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INTERNATIONAL MONETARY COOPERATION: ESSAYS IN HONOR OF HENRY C. WALLICH

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This essay is a collection of nine brief papers written in honor of Henry C. Wallich, with an Introduction by Paul A. Volcker. The collection was organized by David H. Howard, Larry Jay Promisel, Charles J. Siegman, and Edwin M. Truman, four of Henry Wallich's colleagues at the Federal Reserve Board and, in two cases, also his former students. The contributors are introduced in the Foreword, which describes the origin of the Essay.

PETER B. KENEN, *Director*
International Finance Section

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CONTENTS

FOREWORD

This collection of papers honors Henry C. Wallich on the occasion of his retirement from the Board of Governors of the Federal Reserve System. It is introduced by Paul A. Volcker, Chairman of the Board of Governors from 1979 to 1987. The papers were written in the summer of 1987.

All of the authors are colleagues or former students of Henry Wallich. Ralph C. Bryant is Senior Fellow in Economic Studies, The Brookings Institution, and before that was Director of the Division of International Finance at the Federal Reserve Board. Leonhard Gleske is a Member of the Board of Directors and of the Central Bank Council of the Deutsche Bundesbank. Gottfried Haberler is Resident Scholar at the American Enterprise Institute and formerly Professor of Economics at Harvard University. Alexandre Lamfalussy is General Manager of the Bank for International Settlements. Shijuro Ogata was Deputy Governor for International Relations of the Bank of Japan before his appointment in September 1986 as Deputy Governor of the Japan Development Bank. Jesús Silva-Herzog was Secretary of the Treasury of Mexico from 1982 to 1986. Ross M. Starr is Professor of Economics at the University of California, San Diego. James Tobin is Sterling Professor of Economics at Yale University. Robert Triffin is Professor Emeritus of Yale and Louvain-la-Neuve Universities.

I am grateful to Edwin M. Truman and his colleagues at the Board of Governors, who proposed and organized this collection of papers, giving the International Finance Section this opportunity to honor Henry Wallich for his many contributions as scholar and public servant.

PETER B. KENEN

INTRODUCTION

Paul A. Volcker

In his long career as an economist, Henry C. Wallich has had many roles—researcher, professor, journalist, policy adviser, and policymaker. Two strong threads have run through all those roles, his interest in education and his talent for clarification. This group of essays by a small sample of his many students, friends, and colleagues is designed to reflect the diversity of Henry Wallich's interests and the range of his influence in order to honor in some small way his contributions to his profession, to his adopted country, and to international cooperation.

Like so many economists, policymakers, and other serious students of public policy, each of the authors in this tribute has been educated by Henry Wallich—some in the classroom or through his writings, and others by professional interaction in academic or policy forums. Indeed, it is a measure of his experience and influence that several of the authors have been both his student and his professional colleague. All of them proudly count him as a friend.

The central subject of these essays is international monetary cooperation. This is, of course, just one of many important issues about which Henry Wallich has thought and written extensively, but, looking back at his career, I perceive it to be a major recurring theme of his work in public service. Indeed, when I first met him almost forty years ago at the Federal Reserve Bank of New York, he was already professionally concerned with analyzing problems of international finance. As I noted on the occasion of his retirement from the Federal Reserve Board, his work in the area of international monetary arrangements and financial diplomacy during his term on the Board stood as a lasting contribution to international cooperation among central banks.

In an autobiographical essay published in June 1982 in the *Quarterly Review* of the Banca Nazionale del Lavoro, Henry leaves the impression that he believes he had a somewhat misspent youth. But I must disagree. After all, learning about the dangers of inflation in interwar Germany and how to drink sherry at Oxford would seem to be important preparatory steps to a career in central banking and international finance! Be that as it may, after his early education in Europe and a spell as an exporter in Argentina, Henry made his way to New York, and eventually Harvard University, where he completed his formal education in economics.

Even before he had written his dissertation, Henry became involved in public policy when he took a job at the Federal Reserve Bank of New York. There he specialized at first in the problems of Latin America—problems that were to continue to occupy his talents in later years. And his experience at the New York Reserve Bank led to another important milestone—his marriage to a research colleague, Mable Brown, who became his partner not only in raising a family but also in some of his professional work.

In 1951, Henry took a professorship at Yale, which subsequently served as his "home base" until he was appointed to the Federal Reserve Board in 1974. During that twenty-three-year period, he never lost his dedication to public service, as evidenced by stints as an adviser to President Eisenhower, Assistant to the Secretary of the Treasury, chief economic consultant to the Treasury, consultant to the Federal Reserve Board, and, in 1959-61, member of the President's Council of Economic Advisers.

