Autonomy and Coordination of Monetary Policy in a Global Economic Order

Yoshio Suzuki

Monetary Coordination and Dollar Misalignment

During the last one or two years, monetary coordination has not been discussed at G5 or G7 meetings as often or with as much urgency as before. The monetary coordination that was begun after the Plaza Agreement of September 1985 had various objectives, but in retrospect its major purpose has been to adjust the medium-term misalignment of the dollar against other major currencies. The dollar declined sharply until early 1988, when the fall came to a stop; and since 1989, the dollar has even strengthened. The first act of the drama, "policy coordination after Plaza," seems to have ended. Frankly, Japan is uncomfortable with the decline in the value of the yen, from the 120-yen level to the 140-yen level that has taken place since 1989. Although we worry that the current account deficits of the United States may expand again, the strong international policy coordination that was carried out from the Plaza Agreement through 1988 was not continued in 1989 to prevent the dollar from rising. The United States did not reduce its official discount rate, and Japan maintained an official discount rate of 2.5 percent, a historical low. There was *no coordination to prevent* the dollar from rising by reducing the interest rate differential between the United States and Japan.

I am pleased to see that the monetary policy coordination that was designed to manipulate the value of the dollar has come to an end.

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The author is Vice Chairman of the Board of Councilors of Normura Research Institute, Ltd., and former Executive Director of the Bank of Japan. This paper was delivered as a luncheon address at the Cato Institute's Ninth Annual Monetary Conference in London, February 23, 1990.

A review of the process of monetary policy coordination since the Plaza meeting shows that it was only before the February 1987 Louvre Agreement that all of us faced no major conflict between the aim of domestic monetary policy—that is, price stability—and the aim of international coordination—that is, the manipulation of the dollar's foreign exchange value. After the Louvre Agreement, however, international coordination imposed a major constraint on the autonomy of monetary policy. If it had not been for international coordination, the stability of the domestic macroeconomies of major countries since 1988 would have been better.

Let me elaborate. The first initiative taken after the Plaza Agreement was to bring down U.S. interest rates, which had been the main cause of the high U.S. dollar. The result was a narrowing differential between long-term interest rates in the United States and those in Japan and Europe. This provided room for interest rate cuts in Japan and Europe. In order to stimulate growth in domestic demand, Japan, the United States, and major European countries reduced their interest rates in a concerted manner while maintaining the narrowed interest rate differential. This was the start of a "coordinative interest rate reduction," a rare case of a happy harmony between autonomy and coordination. This concerted action succeeded in achieving global economic recovery; the narrower interest rate differential resulted in a fall of the U.S. dollar, and international imbalances started to decrease.

By February 1987, when the Louvre Accord was reached, the monetary authorities of major countries reached the common view that a further weakening of the dollar would be counterproductive for the world economy. Coordination entered the second phase. The aim of international policy coordination became the prevention of any further decline in the U.S. dollar. Interest rates were lowered in Japan and Europe and raised in the United States. As a consequence, the interest rate differential widened again.

During 1987, economic recovery became clearly visible in Japan and Europe. Monetary policy in Japan and West Germany was shifted to a stance that allowed an increase in market interest rates. It was expected that the official discount rate would be raised before the end of the year, but the stock market crash in New York changed the trend.

Faced with the crash of stock prices in October 1987, U.S. authorities, in order to prevent panic in the financial markets, eased monetary conditions instead of keeping interest rates high as they had planned. This policy change resulted in a further decline of the dollar, and Japan and major European countries had to lower their

market interest rates again to support the dollar. This launched a third phase of policy coordination, the "period of renewed coordinative interest rate reduction."

