

AVOIDING MONETARY PROTECTIONISM: THE ROLE OF POLICY COORDINATION

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Economists have long questioned the wisdom of attempting to achieve current-account objectives through a monetary manipulation of nominal exchange rates, and most have rejected this practice as little more than a near-term palliative. Nevertheless, aiming monetary policies at nominal exchange rate targets increasingly seems to be the approach of choice among national leaders. We refer to these attempts as *monetary protectionism* in order to emphasize their similarities to more traditional protectionist policies. As with calls for tariffs and quotas, calls for monetary protectionism do not stem from a clear, unequivocal demonstration of market failure, but from political institutions and incentives that encourage those dissatisfied with the market's outcome to seek market intervention. Proponents of monetary protectionism seek to supplant the automatic and nondiscriminatory responses of markets with the discretionary, politically motivated decisions of bureaucrats. Any international order built on such a foundation cannot raise world welfare.

We will explore the political economy of monetary protectionism in order to illustrate its economic shortcomings and to understand its political appeal. As a counterweight to the political pull toward monetary protectionism, we recommend that nations adopt monetary constitutions that focus monetary policy on long-term price stability and that recognize market-determined exchange rates. Moreover,

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we contend that international policy coordination set within this framework is both feasible and credible.

Monetary Protectionism

By monetary protectionism, we refer to attempts to alter *real* exchange rates through a manipulation of monetary policy, with the hope of ultimately promoting a balance-of-payments objective. In the case of a deficit country, monetary protectionists call for an expansion of money growth. A monetary expansion, other things being equal, will produce a *nominal* depreciation.¹ If individuals are unable to adjust prices immediately or if they are slow in perceiving the inflationary aspects of this policy, a real depreciation will accompany the nominal depreciation. As most economists realize, however, the inflation rate will eventually respond to the monetary expansion, off-setting the nominal depreciation and returning the real exchange rate to its initial position. Nevertheless, the tenuous, short-lived relationship between money and the real exchange rate is seductive enough to convince politicians and other “fine-tuners” that monetary policy can serve mercantilist designs.

Our focus on this issue stems from a firm belief that central banks can do no better than to guarantee long-run price stability and that any efforts to limit this guarantee are not likely to raise world welfare. This is the central lesson from the experience of policymaking during the 1970s, as well as the message of much of the professional literature based on models with forward-looking, optimizing agents. Central banks can juggle a real exchange rate and inflation target no better than they can slide back and forth along a stable Phillips curve.

A central bank that attempts to maintain price stability and a nominal exchange rate target has more policy targets than policy instruments. At times, these two objectives might be compatible. For example, in the late 1970s, limiting rapid dollar depreciation through intervention purchases of dollars could have been compatible with a contractionary monetary policy to eliminate inflation. As often as not, however, these two policy objectives will be incompatible, and the central bank must trade one objective against the other.²

Under such conditions, markets will view neither price stability nor exchange rate stability as a credible policy. The knowledge that

¹Monetary policy could play an important role in correcting a current-account deficit in an inflationary economy. The correct response, of course, would be a *contractionary* policy.

²We assume here that the world will not adopt a commodity (gold) standard and that all central banks will not steadfastly pursue price stability.

central banks will deviate from a policy of price stability to pursue an exchange rate objective will raise uncertainty about real returns and will distort the allocation of resources across sectors and through time. The resources devoted to protecting wealth from possible inflation could be applied to more productive uses under a policy of price stability. Moreover, attempts to maintain nominal exchange rates will not eliminate exchange rate uncertainty, since countries inevitably will resort to periodic exchange rate realignments. Hedging exchange risk will remain an important aspect of international commerce.

Although monetary protectionism seems most prevalent under the present system of floating exchange rates, one should not conclude that floating exchange rates promote its use. Monetary protectionism can result any time that a government lacks a strict monetary constitution and will accept nonmarket criteria for exchange rates. In principle, a gold standard or a fixed exchange rate regime can limit the scope of monetary protectionism, because if all countries play by the rules of the game, they link money supplies closely to the flow of international reserves. In practice, however, such regimes do not destroy the political motives for monetary protectionism, and examples abound of monetary protectionism under fixed exchange rates. By allowing some discretion in the choice of exchange rate pegs and by permitting some inertia in nominal exchange rate adjustments, fixed exchange rate regimes often produce a mechanism that weakens the allocative efficiency of exchange markets and promotes mercantilist objectives.

