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MACROECONOMIC POLICY COORDINATION AND THE EUROPEAN MONETARY SYSTEM

Richard Portes

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Centre for Economic Policy Research
6 Duke of York Street
London SW1Y 6LA
Tel: (44 1) 930 2963

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ABSTRACT

Macroeconomic Policy Coordination and the European Monetary System*

This paper discusses the EMS and proposals to move towards EMU in the context of recent theoretical and empirical work on international policy coordination. It treats two particular themes: asymmetry among EMS countries and its implications for policy coordination; and the coordination required to reach agreed European Community macroeconomic policies. Section 1 examines policy coordination in a fixed exchange-rate system. Section 2 discusses policy coordination in the Delors Committee Report, with its emphasis on fiscal policies. Section 3 deals with asymmetry and hegemony, and Section 4 suggests reasons to strengthen 'absolute' policy coordination in the EC.

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Keywords: EMS, macroeconomic policy coordination, hegemony, monetary regimes, fiscal policy

Richard Portes
Director
Centre for Economic Policy Research
6 Duke of York Street
London SW1Y 6LA
Tel: (441) 930 2963

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NON-TECHNICAL SUMMARY

Macroeconomic policy coordination is a major topic in the Report of the Delors Committee. The academic literature on policy coordination stresses the strategic interactions among national governments, between national central banks and finance ministries, and between the domestic policy authorities and their private sectors. The analysis often uses game theory to interpret both cooperative and non-cooperative behaviour. When the latter generates inefficiencies, coordination can make all participants ('players') better off.

Coordination need not mean full cooperation. Some coordination can be enforced by a commitment from each participant to play by a given set of rules applicable to all. The overall framework in which these rules are set is a policy 'regime', of which the EMS is an example. The discussion here deals with the EMS in transition, not full Economic and Monetary Union (EMU).

The rules need not be symmetric among the participants, and even if they are, asymmetry may arise from their different characteristics. One theme of this essay is asymmetry among countries in the EMS and its implications for policy coordination.

Even if all the EC countries join fully in the EMS, and the System itself progresses further towards EMU, the EC will still be only a coalition of players in a broader 'game', the world economy. Fashioning and implementing appropriate strategies in this global context – agreed EC external macroeconomic policies – may also require specified forms of coordination of the policies of individual EC countries. This is the second particular theme of the paper.

Section 1 discusses policy coordination in a fixed-exchange-rate system. The rules of such a system are partial substitutes for policy coordination. There is disagreement over the likely size of the benefits from policy coordination. Fixed exchange rates appear to provide much of the benefits that full coordination would achieve.

Section 2 examines policy coordination in the Delors Report. The Committee were doubtless aware that macroeconomic policy coordination is neither necessary nor sufficient for exchange-rate stability; that its benefits are not demonstrably great; that exchange-rate management is itself a surrogate for policy coordination; and that the constraint of adhering to the EMS has already brought more coordinated decision-making as well as some degree of macroeconomic convergence. So starting from the fixed-rate EMS, why stress more policy coordination, in particular on the fiscal side, beyond what more rigid exchange rates could be expected to bring?

First, there is concern over threats to EC cohesion from divergence in macroeconomic policies and inflation-growth performance. Whatever the preferred model of progress towards EMU, it would be difficult to make Germany become more expansionist (inflationary) as part of that process. Fiscal 'coordination' might be (i) a way of exerting pressure on Germany to compensate for its dominance of EC monetary policy; (ii) a way of forcing fiscal authorities in other countries to become more German, i.e., to 'put their houses in order'.

Second, the Report argues that the 'attainment of national policy objectives will become more dependent on a cooperative approach to policy-making'. The opposite seems more plausible: closer monetary union will mean that countries will want more fiscal freedom, not less.

Third, the Committee maintains that policy coordination is necessary to deal with international spillovers from national policies. But these are partly controlled by exchange-rate stabilization itself; and the fiscal policy rules suggested by the Report do not seem directed at minimizing spillovers.

Section 3 distinguishes between asymmetry and hegemony and argues that the EMS has no hegemon but (at least until 1988) has operated asymmetrically, with Germany as the centre country. If it remains asymmetric, policy coordination might act as a permanent constraint on the growth of the periphery. But financial integration could relax this constraint by facilitating the accommodation of current account imbalances by private capital flows. We note also that the current form of asymmetry could not survive entry of sterling into the exchange rate mechanism of the EMS.

