance-of-payments targets are incompatible.

One can then envisage the following destabilizing process. Country B appreciates to eliminate the surplus. This raises prices and reduces real spending in Country A. So Country A increases the money supply and hence money expenditures further, restoring its real spending level and its deficit. So B appreciates further, and so on. There will be an inflationary spiral in Country A. But provided Country B is willing to use the exchange rate instrument, it can insulate itself from the inflationary consequences. It need not “import inflation.”

Response IV. Finally, we come to the “coordination case.” Again Country B does not want a surplus. But this time it chooses not to use the exchange rate, but rather allows its domestic prices to rise. Again, A does not wish to accept the elimination of its deficit, it expands the money supply further, restores its deficits, provokes a further price rise in Country B, and so on. This time there is an inflationary spiral in both countries, created by the money supply expansion in A. Country B will then have an incentive to seek some coordination of monetary policies and balance-of-payments targets to eliminate the inflation at source. This need only arise because Country B is unwilling to use the exchange rate instrument.