Economic Arguments for Monetary Protectionism

Proponents of exchange market intervention contend that the existing system of floating exchange rates lowers the potential gains from international commerce, because it has proven to be excessively volatile and it has failed to promote adjustment in the trade accounts. In their view, a global monetary system built on cooperative efforts among governments to manage exchange rates would enhance world welfare. Most economists recognize that one must base a legitimate case for government intervention on microeconomic evidence of market failure, that is, evidence of distortions and externalities, which prevent mutually beneficial trades from occurring. What, then, are the alleged market failures that underlie the interventionists' criticism of exchange markets?

Imperfect Information

Prominent themes in the interventionist literature view exchange rates as excessively volatile, maintain that they overshoot their equi-

librium values, and contend that they are subject to speculative runs. Interventionists view such tendencies as being synonymous with “market uncertainty” or “market disorder,” generally implying that they result from imperfect information.

Exchange markets, like other asset markets, are highly efficient processors of information. Forward-looking traders base spot and forward quotations on all relevant, available information. Upon the receipt of new, unanticipated information, traders revise their expectations and their exchange rate quotations. The market pays substantial rewards for investments in knowledge and provides few institutional constraints that restrict participation.

At times, government authorities can possess better information than the market, for example, when they contemplate policy surprises. In nearly all cases, however, market participants and government bureaucrats receive and respond to the same information. Bureaucrats do not enjoy privileged insight. Moreover, the market will learn to anticipate the government’s reaction to market developments, so that routine government interventions will not impart new information. These observations also suggest that unpredictable changes in government policies could be a prominent source of much of the observed exchange rate volatility.

All of this does not imply that exchange rates will remain stable. Indeed, nominal *and real* exchange rates have been substantially more volatile since 1973, following the demise of Bretton Woods. At question is the extent to which one should view volatility as necessarily reflecting market imperfections, which would require government intervention. To the contrary, movements in nominal exchange rates can be part of efficient adjustment in the terms of trade. Moreover, we lack convincing evidence that exchange rate volatility is greater than that observed in other asset prices, or that exchange rate volatility has reduced international trade or worldwide investment (see Bailey and Tavlas 1988).

The interventionists’ characterization of exchange rate overshooting and of speculative runs presumes that they know the equilibrium exchange rate path. Theoretically, a sustainable equilibrium exchange rate path is consistent with our concept of general equilibrium. Unfortunately, economists lack sufficient knowledge to specify accurately such an equilibrium path for a dynamic economy. Interventionists, therefore, designate equilibrium values in terms of a limited set of “fundamentals,” which they hope will track the general-equilibrium path accurately enough that a policy of forcing market rates to this path will increase economic welfare.

We are highly skeptical of such efforts. Volumes of econometric work have attempted to specify the relations among sets of these fundamentals and exchange rates, with mostly unsatisfactory results.³ Most often, analysts specify the equilibrium exchange rate path in terms of purchasing power parity. The problems associated with deriving purchasing power parity estimates of exchange rates are well known. Accuracy assumes that an equilibrium base period is chosen and that all subsequent shocks are monetary, in nature. Because nonmonetary shocks can alter the equilibrium real exchange rate over time, the original purchasing power parity estimate can drift away from the correct equilibrium exchange rate.

Another common alternative is to define exchange market equilibrium in terms of a "sustainable" current-account balance, one equal to "normal" capital flows. This approach relies on an estimation of a stable relationship between exchange rates and the current account after a statistician has removed the effects of business cycles, trade distortions, and other anomalies and temporary influences.

Beyond the obvious technical problems, a strong economic rationale for such a stable relationship between exchange rates and the current account does not exist. As Stockman (1988, p. 535) observes: "Any pattern of correlations between the current account and the exchange rate can be obtained from theory, depending on the source of the disturbance and some characteristics of the model."⁴

In truth, governments have no better information about what constitutes the equilibrium exchange rate path than do markets. Under these circumstances, attempts to force the exchange rate to a designated equilibrium are unlikely to enhance economic welfare.

Sticky Prices and Wages

Building on the idea that exchange rates should respond to trade flows, a second interventionist theme justifies active manipulation of exchange rates because prices (notably wages) are sticky (see Krugman 1989). In this view, exchange rate manipulation is seen as a means of fostering international adjustment when prices, most notably wages in the deficit country, are sticky. A real depreciation is particularly necessary because strong propensities to spend in home markets weaken income-adjustment policies. With sticky prices, a nominal depreciation alters the terms of trade, offering a necessary incentive to switch the pattern of expenditures.

³The seminal study on this issue is Meese and Rogoff (1983).

⁴Stockman (1990) provides examples.

