International Policy Cooperation: Building a Sound Foundation

*Brian J. Cody**

Policymakers have long recognized that the welfare of their economies is tied to the welfare of the world economy. Because goods, services, capital, and even labor are mobile internationally, economic policies in one country invariably have spillover effects on others. Having decided they can no longer ignore these global effects, and hoping to build a more stable world economy, governments have made some heroic attempts to coordinate their economic policies. Unfortunately, their efforts have been largely unsuccessful. Now policymakers are attempting more modest steps toward cooperation.

The seven leading industrial nations—Canada, France, West Germany, Italy, Japan, the United Kingdom, and the United States—are now developing a new system for sharing economic information. A good deal of economic data (inflation statistics, for example) is currently available, but different countries use different

* Brian J. Cody is an Economist in the Macroeconomics Section of the Philadelphia Fed's Research Department.

methods to calculate, analyze, and forecast economic indicators. To overcome the difficulties created by these differences, the major countries are working out a set of "objective indicators"—indicators with well-articulated definitions across countries. The hope is that these indicators will lead to a single analytical framework and a coherent set of economic forecasts. Ultimately, these efforts should enhance policymakers' understanding of how their actions affect not only their own economy but others as well, enabling them to design harmonious national policies.

An exchange of economic indicators may seem like a small step, perhaps even a retreat from past efforts. In large part, however, it is lack of information that has hampered previous attempts at policy coordination. A seemingly modest program of information-sharing can help overcome problems undermining more ambitious plans and provide the foundation for broader agreements down the road.

COOPERATION: WHAT'S IN IT FOR A COUNTRY?

Cooperative policymaking can take many forms, but in general it occurs whenever officials from different countries meet to evaluate world economic conditions.[1] During these meetings, policymakers may present briefings on their individual economies and discuss current policies. Such meetings would represent a simple form of cooperation. A more involved interchange might include economists' reports on a specific problem, coupled with an in-depth discussion of possible solutions. True *policy coordination*, however, goes much further than either of these two cooperative forms: policy coordination is a formal agreement among nations to enact specific policies. Recent attempts by the leading industrial nations to design and jointly implement specific economic policies fall into this last category.

In a sense, it is surprising that previous efforts have not been more successful. Theoretically, any group of nations whose economies interact and influence one another can benefit from policy coordination. Regardless of national economic objectives, policy coordination can, in principle, make each participating nation better off than if it chose to operate in isolation.

If policy coordination offers so many benefits, then why have previous attempts at it failed? In large measure, the problem has been lack of information. Achieving true policy coordination, with agreement to jointly implement specific policies, requires a greater capacity to collect and analyze data jointly than countries now have. A simple example helps demonstrate the potential benefits of economic policy coordination—and highlights the potential problems.

Two Countries Whose Situations Are Less Than Ideal. Suppose there are just two countries in the world, the Highlands and the Lowlands. They freely trade goods and services with each other, but want to pursue national economic interests. Highlanders expect their government to keep the economy close to full employment and to avoid trade deficits with the Lowlands. Meanwhile, Lowlanders expect their government to keep the economy close to full employment and to avoid trade deficits with the Highlands.

The current economic situation in the two countries is less than ideal: trade between them is balanced, but both economies are operating below full employment. Each government has considered increasing its spending in order to bolster domestic demand, raise output, and increase employment. Each has also rejected the idea, recognizing the adverse impact it

[1] For a formal definition of policy cooperation, see Jocelyn Horne and Paul R. Masson, "Scope and Limits of International Economic Cooperation and Policy Coordination," International Monetary Fund Staff Papers (June 1988).

would have on the trade balance. The Highlands' government knows that more employment and higher incomes for Highlanders would mean a greater tendency for them to buy imports from the Lowlands and thereby drive their trade account with the Lowlands into deficit. Similarly, the Lowlands government sees that spending to boost national employment and incomes would raise Lowlanders' tendency to import goods from the Highlands and thereby drive their trade account with the Highlands into deficit. Consequently, neither government acts and unemployment persists in both countries.

