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Do We Really Need a New Global Monetary Compact?

Over the past fifteen years, there has emerged a widespread consensus that monetary policy should be delegated to an independent central bank, one that primarily focuses on inflation but also pays attention to the general health of the economy. Literally dozens of countries have engaged in dramatic institutional reform—often involving constitutional amendments—so as to greatly increase the level of independence of their central banks. Converts include England, Canada, the euro zone, and many developing countries. These changes have almost certainly been a major factor in the return to low inflation we have witnessed throughout much of the world over the past decade and a half. True, there remains quite a bit of controversy about the details. Is it better to rely on having a conservative central bank board, or is it preferable to try to have the government legislate incentive contracts? How much accountability should the central bank have to the main legislature? How much transparency is needed? But today, credibility increasingly takes a backseat to implementation in central bank debate, hence the large and growing literature on "optimal (John)

Taylor rules" for setting interest rates in response to inflation and output data.

Curiously, as new central bank constitutions have become increasingly set in stone, little attention has been paid to international spillover effects. Is it a problem that the United States pays so little attention to Europe's interests in designing its rule and vice versa? Certainly, smaller countries such as Canada, though important as a group, pay absolutely no attention to spillover effects to the United States and elsewhere. Should we be rethinking the whole process of central bank reform to ensure that international spillovers are given more attention? The recent plight of the euro, which has fallen by more than 25 percent against the dollar since its inception, is a case in point, as is Japan's severe recession. For example, it would be far easier for Japan to use loose monetary policy to counter its severe recession if the United States and Europe shared the burden of the global expansion, thereby alleviating pressure for (perhaps) excessive devaluation of the yen. One of the main lessons of the academic literature on international monetary cooperation from the 1970s and 1980s is that, in certain circumstances, international monetary policy coordination failures can be quite dramatic.

In their paper in this volume, Obstfeld and Rogoff make a first attempt at tackling this kind of issue. The answer they get, in brief, is that the current trend in central bank design, which pays very little attention to global spillovers, might not be so bad. Under what seem to be rather reasonable assumptions, they find that the gain to coordinating international efforts at central bank reform are likely to be very small. Indeed, halfway efforts at coordination (such as Ronald McKinnon's world money standard or John Williamson's target zones for exchange rates) might well prove inferior to the outcome we have now, where coordination of rule setting is quite limited. Thus, for example, if countries each unilaterally implement domestically optimal Taylor rules while using institutional reform to overcome inflation credibility problems, then the result may be nearly as good as under a global monetary authority. And, of course, any costs of negotiating and policing international agreements are avoided. It is only when countries adopt really bad policies—policies that are bad even in terms of pure self-interest—that spillovers start to really matter. (Thus, if it is true that Japan is running a very poorly designed monetary policy rule, as many have argued, then the United States and Europe should indeed care.)

In Obstfeld and Rogoff's model, domestic monetary policy essentially operates through four channels, each corresponding to a different distortion in the economy. One channel is sticky wages, without which monetary policy would be neutral. This is the usual effect present in earlier models. But there are other important effects as well. One is through international risk sharing, which can be substantially affected by the international monetary system. Thus, if international markets are not complete, the way in which Europe and the United States share the burden of international monetary stabilization policy matters. The idea of international risk sharing may seem rather obscure in terms of conventional discussions of monetary policy, but it is not. The issue of whether the United States today should intervene to support the euro is very much related to how much the United States should take into account the fact that Europe is growing at a much slower rate than the United States—that is, the lack of synchronization in business cycles.

Another channel is the terms of trade, assuming countries do not impose optimal unilateral tariffs. Again, it may seem odd to think of monetary policy as providing a substitute for tariff policy, but with a bit of further thought we can see that it is not. The monetary policy rule matters through its effects on general wage levels at home and abroad. In a world where agents care about risk, the relative levels at which wages are preset will depend on the relative risks agents are forced to bear at home and abroad. If, for example, global monetary policy is tuned so that the home exchange rate is strong when world demand is high, home agents will bear less production risk than foreign agents. Why? Because when global demand is high, the value of extra income is low, so home agents are glad to see an appreciated exchange rate that shifts world demand toward foreigners, leaving home agents more leisure time. But the relative distribution of risk then feeds back into wage levels: if foreign agents are forced to bear more exchange-rate risk, they respond by raising preset wages. This generally has the effect of reducing foreign supply, with effects on world relative prices that are much like those of a tariff.

Finally, if the economy is characterized by a high degree of monopoly, monetary policy can affect the level of that distortion. Even in a rule-based system, where the monetary authorities cannot even try to systematically fool workers, the monetary policy rule can affect the average level of real wages, again through its effects on risk.

In general, understanding policy in an environment with four distortions (sticky prices, monopoly, optimal tariff considerations, risk-sharing problems) can be very difficult since the distortions can interact. Thus, for example, one cannot simply assume that the best monetary policy from a global standpoint is one that mimics a world of flexible wages. This is simply another case where eliminating one distortion entirely is not necessarily optimal unless all distortions are removed.

With so many effects to take into account, why does it turn out that a noncooperative monetary policy gives a similar outcome to a cooperative one? That is, why is it enough for countries to clean up their own house in designing anti-inflation monetary institutions, and why aren't international spillover effects more important?

The basic point is that once a central bank is forced to adopt a rule, it faces a trade-off between balancing different distortions. For example, starting from the cooperative rule, either central bank could alter its rule to improve its country's terms of trade but only at the cost of creating an unfavorable relation between world output and the exchange rate.

The one major potential area for unambiguous gain is in risk sharing, if financial markets are incomplete. Obstfeld and Rogoff are able to characterize the policy that would be optimal from a global perspective, and they contrast this policy with the one chosen in a noncooperative setting. Using numerical methods, they find that the gain to cooperation is not quantitatively large. Indeed, it is generally at least two orders of magnitude (a factor of 100) less than the gain registered by adopting the best noncooperative monetary policies, rather than having fully flexible exchange rates with fixed money-supply paths.

The authors do not presume that theirs will necessarily be the last word on the topic of international monetary cooperation. However, their analysis should give pause to the many economists who presume that the current monetary system is vastly suboptimal and must someday give way to something like a world euro standard.