The key here is an “active manipulation” of nominal exchange rates. Floating rates can promote efficiency and aid in international adjustment, especially when prices are sticky. For example, an increase in foreign demand for U.S. goods produces a dollar appreciation, which dampens that demand. Otherwise, with home prices assumed to be sticky, we would require a nonprice mechanism to accommodate the excess demand (see Stockman 1988, 1990). Such exchange rate adjustments promote mutually beneficial trades and thereby enhance welfare.

The activist view, however, rejects floating rates because they can permit large, persistent current-account deficits. Instead, this approach assumes that current-account deficits are disequilibrium responses to policy errors, which market imperfections aggravate. It characterizes the U.S. current-account deficit as abnormal from a historical perspective and as unsustainable in view of some subjective calculations of our ability to finance this debt. According to this view, exchange markets apparently fail to consider these debt dynamics.

Recent work questions this approach by suggesting that large current-account deficits can be an equilibrium attempt to smooth consumption over time in the face of shocks that temporarily reduce current output or in the face of demographic factors that encourage current consumption relative to future consumption (see Koenig 1989). As Hill (1989) suggests, models that do not consider recent demographic patterns can produce misleading conclusions about the nature of the current-account deficit. Historic patterns, then, might not provide a basis against which to compare recent trends. Moreover, this recent work seems to question the validity of highly subjective calculations of our ability to finance that debt.

We previously addressed a more important criticism of this “activist” view: Monetary-induced changes in nominal exchange rates will alter real rates only temporarily, to the extent that prices are slow to adjust. In the long term, monetary policy cannot alter the terms of trade.

Exchange Rate Indeterminacy

Wallace (1979) offers a justification for exchange rate management based on the argument that equilibrium exchange rates for fiat currencies are indeterminate; that is, many equilibrium exchange rates are possible. Governments can break the indeterminacy either by fixing exchange rates, by introducing legal restrictions on currency holdings, or by credibly threatening future exchange market intervention.

This theoretical model seems to suggest that all volatility is superfluous and unrelated to any economic fundamentals. As already noted, exchange rate volatility that is related to fundamentals—changing supplies and demands—can promote the adjustment process. The model also assumes that fiat currencies are perfect substitutes, but individuals typically hold portfolios of interest-earning assets, not currencies. Evidence suggests that these assets are *not* the perfect substitutes (see Hodrick 1987). The associated risk will render exchange rates determinate.

Even if one accepts the indeterminacy argument, it does not justify the maintenance of fixed exchange rates through intervention in fiat currencies. Legal restrictions, such as a simple rule that governments collect all taxes and other payments in their own currencies, would suffice to solve the alleged problem.

Policy Spillovers

A recent justification for monetary protectionism stems not from market imperfections, but from alleged inefficiencies in government macroeconomic policymaking. Because a few, very large countries (the Group of Five) dominate international macroeconomic policy, the actions of any one nation have significant spillover effects on all of the others. Only through policy coordination can governments internalize these effects and achieve policy choices that are Pareto superior to autarkic policy setting. Many of the recent calls for monetary policy to focus on fixing exchange rates or on establishing target zones stem from policy coordination arguments.

The elegant gleam of the theoretical argument for policy coordination becomes tarnished when exposed to empirical tests. Generally, studies do not offer support for international mechanisms, such as fixed exchange rates or target zones, that require a continual coordination of macroeconomic policies.⁵ Empirical studies of coordination find only small gains, suggesting that policy spillovers are not critical to the economic well-being of the largest industrial countries today.

A major argument against policy coordination is that we lack sufficient knowledge about the nature of international economic interactions to agree on a specific model and on corrective policies. Nearly all econometric models differ in their policy multipliers. When these multipliers refer to domestic policy objectives, the differences are mainly in degree; but when the multipliers refer to international policy effects, the differences are often in direction. This uncertainty

⁵Humpage (1990) surveys this literature.

about the true economic model raises questions about the ability of policy coordination to enhance welfare.

In large part, the lack of success in addressing current-account imbalances among West Germany, Japan, and the United States in recent years has arisen because each country views the cause of the problem differently and, therefore, each has a separate prescription for redressing it. West Germany, for example, regards the current-account imbalances largely as a problem stemming from U.S. fiscal policies.

Another questionable aspect of international policy coordination is that it can challenge the more traditional ordering of policy preferences, which is an important aspect of national sovereignty. West Germany, for example, traditionally favored relatively low inflation and a current-account surplus, and is unlikely to accept a high rate of inflation in order to eliminate its current-account surplus. Countries will pursue international policy coordination only when it is mutually advantageous; they will abandon policy coordination if it conflicts with highly valued, traditional domestic goals.

