

## Macroeconomic Policies

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### Lecture 15

## International Coordination of Macroeconomic Policies

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### Outline of the lecture

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- 1. Gains from international coordination**
  2. Why is there so little policy coordination ?
  3. Examples of macroeconomic policy coordination
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## Gains from international in « keynesians models »

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- Main channels of international transmission :
    - demand effects (imports),
    - financial effects (interest rates),
    - relative price effects (exchange rates and terms of trade).
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## International impact of spending cuts

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- A country that embarks on a policy of spending cuts or tax increases naturally prompts a decline in activity and in domestic inflation.
  - In foreign markets, this policy results in
    - (1) a reduction in global demand and hence exports (via the demand effect)
    - (2) an appreciation of the real exchange rate owing to an interest-rate differential (the UIP2effect) and adverse inflation (via the relative price effect).
  - These two effects tend to generate a current account deficit in neighbouring countries.
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## International impact of monetary policy

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- A fall in one country's interest rates generally leads to
    - a rise in domestic demand ;
    - a depreciation of the exchange rate (UIP).
  - Effect on the trade balance is ambiguous:
    - depends on the channels by which monetary policy is transmitted to domestic demand and on the sensitivity of the trade balance to exchange rates.
  - The effects on trading partners' activity levels are ambiguous also.
  - Exchange rate movements do have distinct effects on the allocation of factors (between investment and consumption, between tradable and non-tradable goods, etc.) and on inflation.
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## The desirability of coordination

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- How to measure the gains from international coordination ?
  - Gains = difference between
    - outcome in the case where the different countries' policies are those a benevolent central planner would implement
    - Outcome in the situation where different national authorities (i.e. central banks and governments) decide on their respective policies independently of each other regardless of externalities.
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## Strategic complementarity vs substitutability

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- The best response to another country's macroeconomic policy cannot be known in advance.
  - In response to a cut in public spending by one of its partners, a country may choose either to:
    - compensate for the loss of activity by boosting its own public spending (this is a case of strategic substitutability, in which country 2 responds by doing the reverse of country 1),
    - it can limit the impact on its current account balance by cutting its spending (this is a case of strategic complementarity, in which country 2 responds by doing the same thing as country 1)
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## Global saving glut as an example of strategic substitutability

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- "Global saving glut" hypothesis links the drop in the US saving rate to an extremely accommodative fiscal policy (via a rapid rise in the fiscal deficit), viewed as a reaction to the "Asian growth strategy" founded on an accumulation of foreign exchange reserves.
  - The sharp increase in US demand is consolidating the Asian strategy in return.
  - In a substitutability situation, if each country does what is most beneficial for itself, the equilibrium achieved is generally inefficient. One possible form of coordination might then be to find a mix of macroeconomic policies that reduce imbalances without affecting global growth.
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## Gains from coordination are real but modest

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- Early work by Oudiz and Sachs (1984) to quantifying the gains from macroeconomic policy coordination.
  - Based on international macroeconometric models.
  - With this method gains are measured to be around of  $\frac{1}{2}$  to 1 percentage point of GDP for all countries, at equilibrium, when full information is available on the functioning of the economy and the reactions of the other countries.
  - The gains from coordination would be smaller, however, when lack of information is taken into account (either because governments are ignorant of how the economy really functions, or because they cannot agree among themselves as to how the economy functions).
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## Gains from coordination on a large range of policies

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- Gains from coordinating a large number of policies simultaneously can be large even if the gain from coordinating each of them individually is low.
  - That is because it is generally not possible for a country that would gain from coordination to compensate a country that would lose from it (the utilities are not transferable between countries).
  - The greater the number of areas included within the negotiation (e.g. macroeconomic policies, trade policies, etc.), the more each country would be able to make concessions in a particular area and obtain compensating concessions in another.
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## Do countries cooperate?

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- Observation of macroeconomic policies shows that :
    - They far away from the cooperative equilibrium
    - They do not correspond to the non-cooperative equilibrium (where each area picks the policy most advantageous to it, taking the others as given).
  
