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Some Thoughts on International Monetary Policy Coordination

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Economics Working Paper 18101

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January 2018

In this short paper, I review previous efforts at international coordination among central banks. In particular, I highlight the ultimate failure of both the gold standard and the Bretton Woods regimes. In both cases, the desire for a fixed rate regime forcing each country to make domestic monetary and fiscal policies subservient to pressures from the external balance. These regimes were not incentive compatible with sovereign nations' desire to pursue independent monetary and fiscal policy. Thus, future efforts at coordination that seek to constrain or limit central bank's domestic goals will most likely fail as well. I agree with John Taylor that the best results are likely to arise in more rule-like regimes with flexible exchange rates and capital mobility where the rules are more incentive compatible with domestic desires.

SOME THOUGHTS ON INTERNATIONAL MONETARY POLICY COORDINATION

Charles I. Plosser[1]

It is a pleasure to be back here at Cato and to be invited to speak once again at this annual conference. This is one of the premier ongoing monetary policy conferences and the participants, both at the podium and in the audience, attest to its prominence.

This is a session on international monetary arrangements and there has already been an interesting discussion. I find myself in substantial agreement with the comments of John Taylor, so I do not wish to repeat his points. What I will try to do is put the rules-based approach to international monetary policy coordination in a context that I hope will help us understand some of the past failures so we might avoid them in the future. In many ways, I will simply be reminding us of some principles we all have known for some time, yet which we seem to forget all too frequently.

A Little History of Efforts at International Central Bank Coordination

The dream of international coordination or cooperation among central banks is not new. Through much of the late 19th and early 20th century, we witnessed an international rules-based effort grounded in the classical gold standard. The idea was that each country was expected to maintain convertibility of its paper currency into gold at an agreed upon nominal rate. The foundation of the system was grounded in the parities agreed upon by the countries involved. These parities amounted to the specification of a fixed exchange rate regime among the participating countries. Of course, like any fixed exchange rate regime, it

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meant that pressures arising from the external balance could put limits on domestic monetary policy and fiscal policy options. This reality ultimately proved to be the regime's undoing.

The arrangement mostly worked during the early 20th century. The outbreak of World War I, however, placed enormous strains on the finances of the warring countries. The European nations had to finance large deficits through a combination of external borrowing and inflation. In most cases, the countries suspended convertibility to prevent large gold outflows. Following the war there was a strong interest in Europe to restore the prewar parities. Unfortunately, external debt and high inflation made this virtually impossible. Despite years of effort, including meetings (public and private), and conferences among central bankers attempting to coordinate actions, misalignments persisted, requiring massive gold flows, particularly from Great Britain to France and the United States. This undermined the credibility of the regime and it never fully regained the success or stability it once enjoyed. By 1933, the entire system had collapsed. The United States abandoned its peg to gold in April 1933 due to the constraints it placed on domestic monetary and fiscal policies seeking to address the Great Depression.

Later, following World War II, world leaders again sought to create a new framework for international financial coordination. The Bretton Woods system laid out rules to bring stability to exchange rates and international capital flows. The new system once again attempted to establish an essentially fixed exchange rate regime by requiring that each country commit to maintaining a targeted exchange rate within a narrow band. It also created the International Monetary Fund to help nations borrow to ease balance of payment problems in the short run. It took a long time, but the Bretton Woods system was finally fully implemented in 1958.

Despite the apparent different words and institutional arrangements, the Bretton Woods regime sought to control exchange rates in order to manage international capital flows and current account fluctuations much like the old gold standard era. Gold convertibility continued to play a role but only internationally, not domestically. The flaw was that the new arrangements still demanded that domestic monetary and fiscal policies take a back seat to the exchange rate regime. One might have guessed that, like the international gold standard regime, Bretton Woods would fail for the same reason, that being that the fixed regime was incompatible with the incentives of sovereign nations to have their own independent monetary and fiscal policies—and, of course, it did. The pegged exchange rate regime faced pressures that resulted in large but infrequent adjustments in the rates. These adjustments encouraged speculative attacks on some currencies as the credibility and the commitment of participants to follow through with the necessary policy actions was undermined. As a result, credibility of the entire regime came into question. The system was abandoned after about 15 years shortly after the United States abandoned convertibility.

