FRBSF Weekly Letter

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# International Policy Coordination

At the recently concluded May 4-6 summit meeting in Tokyo, the U.S. and six other major industrial powers agreed to work toward closer coordination of their economic policies. Such coordination is seen as a basis for moderating exchange rate swings and maintaining a healthy world economy. The focus on improving coordination stems from a heightened awareness by policymakers that the attainment of national interests depends on the actions of others, and that flexible exchange rates do not fully eliminate the effects of the policies of foreign countries on their own economies.

Many regard the agreement reached at Tokyo as the natural result of international cooperation over the past year to bring down both worldwide interest rates and the value of the dollar. This *Letter* examines the motivations behind these policy actions and the prospects for continued international coordination.

**Recent coordination efforts**

The May summit agreement was only the most recent of a series of joint steps undertaken by the United States and other countries over the last year. On September 22, 1985, the G-5 countries — the United States, West Germany, Japan, France, and the United Kingdom — announced concerted support for a reduction in the foreign exchange value of the dollar. While the dollar was already on a downward path, it continued to fall following the agreement.

In January, the G-5 countries agreed on the desirability of interest rate declines but stopped short of coordinated steps to lower interest rates. It was only in March that the United States, West Germany, and Japan lowered their discount rates — the rate that central banks charge on loans to commercial banks — by half a percentage point. In April, another round of reductions was undertaken by the Federal Reserve and the Bank of Japan. The Bundesbank, however, conspicuously chose not to make a similar reduction.

At the recent May meeting of G-7 countries, the G-5 nations plus Canada and Italy agreed to attempt coordination on a more formal ongoing basis by periodically assessing one another's policies and recommending changes to those whose policies are deemed to be out of line and damaging to others. To aid in these assessments and the gauging of economic performance, the countries will use an array of indicators that would probably include output growth rates, inflation rates, interest rates, trade balances, and possibly, a range of values for each country's currency.

**Rules versus discretion**

Policy coordination among countries may take different forms. At one extreme are agreements by individual countries to adhere to particular policy rules. For example, the Bretton Woods international monetary system, in effect from 1944 to 1973, represented a rule-based agreement whereby countries sought to fix the value of their currencies in terms of the dollar. When a currency departed from its fixed rate, the country behind it was expected automatically to intervene to bring it into line. The European Monetary System (EMS) is a more recent example of coordination based on adherence to rules of exchange rate management by cooperating countries.

At the other extreme, coordination may take the form of ad hoc arrangements reached through formal or informal contacts to deal with particular economic circumstances. The joint effort announced last September to push down the value of the dollar and the recent discount rate cuts may be seen as examples of this type of coordination.

By their nature, rules limit policy discretion and encourage individual countries to "bend" or break the rules when they feel it is in their best interests to do so. The collapse of the Bretton Woods international monetary system in 1973 reflected the unwillingness of countries to accept the restraints on their national economic policies required by the formal commitment to maintain fixed exchange rates. For example, in the period starting in the mid-1960s, when inflation was putting downward pressure on the dollar, the U.S. chose to let the dollar drop in value rather than accept the economic stagnancy and greater unemployment that would otherwise have resulted.

Short-term discretionary arrangements allow more flexibility than long-term rules in dealing with specific circumstances. Nevertheless, countries also find it difficult to achieve short-term policy arrangements because the process of bargaining and negotiating is time-consuming and the circumstances underlying each round of negotiations are changeable.

More importantly, the achievement of coordination agreements requires that the countries involved be able to reconcile their various interests and views of the world. For example, some may give higher priority to fighting inflation while others favor lowering unemployment. Even if policymakers could agree on goals, they may differ with respect to views about the structure of the economy and the influence of policy actions on targeted variables. For example, West German policymakers are generally perceived to believe that a given fiscal or monetary stimulus will have a greater influence on the price level, relative to output and employment, than policymakers in the U.S.

In addition, coordination may be inhibited by the unwillingness of individual countries to take the necessary lead even when the same goals are shared. For example, in a world recession, countries may prefer to wait for the expansionary policies of others to generate increased demand for their products rather than stimulate their own economies. Recovery therefore is likely to be delayed or aborted, to the loss of all.

**Reconciliation of interests**

The success of either rule-based agreements or short-term arrangements ultimately depends on the continuing ability of the countries involved to reconcile their interests and to recognize that each has something to gain through international coordination. The importance of reconciling interests is apparent from a closer examination of the episodes of international coordination by the United States, Japan, and W. Germany over the past year.

What motivated the U.S. last September to seek a lower dollar was the desire to encourage exports (by making them more competitive) and discourage imports (by making them more expensive). Both Japan and West Germany also recognized the need to bring down the dollar to head-off protectionist pressures in the U.S. The dollar depreciation would reduce U.S. demand for their products, but the economies of both countries were showing signs of robust health at the time. West German growth was picking up strongly in the second and third quarters of 1985 following a downturn in the first quarter; Japan experienced reasonable growth in the middle of 1985

Six months later, in March of this year, the U.S. cut its discount rate because of a desire to stimulate an apparently sluggish economy (growth in the fourth quarter of 1985 was 0.7 percent). In addition, U.S. long-term interest rates fell over 1½ percentage points between late-October 1985 and mid-March 1986 because of expectations of declining inflation and anticipated reductions in the budget deficit. Since short-term rates had remained relatively stable over the same period, the cut in the discount rate allowed the federal funds rate and other short-term rates to fall in step. Still another rationale was a desire to lower worldwide interest rates to ease the debt burdens of developing countries.