In view of the substantial weight countries attach to domestic policy targets and given the apparent model uncertainty, policy coordination will lack the discipline and the spontaneity that it requires for credibility, much less for success. An approach lacking credibility creates uncertainty about the reasons for government actions and could increase the volatility of asset prices, especially exchange rates.

The Political Economy of Monetary Protectionism

We have attempted to illustrate that the economic arguments offered in favor of monetary protectionism are weak, that such monetary manipulations do not have a permanent effect on the terms of trade, and that they risk inflation. To understand their proliferation, it is necessary to investigate the political institutions that give rise to monetary protectionism.

In contrast to the interventionist literature, which presupposes an all-wise government acting in the public's best interest, a rich and growing literature on political economy characterizes elected officials as seeking to enhance their own power, prestige, and wealth by maximizing their ability to gain votes. Politicians and bureaucrats attempt to extend the scope of their influence by responding to the demands of the most politically active constituencies. This literature has offered important insights into traditional protectionism (see Quibria 1989). What follows are some thoughts on similar elements relating to monetary protectionism.

Buying Time and Deferring Criticism

Elected officials might find exchange rate manipulation attractive because it defers criticism while buying time for more fundamental actions. By 1985, dollar exchange rates were at their zenith; the U.S. current account was deteriorating rapidly, and evidence suggested that the United States was becoming a debtor country for the first time since World War I. U.S. manufacturers, facing increasingly stiff competition worldwide, besieged Congress for trade legislation. Most important, analysts increasingly linked the deterioration in the external accounts with fiscal policies of the administration and Congress. The opportunity cost of government inaction, measured in terms of votes lost, seemed to rise sharply in the early 1980s.

The administration realized that the U.S. current-account deficit reflected imbalances between savings and investment in the United States and in West Germany and Japan. Governments, however, cannot easily redress such structural relationships through fiscal policies because of strong vested interests in maintaining various tax and expenditure patterns. The unwillingness of the United States to take strong measures to cut the federal budget deficit typifies the problem. A corresponding reluctance to expand fiscal policy for balance-of-payments purposes existed in West Germany and Japan in the early 1980s.

Lacking an ability to address these structural problems directly and quickly, policymakers might resort to exchange market intervention. When coordinated through the Group of Seven, such intervention offers a highly visible signal that governments are responding to the desires of their constituencies. If accompanied by credible pronouncements of changes in future monetary and fiscal policies, intervention might serve to diffuse criticism of administration policies, to blunt protectionist demands, and to buy time for more fundamental policy adjustments.

Targeting Benefits and Diffusing Costs

In addition to simply buying time, exchange rate policies can offer temporary benefits to specific constituencies. When goods prices are slow to adjust, a nominal currency depreciation is equivalent to a temporary, across-the-board tax on imports and a subsidy to exports. With the terms of trade temporarily altered, certain groups in the traded-goods sectors can realize benefits from monetary protectionism similar to those afforded by commercial policies. Ultimately, any benefits from monetary protectionism dissipate with a higher inflation rate and with a reduced credibility of monetary policy. The inflation costs of monetary protectionism, however, are dispersed

across a wider spectrum of individuals and over a longer time horizon than the benefits. A constituency that receives net benefits from monetary protectionism (export- and import-competing firms) can exist. Such a constituency is likely to be politically more cohesive than any constituency for price stability. Consequently, a policy that seems myopic from an economic perspective can be politically farsighted.

Another seemingly attractive aspect of monetary protectionism is that Congress and the administration can justify it in terms of broader macroeconomic considerations, such as exchange rate "misalignment" or current-account "imbalance," rather than industry-specific considerations, such as automobile and steel employment. Consequently, the rent-seeking aspects of monetary protectionism are less obvious than those of commercial policies.

In the early 1980s, most import-competing firms sought direct restraints, because Congress can tailor commercial policies to fit specific products or countries. Direct restraints, however, seemed increasingly difficult for legislators to enact. As the frequently heard plea, "I'm for free trade as long as it's fair" suggests, even those who seek restraints recognize that, as a general policy, protectionism is costly and inefficient. Perhaps more important, however, Congress faces a growing antiprotectionist lobby (see Destler and Odell 1987). Multinational firms and domestic exporters fear that U.S. trade sanctions could trigger foreign retaliation. Domestic importers of consumer goods and firms that use traded goods as component parts face higher costs because of import restraints. In addition, Congress is constrained in the use of traditional import restraints because such policies often violate existing treaties or tend to compromise other foreign-policy initiatives.