How Policy Coordination Can Benefit Both. Given their choices, both the Highlands and the Lowlands can clearly benefit from policy coordination.[2] If both governments agreed to increase their spending at the same time, then output, employment, and incomes would expand in both countries simultaneously. While higher incomes for Highlanders would tend to increase their demand for goods from the Lowlands, Lowlanders' incomes would also be rising, which would tend to increase their demand for goods from the Highlands. Let's say that government spending in both countries were increased by an appropriate amount. In that case, each country's increased demand for imports would be matched by an increased demand for its exports, maintaining balanced trade between the Highlands and the Lowlands. In this example, policy coordination—that is, mutual adoption of expansionary policies—would allow each country to attain its goal of full employment while avoiding a trade deficit.

Things Are More Complicated in the Real World. This hypothetical example paints a rosy picture of policy coordination. The coordinated effort seemed easy because the economic problem was so simple—two economies, two goals. In the real world, coordination typically involves many countries and many diverse goals. Recent coordination attempts have involved the seven leading industrial countries and have focused on a broad range of goals—balanced trade, inflation reduction, and output and employment growth.

Even with fewer countries and simpler goals, there is no guarantee that governments can design and carry out coordinated economic policies. In our example, we tacitly assumed that each country possessed perfect information—an assumption that eliminates many potential problems. First, perfect information implies that the Highlands and the Lowlands know the structure of their economies.[3] Consequently, they can calculate precisely their policies' effects on output, employment, incomes, and trade. The assumption of perfect information also implies that when policies do not produce the desired effects, policymakers can quickly pinpoint the cause and renegotiate the agreement. Thus, our example has not considered the effects of an

[2] In "Macroeconomic Strategy and Coordination Under Alternative Exchange Rates" (in *International Economic Policy*, edited by R. Dornbusch and J. A. Frenkel, London: Johns Hopkins Press, 1979), Koichi Hamada presents the classic arguments in favor of international policy coordination.

[3] Using the simulations generated by large macroeconomic forecasting models, two recent papers have demonstrated that unless officials coordinate their policies based upon the "correct" model of the world, policy coordination can reduce general economic welfare rather than increase it. See J. A. Frankel and K. Rockett, "International Macroeconomic Policy When Policymakers Do Not Agree on the True Model," *American Economic Review* (June 1988) pp. 318-340, and M. Canzoneri and H. Edison, "A New Interpretation of the Coordination Problem and Its Empirical Significance," a paper prepared for the Federal Reserve Board Conference "Monetary Aggregates and Financial Sector Behavior in Interdependent Economies," Washington, D.C., May 26-27, 1988. See also J. Frankel, "Obstacles to International Macroeconomic Policy Coordination," International Monetary Fund Working Paper, WP/87/29 (April 21, 1987), and A. Ghosh and P. Masson, "International Policy Coordination in a World with Model Uncertainty," International Monetary Fund Staff Papers (June 1988) pp. 230-258.

unexpected change in economic conditions—an investment boom in the Highlands, for example.

The assumption of perfect information also solves another, different kind of problem. Any situation offering gains from cooperating also offers the potential for even bigger gains from cheating—that is, signing an agreement to do something (in this case, increase government spending) and then reneging. In our example, both the Highlands and the Lowlands would like the other to increase spending unilaterally, mainly because the country that holds the line on spending (while the other spends more) stands to benefit from higher foreign demand for its goods. The increased foreign demand stimulates output and employment, while generating a trade surplus. Perfect information, however, can cramp a country's ability to cheat because it suggests that each country can precisely monitor the policies of the other. Thus, any attempt by one country to cheat on a cooperative agreement would be uncovered immediately by the other country.

Unfortunately, policymakers in the real world have imperfect information. They cannot assume away the difficulties involved in *designing*, *renegotiating*, and *monitoring* an agreement. In fact, it is imperfect information that has stymied past attempts at coordination.

HOW CAN INDICATORS HELP?