Shortly after leaving the Council, Henry broadened his audience to include the general public as well as students and policymakers by adding journalism to his professional repertoire. His work with the media, which began with editorials for the *Washington Post* and ended with a regular column in *Newsweek* magazine, continued until his appointment to the Federal Reserve Board.

At the Federal Reserve Board, Henry was of course involved in all the policy and regulatory issues that confronted the Board during a period of turbulent change. For much of his thirteen years on the Board, he was the senior member, providing an element of experience and continuity that added to his intellectual leadership.

Henry's contributions during that period were particularly noteworthy in two areas. He was certainly the most persistently vocal and prescient among the Board members in calling attention to the dangers of inflation, and his voting record reflected his strong commitment to price stability. That commitment was related in part to his theoretical studies and in part to practical experience in the area of international economics and finance. Henry is by nature a true internationalist, never doubting that peace and prosperity for the United States must be found in the context of a stable international economic order. During his tenure on the Board, Henry readily accepted, and urged others to accept, that international considerations were becoming increasingly important to the formulation of U.S. economic policy. Henry ably represented the Board at innumerable international meetings, forming close professional relationships and personal friendships with many central-banking leaders in all parts of the world.

Throughout Henry Wallich's career, he continued to educate, whether in the confidential settings of meetings at the Federal Reserve or the Bank for International Settlements or through the public medium of one of his many articles or speeches. His is the career of an immensely talented intellectual dedicated to public service. In his 1982 essay noted earlier, he set down two rules that he tried to abide by: the general rule that "an economist has an obligation to accept a call to public service if and when it comes" and the personal rule that he "would not do something purely for the money that might be in it if there was not sufficient intellectual interest."

I trust this small volume is a testimony to how well he followed those precepts—and in doing so served and honored us all.

July 31, 1987

INTERGOVERNMENTAL COORDINATION OF ECONOMIC POLICIES: AN INTERIM STOCKTAKING

Ralph C. Bryant

Gradually but pervasively, the world economy and polity have been transformed in the last four decades. The economic links between national economies—cross-border transactions—have grown more rapidly than economic activity itself, causing a marked increase in economic interdependence. Simultaneously, there has been an increase in political pluralism—a marked expansion in the number of governmental decisionmaking units in the world and a greater diffusion of power among them.

Interaction between the trends of increasing economic interdependence and increasing political pluralism has generated many frictions and problems. The economic significance of national boundaries has been reduced by growing interdependence even as their political significance has been enhanced by increasing pluralism and the associated forces of nationalism. The two trends have exacerbated a mismatch between the economic and political structures of the world: the effective domains of economic markets have coincided less and less with national governmental jurisdictions. In turn, this mismatch has made decisions by nations' governments more difficult and the consequences of their decisions more uncertain. It has also created pressures for the strengthening of intergovernmental cooperation and international institutions. Yet the increasing political pluralism has simultaneously undermined the chances of effective responses to such pressures.

As an economist, Henry Wallich has made numerous contributions to the professional literature analyzing these pervasive changes in the world. As a central banker, he has played important roles in shaping government policies for dealing with them. It is a privilege to participate in this effort to honor Wallich's distinguished career as teacher, author, and public servant.

* * *

In this essay, I present a summary appraisal of theoretical and practical thinking about intergovernmental cooperation, and in particular the "coordination" of economic policies. Necessarily, this is an interim and personal stocktaking; neither theory nor practice is in a settled state.

Varieties of Intergovernmental Cooperation

Collaborative activities among governments can take many forms and can be modest or ambitious. "Cooperation" is best used to refer to the entire spectrum of these activities.

For most of recent world history, cooperation has taken limited forms. During brief, exceptional episodes of rulemaking characterized by cooperative bargaining, governments have agreed on covenants defining the environment within which they will interact. Then, during the lengthy periods between the intermittent bouts of rulemaking, they have made decentralized, independent decisions about the policy instruments under their control. The rules agreed to in the negotiating episodes have served as traffic regulations. Just as the drivers of automobiles mutually consent to drive on either the right or the left side of the road (but not on both sides in the same country!), governments have consented to understandings such as the General Agreement on Tariffs and Trade and the IMF Articles of Agreement to insure against the worst excesses of unconstrained noncooperative behavior.

In the absence of agreed procedures for monitoring and of sanctions to penalize infringements, traffic regulations have not always been rigorously observed. Departures have been especially noteworthy when the rules themselves have been deliberately left unclear (what lawyers call "soft law").

Although traffic regulations represent only the most limited form of cooperation, they have nonetheless nurtured a minimum sense of comity among national governments. Many of the regulations have significantly influenced world economic developments.