Wary of the pitfalls of traditional commercial policies, some members of Congress sought to satisfy constituencies and avoid foreign retaliation through a manipulation of nominal exchange rates. By the end of 1985, many bills, introduced and supported on both sides of the aisle, contained specific endorsements of exchange rate policy. One item, submitted by Senators Bradley, Moynihan, and Baucus, called for the creation of a "Strategic Capital Reserve," akin to the Exchange Stabilization Fund, which the U.S. Treasury would use to purchase foreign currencies when the current-account deficit exceeded a target value and when the dollar deviated from a level compatible with a current-account balance. The bill also instructed the Federal Reserve System not to sterilize the monetary effects of intervention from the Strategic Capital Reserve.⁶ The demands for

⁶Destler and Henning (1989, pp. 108–12) discuss this legislation.

protectionism seemed to lessen after the United States and the other large industrialized countries began to intervene and after the dollar began to depreciate.

Government Collusion

Countries interested in establishing exchange rate targets have a strong incentive to collude in their efforts with foreign governments (see Vaubel 1986). In the case where countries attempt to alter nominal exchange rates, such collusion provides tacit foreign approval of these policies and limits the chances that a foreign government will take steps to neutralize the exchange policies of another. Sometimes such collusion involves having cartel members delay policy negotiations or exchange rate adjustments when individual cartel members face critical elections. Bretton Woods and the European Monetary System (EMS) are examples of fairly successful collusion. The competitive currency devaluations of the 1930s show what can happen when governments attempt to fix a price, but the cartel breaks down.

Coordinated efforts to fix exchange rates can allow individual countries to influence the policies of others and to defer some of the adjustment burdens of maintaining the peg. Such mechanisms are found in the EMS and figure in some proposals for target zones and for fixed exchange rates. Many support the European central bank proposal for just this reason. The alternative is to sacrifice monetary sovereignty to maintain a fixed exchange rate and to follow the monetary policy of a dominant country.

Rogoff (1985) offers another important reason why governments might collude to manipulate nominal exchange rates. In his model, governments have a higher tolerance for inflation than the public, and they attempt to exploit any short-term stickiness in prices for a higher rate of output and employment. Under floating exchange rates, a rapid depreciation in the nominal exchange rate in response to such inflationary policy signals the market's displeasure and constrains governments. Through collusion to fix the exchange rate, however, governments can blunt the exchange rate reaction to their policies and reduce the political costs of pursuing inflationary policies. Generalizing from Rogoff's argument, coordination to limit exchange rate fluctuations is politically attractive, because it eliminates an important, immediate barometer of the market's opinion of government policies.

Extending Influence

As in the United States, exchange rate policy often falls under the purview of treasuries and finance ministries, but its success requires

the participation of central banks. As is well known, sterilized exchange rate intervention has no lasting effects on exchange rates (see Humpage 1986).

For their part, central banks often are willing participants, viewing exchange rate management as a legitimate aim of monetary policy. Exchange rate movements can impart useful information for policy-making, and exchange rate targets can sometimes be consistent with a monetary policy of price stability.

As often as not, however, exchange rate policies conflict with price stability. For example, U.S. intervention sales of dollars in 1989 seemed inconsistent with a goal of price stability. When these objectives conflict, the Federal Reserve System faces a dilemma between its mandate of policy independence and its accountability to the broad national policy goals set by Congress and the administration. The Fed does not wish to appear unresponsive in the eyes of the public to the objectives of Congress and the administration. Participation also enables a central bank to influence policy formulations that it is powerless to prevent. Nevertheless, as Herbert Stein (1989) noted, "Despite all the formal provisions for its independence, the Fed seems constantly to feel that if it uses its independence too freely it will lose it."

In countries with independent central banks, intervention policies might enable fiscal agents to extend their influence beyond the exchange market to domestic monetary policy. Elected officials often seek easier monetary policy than central banks, hoping to lower interest rates and to stimulate real growth and employment. In choosing a nominal exchange rate target, engaging in intervention, and encouraging the central bank not to sterilize the intervention, fiscal agents have a mechanism for such an influence. This channel of influence would not usually be open. At times, however, such as when the central bank's policy committee is not in unanimous agreement, such an influence, marginal though it may be, could prove decisive in charting future monetary policy.

A Global Monetary Order: 1992 and Beyond

We have attempted to instill a healthy skepticism for exchange market manipulation, arguing that monetary protectionism is not grounded in widely supported economic evidence of market failure and, therefore, that it is unlikely to enhance economic welfare. Instead, monetary protectionism stems, as a near-term palliative, from the political interactions between policymakers and constituencies with vested interests in particular market outcomes.