Beginning a couple of decades ago and continuing today, the United States and its major trading partners have strengthened international policy *cooperation* through such efforts as the Economic Policy Committee and its Working Party 3 at the Organization for Economic Cooperation and Development, the series of annual economic summits, and the International Monetary Fund's world economic outlook process. Since the early 1970s, however, these countries have engaged in three major attempts at *coordinated* policymaking. (See *Three Examples of Policy Coordination*, p.8.) Each of these real-world agreements has faced difficulties. In two cases, the Smithsonian Agreement and the Bonn Summit, the coordinated policies broke down completely. The third coordinated policy—initiated with the Plaza and Louvre accords and developed at subsequent meetings—has survived, though it has produced somewhat disappointing results. The current coordination attempt can benefit from (and perhaps previous agreements could have been saved by) a better system for sharing economic information.

Perceiving the benefits of shared information, policymakers from the G-7 countries, under the auspices of the IMF, have begun to develop a set of objective indicators of economic performance.[4] The sharing of objective indicators—so named because their definitions and measures are accepted across countries—will increase the quality and range of information available to governments.[5] In general, an appropriate indicator is any economic variable that can be used to measure policymakers' actions, the performance of an individual econ-

[4] There have been widespread calls for the use of "objective indicators" in the policy cooperation process. Recent publications by the International Monetary Fund have presented thorough summaries of the recent developments concerning the use of economic indicators. See A. Crockett and M. Goldstein, "Strengthening the International Monetary System: Exchange Rates, Surveillance, and Objective Indicators," International Monetary Fund Occasional Paper, No. 50 (February 1988); J. Horne and P. R. Masson "Scope and Limits of International Economic Cooperation and Policy Coordination," International Monetary Fund Working Paper, WP/87/24 (April 7, 1987).

[5] At the close of the Toronto summit in June 1988, the G-7 countries summarized the ongoing advances made in the use of objective indicators, stating, "We welcome the progress made in refining the analytical use of indicators, as well as the addition to the existing indicators of a commodity-price indicator. The progress in coordination is contributing to the process of further improving the functioning of the international monetary system" ("Economic Declaration," Final Toronto Economic Summit Communique, issued June 21, 1988).

omy, or the spillover effects of one nation's policies on another. Not open to confusion over definitions, objective indicators provide policymakers with the basic data they need to overcome three information problems that have frustrated past attempts at policy coordination.

Policymakers Disagree over Appropriate Policies... In our example, we assumed that policymakers had sufficient information to understand how their policies would affect both economies. For instance, we assumed that the Highlands' officials knew how much they would have to raise government spending in order to reach full employment. We assumed also that the Highlands' economists had sufficient information to predict what effect this policy would have on their trade account with the Lowlands. Of course, the Lowlands' economists had analyzed the same questions and had reached the same conclusions.

In the real world, neither economists nor policymakers have complete information. Moreover, the study of economics has not yet reached a stage that would end honest disagreements over interpretations of a single set of data. The seeming inability of economists to agree on anything has even led some skeptics to contend that if all of the economists in the world were laid end to end, they would still not reach a conclusion. If policymakers and economists can reasonably disagree using the same data, then the potential for disagreement is simply magnified if they lack a common framework.

Our experience since the recent Plaza and Louvre accords illustrates the difficulty of designing appropriate policies when governments disagree about economic fundamentals. To effect the accords' goals—a sustainable, balanced pattern of international trade and continued economic growth—the United States agreed to follow a less stimulative fiscal policy; meanwhile, other governments, in particular West Germany and Japan, were to implement more stimulative policies. Although economic growth has continued since these accords, improvements in the U.S. current account and fiscal deficits and reductions in other countries' trade surpluses have been slower than was hoped.

The accords' limited success in trade adjustment can be traced, at least in part, to the countries' lack of agreement over appropriate policies to follow. In the summer and autumn of 1987, West German officials approached cautiously the implementation of a coordinated fiscal policy expansion, fearing that such a policy could ignite domestic inflation. The U.S. government, on the other hand, argued that West Germany's inflation rate, at 2 percent, was low enough—and the coordinated expansion moderate enough—to preclude any exacerbated price pressures from an expansionary fiscal policy.

