

COMMENTARY

International Coordination

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Overview

The paper provides an insightful synopsis of the history of international economic cooperation from the Great Depression, analyzing episodes where countries behaved cooperatively or noncooperatively in two international fiscal games and two international monetary games.

The fiscal games are as follows:

- 1 **The “locomotive game”:** The superior cooperation outcome means coordinated fiscal stimulus expansion of countries in recessionary times, inducing positive spillover effects, and increasing the GDP of countries without increasing their trade surpluses. The noncooperative outcome is the “beggar-thy-neighbor” equilibrium inducing deeper global recession, as would be the case when each country pursues a contractionary fiscal policy due to concerns associated with larger trade and fiscal deficits.
- 2 **The moral hazard game:** The superior cooperative outcome is an agreement on fiscal rules to eliminate moral hazard. The noncooperative outcome is when everyone runs excessive deficits because of possible anticipated bailouts, as may be the case in loose currency or fiscal unions.

The monetary games are as follows:

- 1 **The currency war game:** The cooperative equilibrium occurs when everyone agrees to refrain from currency warfare induced by loose monetary policy aimed at depreciating a country’s currency in order to gain competitiveness and trade stimulus. The noncooperative outcome occurs when all countries follow an expansionary monetary policy, and thereby nobody achieves real depreciation or trade stimulus.
- 2 **The competitive appreciation game associated with interest rate setting:** The cooperative equilibrium implies low interest rates everywhere. Exchange rates stay unchanged, but growth is sustained. The noncooperative equilibrium occurs when monetary policy is too tight due to high interest rates everywhere, and the world remains stuck in recession.

The main lessons of the paper are as follows:

- Perceptions of the signs of spillovers and directions of coordination vary widely, inhibiting cooperation.
- The existence of different models and different domestic interests is as important as the difference between cooperative and noncooperative equilibria.
- Complaints about foreigners' actions and calls for cooperation may obscure the need to settle disagreements domestically.

Comments

A central policy lesson of this paper is that international cooperation is rare and occurs mostly in exceptional circumstances. Hence, countries should invest more in precautionary strategies and putting their house in order, in anticipation of trouble. My comments highlight first the rare conditions leading to international cooperation, next the obstacles preventing cooperation, and then conclude with policy implications.

Circumstances Leading to Greater International Cooperation

The rarity of international cooperation does not imply that such cooperation should be ignored. The first year of the global financial crisis (GFC) illustrates that exceptional circumstances may lead to needed and highly beneficial cooperation. This is in line with the view that in "normal times," associated with no bad tail events, the gains from cooperation have the size of Harberger's triangles, about 0.5–1 percent GDP points. These gains may not be worth the possible income redistribution effects, which may be of even larger magnitude than the efficiency gains from cooperation. In contrast, clear bad tail events that may cause the imminent collapse of financial markets would induce massive losses. Collapsing financial markets may terminate the entire Marshallian surpluses associated with their normal operations, triggering global financial contagion in domestic and global networks, inducing costs of double-digit GDP points.

Thereby, in normal times, the cooperative solution is associated with welfare gains akin to Harberger's second-order magnitude triangles, hence the odds of cooperation are low. In circumstances of bad tail events inducing imminent and correlated threats of destabilization in most countries, the perceived losses have a first-order magnitude of terminating the total Marshallian surpluses. The looming threat may induce fiscal and monetary cooperation, as has been the case during the first quarters of the GFC. As a result, short of positively correlated impending threats, do not expect deeper cooperation. Yet, a key benefit of ex ante international cooperation may be reducing the probability

of tail events. This mission should be a top priority for international financial institutions (IFIs) and central banks (CBs). The benefits of such *ex ante* cooperation include setting swap lines and contingent credit lines, establishing leverage rules reducing the amplitude of credit cycles, and the like.

Achieving this cooperation cannot be taken for granted—*ex ante* cooperation should deal with complex moral hazard and agency problems. Furthermore, the benefits of such cooperation are easily overlooked, as the counterfactual—identifying all the tail events that were prevented—is hard to measure.

Obstacles Preventing Cooperation

The obstacles preventing cooperation may be hard to overcome. Status quo may reduce macroeconomic cooperation, both domestically and internationally. This is the case if policymakers and agencies take the view that “if it ain’t clearly broken from my perspective, don’t fix it.” Frequently, new policies inducing welfare improvements raise income distribution concerns, triggering a possible war of attrition among key stakeholders, aiming at shifting the costs to others, and delaying cooperation. One expects that greater income inequality and polarization may intensify the incidence of wars of attrition delaying adjustment.

To illustrate, Eichengreen and Sachs’s (1985) interpretation of the gains from competitive devaluation during the Great Depression is an example of a noncooperative outcome, leading over time toward an outcome akin to global coordinated monetary expansion. The delay in achieving this cooperative outcome may reflect the resistance of domestic powerful groups (e.g., “rentiers”) to policies lowering interest rates, engaging in a war of attrition against interest rate cuts and monetary expansions.

Similarly, large fiscal and current account adjustments, frequently needed to stabilize developing countries, may be easier to achieve in countries with lesser polarization. South Korea improving its current account by about 13 percent GDP points in the two years following the Asian crisis is the exception. This was feasible in Korea but not in euro-area periphery countries in recent years, nor in most developing countries. Status quo bias may also explain the CBs’ unwillingness to increase inflation targeting at times of global peril from 2 percent to 4 percent, as was advocated by Blanchard, Dell’Ariccia, and Mauro (2010).