AVOIDING MONETARY PROTECTIONISM

Any international monetary order willing to accept nonmarket criteria for exchange rates and failing to bind governments with monetary constitutions is ripe for monetary protectionism. To counter the political incentives toward monetary protectionism, we urge nations to adopt monetary constitutions along lines similar to the Neal Resolution in the United States, which focuses monetary policy on achieving long-term price stability. This would do more to eliminate exchange market uncertainty and to foster the efficient worldwide use of real resources than any program to manipulate nominal exchange rates.

Our comments are not meant as a blanket condemnation of international policy cooperation. We strongly support cooperation that emphasizes monetary constitutions, focusing on price stability, and that recognizes market-determined exchange rates. Only cooperation based on these conditions seems both feasible and credible, because it recognizes the pre-eminence of national policy objectives and monetary sovereignty.

Contrary to what some might infer, this approach does not preclude European monetary unification, but it suggests a different approach than currently seems to be favored (see Hoskins 1989). European governments are not likely to relinquish national monetary sovereignty upon adoption of a single market in 1992. Indeed, this concern is at the heart of the British reluctance to join the EMS. Consequently, greater exchange rate flexibility than the EMS currently provides seems necessary to ensure that exchange rates do not interfere with the efficient flow of goods, labor, and capital following the removal of restrictions.

The free flow of resources will foster a convergence of policy preferences within Europe as governments compete for these resources by providing stable economic and political environments. Governments that fail to provide such an environment will lose resources, as markets "vote" on policies. The resulting convergence of monetary and fiscal policies will lead to greater exchange rate stability. In time, when the governmental competition for resources attains a convergence of macroeconomic policy, issues of national policy sovereignty, in effect, will be muted. Only then will a monetary union with a common currency be feasible, and only then will monetary union augment the efficiency gains of a single market.

To fix exchange rates prior to a convergence of policy preferences within the Economic Community seems to ensure that interest rates and prices will bear more of the adjustment burden as resources move across currencies. Moreover, if we judge from the experience of Bretton Woods, fixed exchange rates would seem to guarantee

speculators of periodic and obvious exchange rate adjustment and to encourage governments to impede the flow of goods and capital through the reintroduction of restraints. The dynamics of achieving monetary union are as important as the goal.

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THE FOLLY OF POLICY COORDINATION

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My own views on protectionism and policy coordination are so close to those of Lee Hoskins and Owen Humpage that most of my comments involve an elaboration of their paper.

Monetary and Trade Protectionism

The *temporary* real effects of monetary protectionism are similar to those from the traditional forms of trade protectionism: Both policies increase output and real income in the import-competing industries only by making most of us *poorer*. Monetary protectionism, to the extent that it is not fully anticipated in domestic prices and wages, temporarily reduces the real exchange rate, reducing the general foreign price of domestic goods and increasing the domestic price of foreign goods. The effects of traditional trade protectionism are similar but less general to the extent that tariffs and quotas are not uniform across goods.

The long-term effects of these two types of policies, however, are quite different. Monetary protectionism has no significant effect on the long-term real exchange rate, except to the extent that the tax code is not fully indexed to the price level. In the long term, monetary stimulus provides no significant protection of import-competing industries, and its primary distributional effects are a one-time redistribution of wealth from lenders to borrowers of fixed-rate debt instruments. Trade protectionism, in contrast, provides sustained protection of import-competing industries, although at a generally larger loss of output in other industries.

Monetary stimulus, in summary, provides only a temporary palliative to political demands for protectionism but has few long-term

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real effects, except to the extent that the variance of money demand reduces real output. Trade protection, in contrast, leads to a sustained misallocation of resources and a lower total output. For this reason, monetary stimulus may reduce the demands for trade protectionism in the near term but not in the longer term. The relative political demand for these two types of policies, therefore, will depend in part on whether the affected industries are perceived to face only a temporary or a longer-term competitiveness problem. In both cases, one should recognize that either policy achieves its intended distributional effects only by reducing total output and average real income.

Fiscal Policy and Real Exchange Rates

Most of the variation in the real exchange rate does not appear to be related to changes in monetary policy but rather to changes in *fiscal* policy—a point that Hoskins and Humpage do not mention. During the 1980s, for example, the trade-weighted real exchange rate of the U.S. dollar was strongly related to the real long-term bond rate, both of which increased sharply from 1980 through 1985 and declined sharply through 1988. This pattern does not appear to be related to changes in either the monetary aggregates or in nominal total demand; the highest rates of nominal GNP growth, for example, were in 1981 and 1984, years in which both the real exchange rate and the long-term real interest rate increased sharply.