Moreover, the slow progress on deficit reduction in the United States, particularly in the autumn of 1987, has raised questions about the U.S. government's implementation of the agreements. With its concerns about accelerating inflation, the West German government has been reluctant to enact stimulative policies without evidence of fiscal restraint in the United States.[6]

These disagreements would be reduced if policymakers can 1) develop a common framework in which to measure fiscal policy changes and analyze the potential for noninflationary growth in the United States, Western Europe, and Japan and 2) agree on which variables best

[6] For some background on these disagreements, see *The New York Times*, "Long Road For Tokyo and Bonn," October 1, 1987, and "3 European Allies Reduce Key Rates to Spur Economies," November 25, 1987; and "Restoring International Balance: The Federal Republic of Germany and World Economic Growth," Joint Economic Committee, June 2, 1988.

Three Examples of

Smithsonian Agreement (December 1971)

Background: Under the Bretton Woods system of fixed exchange rates, set up after World War II, the U.S. was committed to maintaining the dollar as the anchor of the world exchange rate system by stabilizing the dollar price of gold at $35 an ounce. All other participating countries then pegged the value of their currency to the dollar. In the face of large and growing current account deficits, which were threatening the stability of the dollar, President Nixon suspended the convertibility of the dollar into gold in August 1971, effectively ending the system of fixed exchange rates.

Agreement: In December 1971, officials from the 10 largest economies in the Organization for Economic Cooperation and Development met at the Smithsonian Institute in Washington D.C. to draw up a new exchange agreement. The dollar was devalued by raising the official price of gold to $38 an ounce, from $35. The German mark and the Japanese yen were revalued against the dollar by 17 and 14 percent, respectively. Since gold convertibility was not restored, the world was not on a gold standard but a dollar standard. President Nixon promised that the U.S. current account deficit would be adjusted so that the dollar would not experience any further weakness.

Result: Continued weakness in the U.S. current account in 1972 led to speculation that the agreement was not working and that the dollar would have to be devalued again. The U.S. currency was devalued by 10 percent in February 1973, and the agreement was finally abandoned one month later, when the major industrialized countries decided to allow their currencies to float against the dollar.

Bonn Summit (July 1978)

Background: The strong U.S. recovery from the 1974-75 recession contributed to a U.S. current account deficit and a weakening dollar. This condition produced calls for other countries, in particular West Germany and Japan, to enact expansionary fiscal and monetary policies. Such policies, it was hoped, would increase demand for U.S. goods, thereby helping to reduce the U.S. trade deficit and strengthen the dollar. There was also widespread sentiment abroad that artificially low oil prices in the United States

measure that potential.[7]

...But Indicators Can Help Answer Basic Questions. Policymakers recognize that they can never be sure of the outcome of their actions. By gradually introducing objective indicators into the Plaza and Louvre accords, however, policymakers hope to obtain a clearer picture of the prospects for noninflationary growth in Western Europe, Japan, and the United States. Following their May 1986 summit in Tokyo, the seven leading industrial nations announced their intention to adopt a group of useful indicators, including GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, money growth rates, foreign exchange reserves, and exchange rates.[8] As this program develops, policymakers should be better equipped to design workable

[7] In describing the Plaza and Louvre accords, we have focused on the uncertainties surrounding a fiscal policy solution to trade imbalances. Policymakers could also use monetary policy to address this problem. Unfortunately, no matter which course is followed, policymakers cannot be sure of the impact on the current account. A contractionary monetary policy in the deficit country, for instance, would tend to discourage imports, as higher interest rates resulting from the policy induce consumers to spend less and save more. However, the boost to interest rates would also cause the domestic currency to appreciate, thereby reducing the cost of foreign goods and stimulating imports. These offsetting effects make it difficult to assess the linkages between even monetary policy and the trade balance.

[8] See "Tokyo Economic Declaration," Final Tokyo Economic Summit Communique, issued May 6, 1986.

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were exacerbating the U.S. trade imbalance.

Agreement: West Germany would expand government spending by 1 percent of GNP. The U.S. would introduce a program to reduce oil imports and undertake anti-inflationary measures.

Result: As West German policy was having its effect, the OPEC countries engineered a sharp increase in crude oil prices, fueling inflationary fears in West Germany. Despite efforts to reduce the U.S. trade imbalance, the dollar continued to weaken into 1979. The United States tried to persuade West Germany to intervene in the foreign exchange markets, while the West Germans called for further adjustments in U.S. policy. The onset of unexpected inflation and conflicts over continued adjustment of policies led to abandonment of the agreement.