The major reason both West Germany and Japan followed suit appears to have been a concern that the dollar was falling too rapidly. Matching discount rate cuts would reduce the likelihood that the cut by the Fed would drive the dollar down faster. Japan was more than willing to cooperate (and, in fact, had enacted a unilateral discount rate cut in January) because the cut would also stimulate its own then-slowing economy and temporarily halt the effects of a declining dollar on its exports. Because of the fall in the price of oil and the growing strength of the yen, the inflationary effects of such a stimulative action were perceived to be small.

West Germany's motivations were similar. Even though the expansion of its exports was slowing because of the strengthening of the deutschemark, overall economic growth was moderate. Domestic demand was being spurred by consumer spending bolstered by income-tax cuts that went into effect at the beginning of 1986. Nevertheless, because unemployment remained historically high at a level of between 8 and 9 percent, West Germany viewed the stimulative effects of the small discount rate cut as desirable.

Only the U.S. and Japan participated in the second round of discount rate cuts in April, for much the same reasons as they had in March. West Germany refused to join in, citing the possible long-term inflationary effects of further stimulatory actions despite inflation rates of less than 2 percent in 1985 and 1 percent so far in 1986. Divergent domestic interests thus prevented a complete agreement on policies.

**The Tokyo agreement**

The Tokyo agreement can be interpreted as an attempt to create a relatively long-term arrangement to coordinate international economic policies that also recognizes the general unwillingness to return to a rule-based system that rigidly limits policymaking discretion.

Before noting the achievements, it is worthwhile to look first at what was not achieved at the Tokyo summit. First, the countries did not agree on a stronger form of coordination, such as jointly set "target zones" beyond which currency values would not be allowed to fluctuate. Most countries were unwilling to commit themselves to such a scheme because it would have required them to take economic steps — such as changing government spending and taxation levels, reducing or raising interest rates, or liberalizing access to their markets — solely in response to pressures on their currencies.

Second, the U.S. could not obtain agreement, particularly from West Germany and Japan, on an arrangement whereby countries automatically would be obliged to adjust their policies in response to "objective indicators" for measuring economic performance. Such an arrangement would have called for both West Germany and Japan to stimulate their own economies further by increasing their fiscal spending and, in so doing, assume the "locomotive" role of sustaining growth in the world economy as U.S. economic growth slowed.

Both West Germany and Japan have staunchly opposed such policies. While West Germany cut income taxes in January and has scheduled a second set of cuts for 1988, one of its overriding policy objectives remains to reduce the relative size of its public sector. Because of the size of its central government deficit (near 5 percent of GNP in 1985), the substantial increase in central government debt over the past ten years, and a prospective large increase in social security payments, Japan also continues to emphasize reductions in the level of its central government spending.

Instead of policy rules, the Tokyo agreement calls for the recommendation, rather than the requirement, of appropriate policies to countries that diverge from desired international economic goals. Individual goals are to be set each year at ministerial meetings of the member nations, with the International Monetary Fund to monitor how well each country lives up to them. Proponents of the plan hope that the pressure of international attention will force individual countries to comply with the jointly set goals. Nevertheless, the ultimate success of the plan still depends on a continuing coincidence of interests.

Certainly, the prospects for coordination have been enhanced by the fact that all the major economies are now growing. The sustained drop in oil prices has improved the inflation outlook both in the U.S. and abroad. In addition, the anticipated decline in U.S. federal budget deficits together with the recent discount rate cuts represent a convergent trend among national economic policies.

Given all these developments, the conditions may be conducive to arrangements and concessions that are to every country's best interests. Thus, the Tokyo agreement should be seen as a positive step by the large industrial countries to reduce the instability in world economies that arises from conflicting national policies.

**Reuven Glick**



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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| **Selected Assets and Liabilities Large Commercial Banks** | Amount Outstanding 5/21/86 | Change from 5/14/86 | Change from 5/22/85 Dollar | Change from 5/22/85 Percent[7] |
|---|---|---|---|---|
| Loans, Leases and Investments[1 2] | 202,276 | 190 | 10,197 | 5.3 |
| Loans and Leases[1 6] | 183,412 | 185 | 9,943 | 5.7 |
| Commercial and Industrial | 52,386 | − 489 | − 149 | − 0.2 |
| Real estate | 66,968 | 244 | 3,881 | 6.1 |
| Loans to Individuals | 38,922 | − 48 | 4,843 | 14.2 |
| Leases | 5,627 | − 8 | 266 | 4.9 |
| U.S. Treasury and Agency Securities[2] | 11,028 | 12 | − 564 | − 4.8 |
| Other Securities[2] | 7,836 | − 7 | 817 | 11.6 |
| Total Deposits | 200,491 | −1,318 | 7,644 | 3.9 |
| Demand Deposits | 48,297 | −1,646 | 4,464 | 10.1 |
| Demand Deposits Adjusted[3] | 33,792 | − 650 | − 6,269 | −15.6 |
| Other Transaction Balances[4] | 15,737 | − 20 | 2,621 | 19.9 |
| Total Non-Transaction Balances[6] | 136,457 | 347 | 560 | 0.4 |
| Money Market Deposit Accounts—Total | 46,440 | 440 | 3,063 | 7.0 |
| Time Deposits in Amounts of $100,000 or more | 36,234 | − 135 | − 2,162 | − 5.6 |
| Other Liabilities for Borrowed Money[5] | 23,854 | − 405 | 552 | 2.3 |

| **Two Week Averages of Daily Figures** | Period ended 5/19/86 | Period ended 5/5/86 |
|---|---|---|
| **Reserve Position, All Reporting Banks** | | |
| Excess Reserves (+)/Deficiency (−) | 28 | − 15 |
| Borrowings | 41 | 39 |
| Net free reserves (+)/Net borrowed(−) | − 13 | − 55 |

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change