Section 4 gives several reasons to strengthen 'absolute' policy coordination, dealing with EC-wide macro targets and their global impact, as the EC moves towards EMU. First, tighter economic integration will make uncoordinated responses to external (from outside the EC) shocks more costly, because the spillovers that are ignored in framing those responses will be greater. Second, aggregate EC monetary policy will have to be devoted to fixing the aggregate EC effective exchange rate. Therefore a more active fiscal policy will be needed to give internal balance (stabilization), and it will have to be used consistently across countries. Third, the need to take account of the trade balance of the exchange-rate union as a whole generates an externality in the interaction among its members as they adjust to shocks from outside the EC.

A final motive for absolute policy coordination among EC members is the desire that the Community should be able to negotiate as a macroeconomic unity with the US and Japan, just as it does as a trading partner.

Macroeconomic policy coordination is a major topic in the Report of the (Delors) Committee for the Study of Economic and Monetary Union (1989). Indeed, its treatment of fiscal policy coordination immediately became one of the more controversial aspects of the Report. The academic literature in theoretical and applied macroeconomics over the past few years has also emphasized policy coordination (see Buiter and Marston, 1985; Bryant and Portes, 1987). This literature stresses the strategic interactions among national governments, between national central banks and finance ministries, and between the domestic policy authorities and their private sectors.

These interactions are often analyzed with the tools of game theory, which are particularly helpful in understanding cooperative and non-cooperative behaviour. The latter, whether strategic or passive, can generate inefficiencies. Explicit or tacit coordination can make all participants ('players') better off. But 'coordination' need not be full cooperation. Some degree of coordination can be enforced by a commitment from each participant to play by a given set of rules applicable to all. The overall framework in which these rules are set is often called a policy 'regime', of which the EMS is an example (the concept of an international monetary regime is elaborated by Aglietta, 1989).

The rules, either as written or as applied in practice, need not be symmetric among the participants, just as full cooperation may involve bargaining in which the participants may have different bargaining power. Even if the rules do not embody any asymmetry, it may arise from the different characteristics of the participants. One theme of this essay is asymmetry among countries in the EMS and its implications for policy coordination.

Even if all the EC countries join fully in the EMS, and the System itself progresses further towards economic and monetary union (EMU) with whatever policy coordination this may require internally, the EC will still be only a coalition of players in a broader 'game', the world economy. Fashioning and implementing appropriate strategies in this global context - agreed EC external macroeconomic policies - may also require specified forms of coordination of the policies of individual EC countries.

This will be the second particular theme of the paper.

A basic premise of the discussion here is that it refers to the EMS in transition and managing that transition over the next several years, not to full economic and monetary union itself. Research is only now analyzing the conditions under which, in a monetary union with irrevocably fixed parities or a common currency, fiscal policy coordination among political units may be unnecessary (it is, after all, unheard of among American states or Canadian provinces). A central fiscal policy for the Community may then be desirable for distributional and other reasons, but I shall not discuss that here, except in relation to the Community's external economic policy (Sec. 4).

1. Policy coordination in a fixed-exchange-rate system

Rules are at least partial substitutes for the bargaining in full, directly cooperative policy-making. That bargaining is often difficult, time-consuming, conflictual in process, and even sometimes inconclusive after all that. So if the rules function fairly well - countries seldom deviate from them and the outcomes are generally satisfactory - it is not obvious that there should be any strongly felt need for policy coordination, at least in respect of policies covered by the rules.

Policy coordination is neither necessary nor sufficient for exhange-rate stability. If the rules specify fixed exchange rates, and the premise is that imbalances in national macroeconomic policies are the prime source of exchange-rate instability, then appropriate policy coordination is of course a

sufficient condition for following the rules. But this is a strong premise - it ignores inefficiencies in financial markets, for example. Nor is it clear that optimal, internationally coordinated macroeconomic policies are required to sustain exchange-rate stability - weaker measures that are easier to specify and implement may be enough for that (common monetary targets, intervention rules, reserve pooling, etc.).

Moreover, full policy coordination is not obviously desirable, even if it is feasible. One need not be so negative as Feldstein (1988) to question whether the benefits of international policy coordination outweigh the costs. There is significant disagreement over the size, and even the likely sign, of the benefits (see Currie et al., 1989, for a survey). And even if our understanding of the national and international economies were enough to make fully coordinated policies desirable in principle, they would be hard to calculate in practice, as the academic literature demonstrates.