From the beginning of 1988, the negative side of such coordinative activities became increasingly obvious. Inflationary expectations mounted worldwide following "renewed coordinative interest rate reductions" that, in retrospect, might have been excessive. From the summer of 1988, the United States, West Germany, and other European countries began to raise their official discount rates to achieve domestic price stability. It was around that time that the fear of a further decline in the dollar subsided, and the monetary policy coordination that started after the Plaza Agreement came to an end. Thus, the autonomy of major countries' monetary policy was restored. But it was a bit too late because inflation rates in most major countries had already started to rise.

Lessons from Past Coordination

What lessons have we learned from our experience between September 1985 and 1988? The benefits from the policy coordination have been a solution to misalignment among exchange rates of major currencies and the resultant contraction of the current account imbalances in Japan and the United States, from over 4 percent to nearly 2 percent of GNP. Taking into account lagged effects of direct investment, the ratio of the international imbalance to GNP should shrink more even under the current exchange rate. Moreover, these effects were achieved without sacrificing free trade and capital movement.

What then are the costs of policy coordination? They include an increase in inflation rates of major countries and an increase in interest rates worldwide. In Japan, the strong yen somewhat curbed the increase in goods and service prices. But because Japan maintained low interest rates between February 1987 and May 1989, the growth rate of the broad money stock reached double digits. This resulted in a surge in asset prices, including land and stock prices. The resulting wealth effects on aggregate demand have clearly generated potential inflationary pressure.

In addition to these costs, there has been an unexpected by-product in the global economic structure. Because the yen's value against the U.S. dollar almost doubled and because the low interest rates required for policy coordination caused asset prices in Japan to surge, the total assets of Japan's private sector at the end of 1988 reached \$43 trillion, 16 times as much as GNP; net worth reached \$22 trillion, 8 times as much. These figures sharply exceeded the corresponding

figures of $39 trillion and $14 trillion for the United States. Although Japan's gross external assets accounted for only 3.1 percent of total assets and its net external assets accounted for only 1.3 percent of total net worth, it has become the world's largest net creditor country. This implies that any domestic policy or reform that induces portfolio adjustments in Japan may have large spillover effects on overseas interest and exchange rates. As a matter of fact, raises in the official discount rate by the Bank of Japan in October and December of 1989 triggered falls of bond and equity prices in the New York market.

Perhaps international cooperation might have to be extended from the dimension of "flow," such as adjusting trade imbalances and controlling aggregate demand, to the dimension of "stock," which includes managing portfolio adjustment. At least we have entered an era when we must be vigilant that international friction arising from flow, such as trade friction, does not trigger an unexpected reaction in the dimension of stock, such as a rush of global portfolio adjustment, which could result in worldwide disturbance to interest rates and exchange rates. This may imply that international coordination has become even more necessary to achieve international financial stability in the global economic order. In this context, President Bush and his Council of Economic Advisers were quite right in rejecting ideas of "managed trade" and control of direct investments to the United States from abroad in the February 1990 *Economic Report* and in the CEA's *Annual Report* to Congress. The idea of controlling direct investment from abroad together with managed trade is very dangerous indeed, particularly for a large deficit country under a floating exchange rate regime with global capital movement among economies holding enormous amounts of financial assets.

Autonomy and Coordination

International monetary arrangements are always expected to function in a way that will ensure (1) free international trade of goods and capital, (2) stability of the domestic economies of individual nations, and (3) stability of the global economic order. Satisfying all of these conditions at the same time is extremely difficult. Although there is general consensus over the desirability of achieving free trade of goods and capital, the second and third propositions often prove mutually exclusive. In this regard, the period since the Plaza Agreement has not been an exception.

As of February 1990, the governments of the United States, Japan, and West Germany are putting top priority on the autonomy of monetary policy to achieve domestic macroeconomic stability. Meanwhile,

Canada and members of the European Monetary System (EMS) other than West Germany are concerned more with preserving the stability of their currency's exchange rates vis-à-vis the Deutsche mark and, in the case of Canada, with the U.S. dollar. Both the second and third conditions, then, are satisfied to a certain degree within the region covered by the EMS and North America, but friction in tripartite relations among these two regions and Japan could pose a threat to global stability.