There is a broader consensus that the pattern of real interest rates and, in turn, the real exchange rate was primarily due to changes in fiscal policy. There is a continued disagreement, however, about whether this was due more to changes in the federal deficit or to changes in the tax treatment of income from capital. I am personally skeptical of the deficit explanation. For the most part, a large number of studies fail to find any significant effect of current government borrowing on either real interest rates or the real exchange rate. The several articles by Evans (1985, 1986, 1987) may be the best of these studies. During the 1980s, for example, the federal deficit (as a percentage of GNP) peaked in 1983 and the privately held federal debt continued to increase through 1989. I may have been the first to suggest, in December 1981, that the increasing integration of the world capital markets may be the primary reason why government borrowing, even in a very large economy, appears to have so little effect on interest rates. There is still a plausible theoretical reason to expect government borrowing to have some effect on interest rates,

but the empirically estimated effects appear to be both very small and highly variable.

In January 1985, William Poole (my colleague on the Council of Economic Advisers) and I offered a different explanation: that the major changes in real interest rates and the real exchange rate were primarily due to changes in the taxation of capital income. In the 1985 *Economic Report of the President*, we wrote (p. 35):

It appears that the high level of real interest rates is in large part attributable to the major change in [the taxation of business capital] enacted in 1981, which raised the real after-tax internal rate of return on new business investment. . . . It is difficult to sort out the relative magnitudes of the effects on real interest rates of monetary restriction, large budget deficits, and high real rates of return on new business investment. . . . [However], if the monetary or budget deficit effects had dominated, then high interest rates for these reasons would have overwhelmed the new incentives to invest, making business investment relatively weak instead [as was the case in 1983 and 1984] of relatively strong.

Consistent with this perspective, I informed President Reagan in my last memorandum to him in March 1985 that the substantial increase in the effective tax rates on new investment proposed in the Treasury tax reform plan (released in November 1984) would probably lead to a decline in real interest rates, the real exchange rate, and (with some lag) the trade deficit. And this is what happened. Real interest rates and the real exchange rate peaked in the winter of 1985, and the real trade deficit peaked in 1986.

Although the Tax Reform Act was not finally approved until September 1986, the business tax provisions were retroactive to the beginning of that year, and the major features of the act were known much earlier. For example, the major provisions of the Treasury proposal were incorporated in the president's tax reform proposal of May 1985, and the House Ways and Means Committee approved even higher capital income taxation in September 1985—just prior to the Plaza Agreement on exchange rates, which was broadly (but, I believe, incorrectly) believed to trigger the subsequent sharp drop in exchange rates.

In summary, I believe that the sustained decline in the forward-looking auction markets for interest rates and the exchange rate, beginning in the winter of 1985, was primarily due to the increasing expectations of approval of the Tax Reform Act of 1986 and the subsequent effects of that act on the realized post-tax rates of return on new business investment. (Alas, at that time, I had no money to invest.)

There is still no consensus on the interpretation of these developments, but this perspective on the effects of capital income taxation on real interest rates, the real exchange rate, and the trade balance has now been developed by Sinn (1985), Summers (1986), Frenkel and Razin (1986), and Bovenberg (1989). The more important question here is whether the monetary authorities should try to offset these effects of fiscal policy on real interest rates and the real exchange rate. My answer, and surely that of Hoskins and Humpage, is “under *no* circumstances.” In the early 1980s, this would have required a progressively large increase in monetary stimulus, which would have helped stabilize the real exchange rate only if it had been continuously unanticipated and, in any case, would have been sharply inflationary. The opposite policy, of course, would have been required in the late 1980s. In either case, the costs of such a monetary response would have been far higher than the temporary benefits of stabilizing the real exchange rate, especially given the rather small costs of hedging against changes in the exchange rate.

The counterpart question, of course, is whether fiscal policy should be used to offset the effects on real interest rates or the real exchange rate of monetary policy or of economic conditions or policies in other countries. Again, my answer is a strong negative. Most of the effects of monetary policy on real conditions are only temporary, compared to both the time to approve changes in fiscal policy and the lags in their effects. It is especially foolish to increase tax rates in one country to offset the exchange rate effects of foolish policies, such as nationalization or increased taxes on capital income, in another country. In any case, fiscal policy should not be used as a discretionary instrument, because there are high efficiency costs of the variance in tax rates.

In summary, the long search for the optimal mix of monetary and fiscal policy has been futile. These two types of policies have very different effects and should be addressed to different goals. Monetary policy should be implemented to stabilize the general price level, not specific prices, including exchange rates. Fiscal policy should be used for allocational and distributional objectives, not as a discretionary instrument of demand management.