That is why some recent work assesses how a fixed-exchange-rate system functions as a simple rule that imposes some degree of policy coordination, comparing the outcome with what full coordination would (if feasible) have offered. Here, too, the results are not unambiguous (compare Levine et al. and Hughes Hallett et al., 1989), but there does seem to be some basis for arguing that fixed rates provide much of the benefits that full coordination could achieve. A recent study group report opts on different grounds for 'a rule-based system of coordination, with the emphasis on a more managed exchange rate system', as opposed to discretionary coordination or rule-based coordination focusing

on various policy targets or instruments (Group of Thirty, 1988).

None of this denies that fixed rates are often sub-optimal: without substantial international factor mobility and fiscal redistribution, adjusting parities will be the efficient short-run mechanism to compensate for country-specific shocks and imbalances or asymmetries in wage-price behaviour (Giavazzi, 1989). The point is merely that the EMS may go quite far enough already to reap the potential gains from macroeconomic policy coordination.

Another argument based on strategic considerations virtually identifies the EMS itself with policy coordination. It stresses that a key feature of policy coordination is the commitment to maintain it. In the absence of agreed and effective international enforcement (punishment) mechanisms, there will often be an incentive to 'free ride' or a domestic political reason to renege, no matter how desirable sustained cooperative behaviour may be for the group as a whole and, in the longer run, for the potential 'deviant' itself. Joining the EMS is in this view a precommitment to whatever degree of policy coordination is needed to stay in, a political investment in the credibility of the country's commitment not to renege.

2. Policy coordination in the Delors Committee Report

Even on a less extreme interpretation, exchange-rate management in the EMS does already provide or enforce a substantial degree of policy coordination. It is maintained partly because of the economic benefits of that policy coordination, partly because of

structural features of the European Community and political considerations. Without any further specific measures, it is likely to deepen anyway as the EMS widens, goods and capital markets become more integrated, and realignments diminish. So why did the Delors Committee put so much emphasis on extending policy coordination - in particular, for fiscal policy? Even for stage one of its proposals leading to EMU, the Committee specifies a 'procedure that would strengthen economic and fiscal policy coordination', with 'multilateral surveillance' and 'budgetary policy coordination, with precise quantitative guidelines' (Report, para. 51).

The Committee might have taken the view that the absence or ineffectiveness of policy coordination caused the demise of the Gold Standard system or of the Bretton Woods exchange-rate system. But there are more plausible alternative explanations for te collapse of previous exchange-rate regimes. More and better macroeconomic policy coordination might have been necessary but would not have been sufficient to avoid the financial crisis of the 1930s, although 'beggar-thy-neighbour' strategic behaviour did make it worse (Eichengreen and Portes, 1987). The prime reason why the Bretton Woods rules were abandoned was that the institutional structure could not withstand the pressures of growing and more volatile capital flows. This would suggest we should focus now on dealing with short-run portfolio shifts in the EMS - on intervention rules, pooling reserves, the width of bands, the timing and size of realignments - rather than on any substantial extension of macroeconomic policy coordination. To the extent that

macroeconomic policies were clearly at fault, i.e., insofar as US fiscal and monetary excesses contributed to global macroeconomic instability at the turn of the 1970s, we note that no country in the EMS could now escape from the fixed-exchange-rate discipline as did the US as the issuer of the reserve currency.

The Delors Committee were surely conscious of this historical background. They were doubtless aware that macroeconomic policy coordination is neither necessary nor sufficient for exchange-rate stability; that its benefits are not demonstrably great; that exchange-rate management is itself a surrogate for policy coordination; and that the constraint of adhering to the EMS has already brought more joint and coordinated decision-making as well as some degree of macroeconomic convergence (Thygesen, 1989). So starting from the fixed-rate EMS, why stress more policy coordination, in particular on the fiscal side, beyond what more rigid exchange rates could be expected to bring? Political considerations might have suggested that this would be divisive.

There are several conjectural answers to this question that bear directly on our chosen topics of asymmetry and EC external macro policy. But first we should recall a fundamental premise behind the Report and the creation of the Delors Committee itself. The EMS has not been sufficient, in the ten years in which it has survived and developed, to bring any appreciable progress towards the <u>monetary unification</u> it had explicitly prefigured. Some thought that this demonstrated that the objective of exchange-rate rigidity was inadequate, so it was necessary to force the

pace; the Report's emphasis on extending policy coordination may reflect this underlying motive.