Plaza Agreement/Louvre Accord (September 1985/February 1987)

Background: By early 1985, there was widespread agreement that the dollar was "overvalued" and that the U.S.'s twin deficits (trade and federal budget) were too large.

Agreement: In order to stimulate demand, West German and Japanese officials agreed to more stimulative fiscal policies, accelerating planned tax cuts and expanding spending programs, respectively. For its part, the U.S. agreed to attempt to bring down its budget deficit. Moreover, all participants agreed to intervene in the currency markets, when necessary, to further the dollar's orderly decline.

Result: The accord has been viewed as a success, though not an unqualified one. In 1987, citing increased inflationary pressures, West German officials approached cautiously the implementation of a coordinated fiscal policy expansion. This development has not set well with the United States, which disagrees over the extent to which accelerating inflation is a problem in West Germany. The slow progress on reducing the federal budget deficit in the United States, particularly during the second half of 1987, has also strained the agreement. Other countries have been understandably reluctant to enact stimulative policies without evidence of fiscal restraint in the United States. The accord has, however, survived numerous attacks, with the participating countries repeatedly expressing their support for it.

policies that facilitate international adjustment and continued economic growth.

Responding to Unexpected Events Is Costly... Working from a set of objective indicators has other benefits, as well. Sometimes policymakers observe an event and know that it will affect their agreement. Changing economic conditions pose a problem for policy coordination, precisely because a new set of circumstances calls for changes in policy. Unfortunately, simply observing the event is no guarantee that policymakers will agree on how the event has changed the world economy or that they can successfully renegotiate their agreement. Rather, the countries also need enough information to form a consensus about the nature of the problem and the appropriate response.

A classic example of problems that can follow an unexpected event is the breakdown of the program designed at the 1978 Bonn Summit. At that summit, the largest industrialized democracies agreed to policies that would spur growth in Europe and Japan and fight inflation in the U.S. West Germany, Japan, and the United States faithfully enacted the programs, but just as the policies began to take hold, the OPEC countries engineered a dramatic run-up in crude oil prices and inflation accelerated. As inflationary pressures mounted, policymakers debated whether the run-up in prices was due to the oil price shock, the coordinated fiscal policies, or both. Not surprisingly, West Germany and Japan became increasingly reluctant to carry out the expansionary policies for fear of exacerbating domestic inflation.

Clearly, the coordinated expansion was no longer appropriate and the agreement needed to be renegotiated. Without a common economic framework and consistent information on wages, input prices, and government expenditures, however, they could not agree on a common interpretation of the crisis, nor could they formulate a coordinated response. The lack of a common framework made renegotiation so costly in terms of time and effort that each country withdrew from the agreement and formulated its own course of action.

...But Indicators Would Reduce Renegotiation Costs. This breakdown might not have happened, however, had policymakers agreed to use objective indicators of wages and other input prices in addition to indicators of inflation and output. If such a system had been in place, U.S., West German, and Japanese officials could have quickly, and with less disagreement, analyzed the economic impacts of the oil price shock. This analysis would have speeded a negotiated, coordinated response to rising world inflation.

In developing and exchanging objective indicators, policymakers can review, each month or quarter, the consistency between the indicators and the coordinated policy. They can compare the desired path for inflation, say, with the value of each country's objective inflation indicator and determine if policy changes are warranted. The uninhibited flow of data and multilateral surveillance of general indicators can help policymakers recognize and respond to unexpected events much more rapidly than they could in isolation. Moreover, if everyone shares the same data and analyzes them using the same criteria, disagreements over the appropriate multilateral response can be reduced.

It's Hard to Enforce Agreements... As we've seen, coordinated policies do not always produce the desired results. Unfortunately, policymakers are not always able to trace the problem back to a particular event. When something goes wrong, policymakers often are not sure why.

If the agreement suddenly starts to produce unexpected results, policymakers can become suspicious. Recognizing that an incentive to cheat exists, they may wonder if everyone is honoring the agreement. A change in the world economy would only compound the problem, since it would make cheating even harder to detect. A country could simply hold the unexpected event responsible for the policy's poor performance, deflecting blame from itself.