Principal-agent, moral hazard, and political constraints matter, as they constrain the feasibility of *ex ante* cooperative arrangements and *ex post* stabilization efforts. The provision of swap lines by the U.S. Federal Reserve during the GFC is a prime example of international cooperation inducing first-order effects. Yet, the Fed extended these swap lines only to four emerging markets (EMs). The selectivity of these swap lines reflected the imminent cost to U.S.

interests following defaults of Mexican and Korean counterparties (Aizenman and Pasricha 2010). It also reflected the Fed's concerns that overextending such swap lines would be used by some to constrain the Fed's future independence. China does not face such constraints and is willing to supply swap lines to large groups of developing countries, including Argentina and other countries with a history of defaults.

Precautionary Policies

Developing countries and EMs are more vulnerable to adverse tail events. Their limited financial depth, limited ability to borrow in their own currency, possible history of defaults, and less developed institutions imply greater vulnerability. The scarcity of global cooperation at time of peril implies that emerging markets would benefit from building precautionary buffers, such as international reserves and sovereign wealth funds (SWFs) during tranquil times. The potency of these buffers is enhanced by policies aiming at reducing a country's balance sheet exposures. EMs should also strive toward deeper cooperation between their CB, SWF, and Treasury. The pioneering papers of Frankel (2011) and Frankel, Vegh, and Vuletin (2013) show that this can be done, Chile being a prime example.

Greater exchange rate flexibility is another margin of safety, mitigating the moral hazard game between the private sector (ignoring exchange rate risk) and the CB (that is expected to bail out systemic balance sheet exposure). These precautionary policies were tested by the GFC, with mixed outcomes, leading Rey (2013) to doubt the usefulness of exchange rate flexibility, reducing Mundell's trilemma into a dilemma between financial integration and monetary autonomy. Chances are, however, that the claims on the trilemma's death and the futility of flexible exchange rate regimes are exaggerated. An alternative take is that Mundell's trilemma morphed into a quadrilemma, where financial stability is a fourth dimension of desirable macro outcome. An economy that pursues greater exchange rate stability and financial openness faces a stronger link with the center economies (Aizenman, Chinn, and Ito 2015). Macroeconomic and financial vulnerabilities are significantly greater under less flexible exchange rate regimes—including hard pegs—as compared with floats. Although not especially susceptible to banking or currency crises, hard pegs are significantly more prone to growth collapses, suggesting that the security of the hard end of the prescription is largely illusory (Ghosh, Ostry, and Qureshi 2015). In this context, the quality of institutions matters: countries that constrain their balance sheet exposure keep benefiting from exchange rate flexibility. Macroprudential

policies and capital controls seem to significantly reduce the exchange market pressure, although the economic size of this impact is highly dependent on the institutional quality (Aizenman and Binici, forthcoming).

Latin American countries (LATAMs) may provide useful lessons. The GFC increased their exposure to larger and more volatile financial flows, which were followed in 2014 by LATAMs' collapsing terms of trade due to the drop in commodity prices. Yet, most LATAMs retained so far their resilience, helped by managed exchange rate flexibility and greater coordination between domestic institutions. Chances are that the flexibility of the exchange rate of Mexico and other Latin American commodity countries has so far prevented a balance of payment cum banking crisis, akin to those observed during the 1990s (the 1994–95 Tequila crisis in Mexico, the East Asian crisis of 1997–98, and the Russian and Brazilian crises of 1998–99). Exchange rate flexibility has other side benefits—reducing the exposure of countries to the Spanish syndrome of the 2010s, when the fixed exchange rate associated with being a euro-area member restrained Spain's ability to improve its competitiveness by means of nominal exchange rate adjustment, exposing Spain to destabilizing raises in its sovereign spreads, as was highlighted by the contrast between Spain and the United Kingdom (De Grauwe and Ji 2013). Indeed, LATAMs, Russia, and other commodity countries buffered the adverse commodity shocks of 2014–15 via their exchange rate depreciation, facilitating an easier adjustment in countries with limited balance sheet exposure, yet challenging countries with greater exchange rate exposure, Brazil being a prime example.

However, flexible exchange rate is not a panacea: among n flexible exchange rate currencies, at most only $n - 1$ are independent. Size matters even under flexible exchange rate regimes. The weakening gains from exchange rate flexibility highlighted by Rey (2013) may be the outcome of the evolution leading to the GFC, when financial instability in the United States was transmitted globally due to global balance sheet exposure, as the U.S. global share in finance vastly exceeded its global GDP share. Yet, these factors do not negate the usefulness of exchange rate flexibility in dealing with terms-of-trade shocks, domestic disturbance, and other shocks. Indeed, the lesson of the 1990s has been that emerging markets covered the middle ground of Mundell's trilemma—controlled exchange rate flexibility and limited financial integration, retaining monetary independence. This configuration, properly buffered by precautionary policies (hoarding international reserves and controlling external borrowing) may be the second-best optimal response of countries to the limited efficacy of international coordination (Aizenman and Pinto 2013).

Conclusion

Frankel's contribution brings to the fore the scarcity of global cooperation and the need for countries to put their house in order. This does not negate the key importance of global cooperation in the aftermath of bad tail events that may induce a global depression. A key role of IFIs and CBs remains facilitating deeper ex ante international cooperation aimed at reducing the probability of such tail events. Time will keep testing the viability of such cooperation.

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