The Importance of Credibility and Commitment

A major challenge for any rules-based regime is attaining and preserving the credibility and commitment of all parties to follow the rules. In establishing a rule, it is desirable to ensure that it is one that is incentive compatible. The international arrangements discussed above were not well-designed in the sense that targeting a fixed exchange rate is fundamentally inconsistent with a nation retaining full sovereignty with respect to domestic monetary and fiscal policy. It was this inconsistency that undermined credibility and doomed both the gold standard and the Bretton Woods system's attempts to coordinate international monetary policy. Put slightly differently, a challenge for rules-based systems is how to enforce a commitment to the rule. In these previous efforts there was no mechanism to enforce the rules, particularly when they ran strongly counter to the self-interest of an individual country. This suggests that we must think carefully about the scope of what we can expect to achieve from such coordination efforts. To be effective, the institutional arrangements and the incentives they create must be understood when considering any rule or set of agreements among central bankers.

At Cato's 31st Annual Monetary Conference, in November 2013, I spoke to some related issues in a paper entitled "A Limited Central Bank" (Plosser 2014). I stressed that there were ways to increase the chances of achieving commitment with the right institutional design, and to some degree we see such efforts in practice. For example, many central banks around the world face constraints on what types of assets they can buy and hold. The Fed is generally limited to holding only assets that are guaranteed by the Federal government, although there are many loopholes. For example, during the crisis the Fed exploited Section 13(3) of the Federal Reserve Act to purchase private sector securities (e.g. enabling the rescue of Bear Stearns and AIG). Such purchases constitute a form of off-budget fiscal policy and proved highly controversial. The consequence was that the Dodd-Frank legislation imposed additional limits on what the Fed could do under Section13(3). I have argued that the Fed should be limited to an all-Treasuries portfolio to restrain its discretion to conduct credit policy through asset purchases.

Another way of constraining options is to provide more narrow and clear objectives that are achievable and clearly measurable. Discretion and multiple objectives permit central banks to pursue varying goals at different times. Broad objectives often allow for great discretion to address one goal or another depending on economic conditions or political pressures. This can undermine the credibility and commitment to achieve specific tasks, such as employment, price stability, or exchange rate targets. By narrowing an institution's objective function, it is easier to demonstrate and maintain commitment and achieve credibility. It also improves the accountability of the institution. In the case of the Fed, I argued that a narrow mandate focused on price stability was desirable. It is a narrow and an achievable objective that is directly observable making accountability more effective.

A Brief Refresher on Fixed vs Flexible Exchange Rates

As I have noted, the historical efforts at international coordination have generally focused on achieving exchange rate "stability," often a code word for fixed exchange rates. The argument for fixed rates usually follows from the advantages of a common currency. A common currency promotes trade across regions of a nation as well as efficient competition and integration of markets, both product markets and the markets for factors of production such as labor and capital. The case for fixed exchange rates, by analogy, is that it promotes the integration of markets internationally with similar benefits. Such arguments were made repeatedly in support of the creation of the euro.

Yet the analogy has serious limitations. A major defect is the analogy fails to consider the important role played by the mobility of both products and factors of production. In order to achieve the market efficiencies of a common currency, goods, services, labor, and capital must be free to move throughout the market area. In the international context such free movement is rarely the case. On the product side, tariffs and other constraints are often present. In the case of labor, barriers are even more serious, including immigration policies, language, culture and other domestic laws and practices. National policies also inhibit capital movements much like labor. So, one of the prerequisites for gaining the benefits of a common currency is often absent in the international setting.