An Adaptive Demand Rule

Stability of the general price level is the appropriate goal of monetary policy—a position endorsed by both Hoskins and, apparently, Alan Greenspan—but I suggest that it is not appropriate for a central bank to follow a price-level rule. The reason for my position is that

the general price level is dependent on both demand and supply conditions. A price rule would require the central bank to conduct a contractionary policy in response to an adverse supply shock and an expansionary policy in response to a favorable supply shock. A price rule, in summary, would stabilize the price level only by increasing the variance of the output effects of unexpected changes in supply conditions.

A central bank, I suggest, is better advised to follow a demand rule. The bank, preferably with the endorsement of the political authorities, would set a target path of total nominal demand for a several year period, with the target demand growth in the final year set equal to the expected growth of output. Total demand is probably best measured by final sales to domestic purchasers, the aggregate equal to GNP minus the change in inventories minus the trade balance. In contrast to the effects of a price rule, a central bank following a demand rule would not change monetary policy in response to an unexpected change of supply conditions in either direction. A demand rule, thus, would minimize the variance of output at the expense of a somewhat higher short-term variance of price level. A demand rule, however, is consistent with long-term stability of the price level (since unexpected changes in supply conditions have a zero mean) and for this reason would also stabilize long-term interest rates.

It is also important that the implementation of a demand rule be adaptive to changes in the relation between total demand and the monetary base. The developing empirical evidence, in technical terms, indicates that velocity is difference-stable, not trend-stable. This was first demonstrated by Gould and Nelson (1974) based on annual data and was confirmed by Haraf (1986) based on quarterly data. The implication of these findings is that the growth of the monetary base should be changed in the opposite direction to the revealed changes in demand velocity. McCallum (1988) has suggested one such adaptive demand rule, but more testing would be valuable to identify the rule that minimizes the variance in total demand. The developing evidence, however, is sufficient to conclude that the monetary rule favored by the "high-church" monetarists—a steady (or zero) growth of some monetary aggregate—is not sufficient to stabilize total demand. Another important feature of an adaptive demand rule is that it is forecast-invariant. Economists have a lot to be humble about, but we should have learned a long time ago that we have no special ability to look around the corner of time. A third advantage of an adaptive demand rule is that it is easier to gain a political consensus for a policy rule based only on current and

prior revealed information than for one based on the specific forecast by one of the institutions in the policy process.

The first task is to bring inflation to zero over a reasonable period. With some goodwill and mutual trust, this period should be sufficient to resolve any remaining differences between those who favor a price rule and those who favor a demand rule. I am pleased to report that my conversations with members of the Federal Open Market Committee suggest that they understand the advantages of an adaptive demand rule, although the public statements of several of the members suggest that they favor a price rule. This is a technical difference among friends, however, and should be easy to resolve.

Follies of Policy Coordination

My final point is that Hoskins and Humpage have *understated* the follies of policy coordination across governments. On a simulated basis, the probability that macroeconomic policy coordination is welfare enhancing is only slightly more than 50 percent, as long as the several governments use somewhat different models of how the world works (see Frankel and Rockett 1988). In practice, it is difficult to coordinate economic policy among the Treasury, Congress, and the Federal Reserve. And the two major recent attempts at macroeconomic policy coordination, the first initiated by Treasury Secretary Michael Blumenthal in the late 1970s and the second initiated by Treasury Secretary James Baker in the 1980s, were both U.S. efforts to induce Germany and Japan to take measures that would offset the effects of a failure of the U.S. government to make the necessary hard choices on domestic policy. In the first case, Germany cooperated with Blumenthal's "locomotive strategy" to their later regret, but Japan did not. In the second case, Japan cooperated by measures to increase domestic demand, but Germany, because of its role as the anchor currency in the EMS, did not. In both cases, these attempts to policy coordination had the effects of delaying the necessary hard choices by the U.S. government and of reducing the trust among governments that is necessary for a coordinated response to more important issues.

My criticism of macroeconomic policy coordination is not an endorsement of autarky. For those government officials who prefer to spend their time at international meetings, there are plenty of important issues to discuss and resolve. For the moment, it is especially important to coordinate the response of Western governments to the rapidly changing developments in the Soviet Union and Eastern Europe. It will continue to be important to promote mutual

agreement on the rules of international trade and investment and on the enforcement of property rights. It will continue to be important to promote rules on the international use of "common pool" resources, such as the electronic frequency spectrum, orbital slots, migratory marine life, and the few genuinely international pollution sinks.

In most cases, our finance ministers and central bankers are not the appropriate officials to send to meetings on these issues. In those cases, they should stay home and put their own house in order.

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