On the spectrum of cooperative activities, "consultation" is usually more ambitious than episodic rulemaking and often takes place more frequently. Consultation can involve the exchange of large amounts of information, thereby substantially improving the ability of individual governments to make decisions likely to promote national interests.

Even if consultations are frequent and intensive, each government can still make independent, decentralized decisions. I prefer to reserve the term "coordination" for the most ambitious forms of cooperation, namely, those characterized by jointly designed, mutual adjustments of policy actions. In clear-cut cases of coordination, explicit bargaining occurs and the governments agree to behave differently than they would have behaved without the agreement. The agreement embodies some degree, albeit small and tentative, of centralization in decisionmaking. To be durable, agreements need to be binding and enforceable. In contrast, noncoordinated decisions are characterized by an unwillingness to enter into binding commitments. Each government adapts its decisions to what it observes others doing or expects them to do, but without constraints on its own independence of action and without assurances of constraints on the actions of others.

Recent history affords numerous examples of intergovernmental consultations that go beyond rulemaking. Examples of coordination are harder to find. Significantly, coordination occurs most frequently in areas where there is relatively little controversy and where the mutuality of interests is most clearly perceived. For example, intergovernmental coordination proceeds relatively smoothly for cross-border postal and telecommunications services and for navigation practices, but it is seldom observed for economic policies.

Concepts and definitions pertaining to this subject are imprecise. Along the spectrum of cooperative activities, there is no sharp demarcation between intensive "consultation" and explicit "coordination." It is especially difficult for outside observers of intergovernmental consultations to ascertain whether any explicit coordination has taken place. By my definition, an observer must be able in principle to identify the counterfactual situation—what the governments would have done in the absence of the apparent coordination—and demonstrate that an explicit adjustment of policies was agreed. Even inside participants may be unable to make a sharp distinction between consultation and coordination. Just as "implicit contracts" exist in labor markets, it is conceivable that governments implicitly coordinate their policies as a result of the exchange of information in their consultations.

Subtle differences between the varieties of cooperation cannot be discussed further here. In what follows, I am mainly concerned with the most ambitious forms of cooperation, which I will call "coordination proper."

One of the distinguishing features of ambitious forms of cooperation is their wider scope. The traffic regulations negotiated in intermittent episodes of rulemaking typically apply only to cross-border transactions and relationships, while coordination, and even the most intensive forms of consultation, are more likely to cover a much wider range of variables and policies, including those that are traditionally deemed "domestic." In principle, intergovernmental coordination could be relevant for all national policies having significant effects on foreign countries.

Should Governments Aspire to Coordinate?

A large part of economic life in democratic societies (and an even larger part of economic theory) presumes decentralized and uncoordinated decisionmaking. Why not apply the same presumption of decentralized decisions to the economic policies of national governments?

Several thoughtful economists who have asked this question have reached the conclusion that attempts to coordinate national economic policies will often be unnecessary or undesirable (see, for example, Corden, 1983; Corden, 1986; Stein, 1978; Stein, 1987). As I explain below, I agree with arguments asserting that coordination of economic policies may not be *feasible*, especially if it is detailed and comprehensive, but I cannot agree that it is unnecessary or undesirable.

Theory and history both provide decisive support for the presumption that, in certain circumstances, governments can mutually benefit from the coordination of their individual policies. The possibility that decentralized, noncooperative decisionmaking can produce outcomes that are decidedly inferior to the set of efficient, Pareto-optimal outcomes attainable through collective action has been recognized in political theory for centuries. Economic theorists studying market failures, externalities, collective (public) goods, and strategic interactions within national economies have identified numerous instances in which unconstrained maximization by individual agents, while rational for each agent, can be irrational for all individuals together. The presumption in favor of cooperative decisions extends naturally to many types of intergovernmental relations and international collective goods (Bryant, 1980, Chap. 25). And intergovernmental cooperation about macroeconomic policies is a clear-cut case of an international collective good. As the economic "spillovers" among economies continue to increase, the presumption strengthens that nations cannot foster their mutual economic interests if all their decisions are made in a noncooperative, decentralized manner.

The fundamental presumption in favor of cooperative decisions where externalities and collective goods are important is thoroughly discussed in the literature (for the case of economic policies, see Hirsch, 1976; Buiter and Marston, 1985; Cooper, 1985; Hamada, 1985; Bryant and Portes, eds., 1987; and Canzoneri and Henderson, forthcoming). Although I do not have space to develop that case here, it seems compelling to me that governments should extensively consult about their economic policies and, in selective cases, aspire to coordinate them.