The benefits of a common currency domestically are also made possible by the existence of a common fiscal framework. This means that there is a fiscal means of addressing regional imbalances through transfers (for better or worse). A currency union of sovereign countries rarely has such mechanisms. In an international context, the failure of the gold standard and Bretton Woods highlighted all these weaknesses. In each case, the arrangements failed to adequately address the issue of mobility of either products or factors of production. Moreover, these systems did not address the fundamental challenge that each nation continued to want to conduct independent monetary and fiscal policy.

Economists have been aware of these points for a long time. Many economists voiced skepticism regarding the prospects for the euro for many of these reasons. While the euro did create a common central bank, it failed to adequately address the free movement of labor and capital. It also failed to develop an adequate fiscal mechanism to address national shocks and imbalances. The current troubles in the eurozone were largely predictable and mirrored many of the failures of previous attempts to fix exchange rates.

Recent Efforts to Coordinate International Central Banks

The recent calls for international coordination among central banks are somewhat different from the past, yet somewhat the same. On the one hand, the calls from some sectors in the global economy are not, on their face, calls for fixed exchange rates. It seems likely that the weight of experience and empirical evidence is beginning have an impact on international policymakers. The attention is mostly focused on the volatility of capital flows that may be a consequence of surprise or unusual changes in monetary policy. The source of the frustration stems from two factors. The first is that the Fed is arguably the most important central bank in the world and its decisions can have important effects, “spillovers” they are often called, on the exchange rate and trade balances with other countries. The second factor is that the severity of these "spillovers" for individual countries are often a consequence of the country's own choice of policies and institutional arrangements.

Countries with large fiscal deficits, heavy external debt, and high inflation likely will have more trouble contending with spillovers and thus complain about a U.S. policy decision. They then press for greater consideration of their circumstances in U.S. monetary policy decisions. Countries maintaining sound fiscal policies, low inflation and a commitment to flexible exchange rates are less affected.

While calls for coordination on interest rate decisions from some countries do not explicitly argue for fixed exchange rates, that seems mostly what they long for—they just don't say it. On the other hand, the major central banks were playing a somewhat different tune. The sequential adoption of quantitative easing (QE) by one major country after another was mostly cited as a domestic policy action, yet the undercurrent was about exchange rate effects. They didn't call it a currency war, or even competitive devaluations, because everyone understood such strategies are ineffective and undesirable. Nonetheless, it seems to have been the unspoken strategy that no one wanted to admit.

These different strategies highlight the underappreciated challenge to the case for international coordination among central banks. Our models usually don't deal with a world in which there are many different exchange rate regimes or many different fiscal regimes. How should the United States coordinate monetary policy in a world in which different countries experience differential impacts from a given monetary policy decision by the Fed? Which countries' outcomes matter and which do not? For example, the Fed's response to an inflation shock in the United States can have different impacts on a country that ties its currency to the dollar and has a balanced current account from a country that operates a floating exchange to a broad basket of foreign currencies but runs a persistent current account deficit and imposes capital controls. Which countries should be taken into account in the Fed's decision, and which should not? Should U.S. monetary policy play favorites? How should it decide which countries consequences demand consideration and which countries do not?

So, from my perspective, the concept of coordinated monetary policy is deeply problematic. Moreover, as I argued at the outset, any regime that attempts to target exchange rates among sovereign countries is most likely to fail if those countries desire an independent monetary policy.

Conclusion

I agree with John Taylor that the best results are likely to arise in more rule-like regimes with flexible exchange rates and capital mobility (Taylor 2018). With regard to monetary policy, the rule matters. Rules that require multiparty coordination to "stabilize" exchange rates are likely to fail and cause more problems than they solve. Rules that are incentive compatible with independent monetary and fiscal policy are more likely to be followed and further reducing the discretionary options permitted monetary policymakers would enhance the commitment and credibility of the rule-like behavior.

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