  - It seems that gains arising from coordination (the transition from non-cooperative equilibrium to a cooperative equilibrium) are smaller than gains from switching from observed policies to the non-cooperative equilibrium.
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1. Gains from international coordination
  - 2. Why is there so little policy coordination ?**
  3. Relevant areas for policy coordination
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## The impossibility of contractual commitments

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- Countries involved in macroeconomic policy coordination share the same information on the risks and are perfectly able to observe each others' actions,
  - Coordination is hampered by the difficulty, indeed impossibility, of describing the risks entailed and hence its content (i.e. the policies to be implemented). They cannot rely on this information for the purposes of *ex ante* coordination.
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## The impossible full ex ante coordination

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- All countries have now identified the risk of a sharp dollar depreciation.
  - But it is very difficult to imagine the entire range of possible adjustment scenarios:
    - The way central banks will react depends on the rate at which the currency depreciates, on whether or not risk premia rise, on the disconnection between long-term rates on either side of the Atlantic, etc.
  - *Ex ante* coordination cannot organize optimum economic policy responses as from today,
  - Ex ante coordination consists into reducing the risk of a disorderly depreciation of the dollar, by means of appropriate macroeconomic policies and by announcing in advance (via G7 statements) their determination to engage in *ex post* coordination if the situation so requires.
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## The difficult ex post coordination

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- The asymmetry of available information also limits *ex post* negotiation.
  - Parties' capacity to commit themselves is heavily curtailed when:
    - available information is not equally shared during negotiations (typically, one party is always better informed about its own situation than the others are),
    - actions taken by the different parties are only incompletely observable (as it is the case, for example, with complex policies such as structural reforms)
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- ❑ Monetary Union
  - ❑ In a liquidity crisis.
  - ❑ Exchange rates misalignment
  - ❑ Balance of payments crisis common to a whole region.
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## The stability and growth pact 1/

- ❑ Monetary union does not, *per se*, impose fiscal policy coordination.
  - ❑ A certain degree of fiscal heterogeneity may reflect that countries experience asymmetric shocks.
  - ❑ However, two risks associated with uncoordinated national fiscal policies impose a certain degree of discipline and coordination:
  - ❑ National policies may cause negative external effects on other countries within the area (eg inflationary policies)
  - ❑ The risk of a state insolvency, bears on all member states through the single currency, even though only one state actually defaults.
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## The stability and growth pact 2/

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- The Stability and Growth Pact was designed to contain these two risks:
    - 3% public deficit threshold
    - 60% public debt threshold,
  - The definition by each member state of its own stability program, its annual re-evaluation before the Commission and its approval by the Council of Finance Ministers, constitute a series of measures that can, *de facto*, lead to greater coordination, notably through the appropriate use of "peer pressure".
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## Liquidity crisis 1/

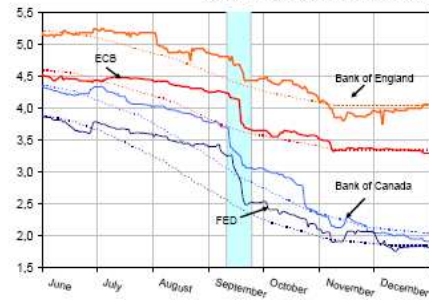
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- Liquidity crises emerge when the presence of illiquid agents triggers a chain reaction leading to their proliferation
  - In general, these crises can be contained if there is a lender of last resort capable of directly pumping money into solvent agents who have become illiquid, or to prevent a financial panic (in the form of a share price fall or a run on the banks) by signaling that it stands ready to play its role.
  - In theory, a single institution is sufficient to play the role of lender of last resort. But the fact that most of the major central banks announcing in concert their intention to supply liquidity in abundance (a case of *ex post* coordination) serves to reinforce the signal and sharply limit the risk of panic.
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## Liquidity crisis 2/

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Chart 2: Nominal short-term interest rates at the time of the World Trade Center attacks in 2001



## Currency misalignment Coordinated interventions / September 2000

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Chart 3: Euro-dollar interventions in late-2000



Source : ECB.

# Currency misalignment / imbalances Plaza (1985) and Louvre accords (1987)

Chart 5: Yen and DM movements against the Dollar

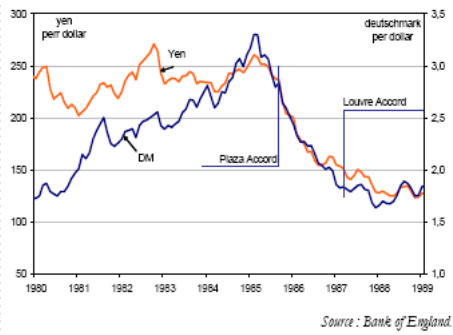


Chart 6: US current account (% of GDP) and dollar