A solution could be found to all three issues if the world were to adopt a single currency, but at the moment that is not possible. The United States, Japan, and West Germany are left with no alternative but to try to stabilize the global economic order under a regime of floating exchange rates with free trade and capital movements.

Judging from events in Eastern Europe and the Soviet Union since the end of 1989, we see that the economic competition between capitalism and communism, or between "decentralized market economies" and "centrally planned economies," is nearly over. But I do not believe that the basic confrontation in the global economic order has come to an end. From now on, confrontation will center on the front between the "liberal" market economies of the front-runner countries and the "developmental" market economies of second-tier, or catching-up, countries. The former group includes Britain, the country that founded that group in the 19th century; North America and Western Europe, which have joined since the end of World War II; and Japan, which joined in the 1970s. The typical success stories of the developmental market economy include Japan from the end of World War II until the 1970s and the Newly Industrialized Economies in Asia today. Some ASEAN countries and recently East European countries, the Soviet Union, and China are about to join the second-tier group. The developmental market economy uses a development strategy of industrialization based on the framework of a market economy but with strong government guidance and intervention to achieve high-speed capital accumulation and high growth to catch up with the front-runner countries. It is characterized by the supremacy of the economy and nonideological philosophy.

If the second-tier nations successfully develop their economies and expand into the world market, the front-runner countries must shift their industrial structure to a higher technological level. Otherwise, economic friction between the two will mount. If advanced countries impatiently criticize the government intervention of developmentalism and demand liberalization with cries of the universal justice of liberalism, then the developmental nations will resort to nationalism. There is a danger that, being disappointed by this con-

frontation, the front-runner countries will resort to new protectionism. If this happens, we will see the world divided into several blocs of market economies surrounded by fortresses, instead of drawing close to one global market economy characterized by free trade and capital movement.

Conclusion

The most desirable form the global economic order could take in the 1990s would be to have three liberal market economies: integrated Western Europe; North America, consisting of the United States and Canada; and Northeast Asia, consisting of Japan, South Korea, Hong Kong, and Taiwan. Liberalization of the economies in Northeast Asia is as yet insufficient and should be promoted more vigorously. Three groups of liberal market economies will have increasingly deep relations with adjoining developmental market economies through trade and capital investment: Western Europe with Eastern Europe, North America with Latin America, and Northeast Asia with the rest of Eastern Asia. These three economic spheres, within which intra-regional trade is growing sharply, must remain open to each other. West Germany, the United States, and Japan should maintain the stability of their own domestic macroeconomies through autonomous monetary policies and play the role of an anchor in each sphere. The financial markets in London, New York, and Tokyo should function as international financial centers. The U.S. dollar, the yen, and the Deutsche mark—or the unified European currency if it materializes—should compete with each other under a floating exchange rate regime with free trade and capital movement. Individual countries should determine which currency they will use for international reserves, contracts, and settlements. Individual countries should also be free to choose whether their own currencies will float freely under autonomous monetary policy or be pegged to one of the three polar currencies.

Policy coordination should not impede the autonomy in the monetary policies of the tri-polar economies. There are two major objectives for policy coordination in the 1990s. One is to avoid the rise of protectionism among the front-runner countries and nationalism among the second-tier countries and to promote both gradual structural changes in the liberal market economies and the industrialization of the developmental market economies with a common aim of achieving one global market economy with free trade and capital movement. The three economic spheres should freely compete

among themselves with respect to trade, capital, and currency as open markets where intra-regional trade is developing rapidly.

The second objective of coordination is to ensure that the financial stability of the global economic order is maintained. As transfer costs of information decrease and as global links of electronic payment systems develop, the global systemic risk will also increase, particularly when the accumulation of assets as compared to income levels advances further. Deliberate international coordination is becoming even more important for preventing conditions that might trigger a rush of global portfolio adjustment and induce a market crash.