Many critics of efforts to coordinate economic policies, it should be noted, are guilty of a serious confusion. They assert, or imply, that coordination (and cooperation) are synonyms for amity, harmony, or altruism. But coordination merely implies self-interested mutual adjustment of behavior. It certainly does *not* imply that national governments have common goals, that their goals are compatible, or that some governments must give up their own goals in deference to the goals of others. Indeed, it implies nothing about goals. The goals of governments are plainly different and often incompatible. Yet the potential for large gains from coordination may well be greatest when goals are inconsistent and discord is high.

Are the Potential Gains Sizable?

A practical policymaker will not be satisfied, nor should he be, with a general presumption in favor of coordination. He will ask whether the potential gains are large or small.

An important difficulty here is that the question is not well defined. Measurement of gains, in practice or in analytical calculations, can be sensitive to the range of policies considered. Economists have focused primarily on the possibility of mutually designed adjustments in fiscal and monetary policies. But the potential gains from agreements spanning microeconomic and noneconomic as well as macroeconomic policies could conceivably be of a different order of magnitude. Recall that at the 1978 Bonn economic summit, perhaps the most salient historical example of coordination among the seven major industrial countries, the resulting package of agreements involved tradeoffs of both macroeconomic and energy policies (Putnam and Bayne, 1984; Putnam and Henning, 1986). The wider the domain of policies considered, it may be conjectured, the greater the chances of mutually beneficial "exchanges of policy adjustments." (On the other hand, the direct costs of negotiations and of political obstacles to reaching agreement presumably also become larger as the scope of attempted coordination is widened. There are sound reasons why intergovernmental discussions about monetary policies and those about geostationary orbits for telecommunications satellites are normally conducted in separate forums by separate people.)

Another measurement problem stems from the difficulty of distinguishing welfare improvements attributable to coordination proper from those attributable to the gains accruing simultaneously from less ambitious types of cooperation. My guess is that we economists underplay the importance of the "mere" exchange of information that occurs in consultation. It is true that a sharing of information and forecasts is all that typically happens in most intergovernmental discussions of economic policies. But it does not follow, as is often assumed, that this consultation has negligible welfare consequences. Since consultation and coordination tend to shade into each other along the spectrum of cooperative activities, the associated gains tend to blur into each other as well.

What empirical evidence do we have about the size of potential gains? Some important research in recent years has addressed this question, for example, Oudiz and Sachs (1984); Frankel and Rockett (1986); Holtham and Hughes Hallet (1987); and Canzoneri and Minford (1986). But these studies have examined only macroeconomic policies and have focused on the gains associated with moving from a so-called Nash noncoöperative outcome to one or more definitions of a cooperative-bargaining outcome. Furthermore, the sensitivity of these calculations to alternative specifications of underlying assumptions has not yet been adequately explored.

Unfortunately, we cannot yet safely generalize. Several of these studies have been characterized as showing only modest gains associated with moving from the Nash noncooperative to an explicitly coordinated solution, but the gains, even as measured, seem far from negligible to me. My personal hunch, moreover, is that these estimates of the potential gains from coordination, narrowly defined, may prove to be biased downward. And, again, I surmise that the mutual benefits of consultation ("pre-coordination," so to speak), which cannot readily be separated from the gains due to coordination proper, are quite substantial. While acknowledging that agnosticism is the only defensible conclusion for the moment, I thus still incline somewhat toward the view that the gains potentially realizable through cooperation (consultation *and* coordination) are worth writing home about.

Is Coordination Feasible?

The practical policymaker will want to know not only whether the gains from coordination would be sizable, but also whether the exercise is feasible in the first place. On these grounds, sad to say, the policymaker must have considerable doubts.

There is great uncertainty about how policy actions and nonpolicy shocks originating in one nation influence economic developments in others. Even the sign of some important effects is uncertain. For example, neither macroeconomic theory nor empirical research definitively answers the question whether a monetary expansion in the United States causes an increase or a decrease in real economic activity in Europe and Japan (relative to what otherwise would occur). Even when analysts agree about the sign of effects, moreover, little consensus exists about their empirical magnitude.

Obviously, uncertainty about the size, and sometimes even the direction, of cross-border interactions among economies severely undermines the ability of analysts and policymakers to design coordinated policies.

Individual governments do not even have at their disposal an agreed analytical framework for evaluating the effects of external forces on their domestic economies. (Even if agreement exists within a government, analysts outside the government are likely to hold differing views.) Much less do governments have adequate frameworks summarizing how their policies affect other nations. What is true for the individual government is even more true for the collectivity of national governments.

To analyze the world economy as a whole, governments and international institutions require at least an internally consistent analytical framework—