The breakdown of the 1971 Smithsonian Agreement exemplifies the problems that can arise when an agreement is clearly not working and there is insufficient information to tell whether the world has changed or if someone is cheating. In the early 1970s, the United States was running a sizable trade deficit, which produced a burgeoning supply of dollars on foreign exchange markets. This excess supply was depressing the dollar's value, thereby jeopardizing its role as the reserve currency.[9] Attempting to restore stability to the dollar, the Smithsonian Agreement called for devaluing the dollar, both by raising the official price of gold to $38 per ounce, from $35, and by raising the dollar values of the West German mark and Japanese yen by 17 percent and 14 percent, respectively. The agreement also sought U.S. policies to correct the U.S. trade deficit.

After the agreement was signed, however, the trade balance did not improve and dollars continued to flood the foreign exchange markets. Other countries viewed their growing dollar balances as prima facie evidence that the United States had abandoned the maintenance

[9] Under the international monetary system outlined in the Bretton Woods agreement, the dollar served as the chief international asset, or reserve currency, held by governments. They held dollars in anticipation of possible future payments deficits that would have to be settled. Thus, we refer to the dollar during this period as the international reserve asset or reserve currency.

of its external position as a domestic policy goal. In essence, they accused the United States of cheating.

The United States responded that it had implemented the policies, but that the world economy had changed and that the coordinated policies would no longer produce the desired results. Confusion ensued and policymakers, despite the need for further action, could not resolve their differences. The failure to renegotiate a coordinated plan fueled speculation that the dollar's value could not be sustained, and eventually the agreement broke down.

...But Indicators Can Help Monitor Compliance. The conflict surrounding the Smithsonian Agreement was spawned by inadequate measures of U.S. commitment to the policy. U.S. officials viewed their implementation of the mandated policies as sufficient evidence of their fidelity to the agreement. Other countries, however, doubted the U.S. commitment because the U.S. current account had failed to improve. While data both on the U.S. current account and on policy actions, such as the dollar's devaluation, were already available, the policymakers had not agreed on a uniform framework in which to evaluate U.S. performance. If the agreement had explicitly stated which objective indicators would be used to monitor policy compliance—the dollar, the U.S. current account, or some other measure—it would have been much easier to determine whether the U.S. trade balance had worsened because the agreement had been violated or because the policy was no longer appropriate.

In general, if participants agree to exchange data on their policy actions, the chore of monitoring everyone's behavior will be eased.[10] For instance, if a coordinated policy required each country to enact anti-inflationary monetary policies, then officials could first select, as an objective indicator, a particular interest rate or monetary aggregate to follow. They would also choose an indicator of inflation. If after some time inflation had not abated, the indicators would reveal whether each country had faithfully implemented the coordinated policy—or whether their economies had changed and the policy needed to be redesigned.

CONCLUSION

Recognizing that their policies can have significant impacts on trading partners—and that their economies are not immune to the effects of changing economic conditions abroad—countries have often attempted to cooperate in setting economic policies. They have acted on the theory that a system of coordinated policies produces the greatest improvement in economic welfare.

Attempts by the United States and its major trading partners to coordinate policies have met with only limited success. Rather than calling into question the theoretical conclusion that coordination is best, experience suggests that when coordinated policies began producing unexpected results, policymakers lacked the information needed either to decipher the cause or to redesign the policy.

In response to this problem, policymakers have begun to develop a system for sharing objective indicators of economic performance. The hope is that these indicators will sharpen policymakers' understanding of the world

[10] Charles Schultze, in "International Macroeconomic Coordination—Marrying the Economic Models with Political Reality," *International Economic Cooperation*, Martin Feldstein (ed.), National Bureau of Economic Research (1988), suggests that much of the conflict surrounding policymakers' goals arises from officials considering policies, such as tax reform, as ends in themselves rather than as tools to achieve more general economic and social goals. Forcing policymakers to express their goals in terms of quantifiable economic aggregates may help eliminate some of this confusion.

economy, thereby facilitating the policymaking process. When problems do arise, the indicators will help policymakers determine whether a participant is reneging on the agreement or if the world has somehow changed. While we are still a long way from a successful coordinated policy, the use of objective indicators should help resolve some of the problems that have complicated efforts in the past.