We can be more specific. First, the Committee enunciated a desire for more 'convergence of economic performance' (para. 11) as an end in itself, to which policy coordination might be a means. But they did not explain why we should want convergence of the 'fundamentals'. This is not an obvious goal, unless interpreted as the highest growth rate, lowest inflation rate, best income distribution, etc., among EC countries. There will be no agreement, however, on which single country has the best combination of these desiderata, so support for this sort of 'convergence' is a non-operational tautology.

On the other hand, there is in the Report a clear underlying fear of threats to EC cohesion from 'divergence' in macroeconomic policies and inflation-growth performance. Whatever the preferred model of progress towards EMU, it would be difficult to make Germany become more expansionist (inflationary) as part of that process - witness the study by the Board of Academic Advisers to the Federal [German] Ministry of Economics (1989). Fiscal 'coordination' might be seen as (i) a way of exerting pressure on Germany to compensate for its dominance of EC monetary policy (the asymmetry); (ii) a way of forcing fiscal authorities in other countries to become more German, i.e., to 'put their houses in order'.

In the latter interpretation, we have an echo of the global macroeconomic policy attitudes of 1979-85 - the very antithesis of policy coordination (Group of Thirty, 1988, Sec. 2.4). This

too, however, is an implicit recognition and acceptance of asymmetry. In any case, the non-German fiscal authorities will be forced to adapt: without exchange controls, budget deficits will directly affect current-account balances, which will then exercise an unavoidable long-run constraint on fiscal policies.

Second, the Report suggests that coordination makes countries less rather than more constrained - cooperation with the collective sets the individual free. Para. 12 asserts that greater interdependence in goods and financial markets entails that the 'attainment of national policy objectives will become more dependent on a cooperative approach to policy-making.' The economic argument is unclear, and no source in political philosophy is cited.. One political interpretation is practical, not philosophical: it will be necessary to gang up on Germany to get it to be more flexible, and 'policy coordination' is a shorthand for such a process. But this was not the Committee's politics, and the opposite economic proposition seems more plausible: closer monetary union will mean that countries will want more fiscal freedom, not less, although increasing market integration will constrain them.

A third argument is that policy coordination is necessary to deal with international spillovers or 'repercussions' of national policies (para. 13). But these are partly controlled by exchange-rate stabilization itself. Moreover, the thrust of the fiscal policy rules suggested by the Report seems directed at countries with 'lax' policies, whose errors are not likely to have great spillover effects on Germany; and the proposed rules would limit only longer-run rather than short-run excesses, so

the stress is in any case not on stabilization problems. All these points in fact relate to the serious, difficult issue of asymmetry among the countries in the System. Germany is not expected to change its preferences nor its underlying economic structure, under which German growth is seen as export-led while constrained by monetary conservatism and demography.

There is a less fundamental but equally important feature of the Report's attitudes to fiscal coordination. Fiscal laxity in some countries and 'incompatible national policies' are judged to put an excessive burden on monetary policy (paras. 5, 12). We might interpret these remarks as a justification by the central bankers' club of their ganging up to support each other in their battles against national treasuries (see Katseli, 1989). Should they not find it sufficient, however, to prescribe that deficits should not be financed by central bank credit and let the capital markets discipline the fiscal authorities? The Report asserts that this would be an unacceptably weak constraint but offers no argument or evidence, and further research is doubtless necessary on this key point.

A final argument for fiscal policy coordination in the Report raises the second of our two themes: that the EC as a whole needs a fiscal and monetary mix appropriate to internal and external balance for the Community (para. 30). The earlier points relate to what has been called 'relative coordination' (Currie, et al., 1989), which focuses on exchange rate relationships and balance of payments interactions. 'Absolute coordination' refers to the overall stance of policy and the

avoidance of collective or global errors of economic management. The basis of reference changes if we shift from the G7 or G3 to the EC, but the distinction is still valid and clear. 'Absolute coordination' and the EC's external macro policies are not unrelated to 'relative coordination' and the issue of asymmetry. One justification of asymmetry is that it is an efficient way of providing the System with a 'nominal anchor', which is an element of absolute coordination (one we shall not discuss).

3. Asymmetry and hegemony

Giovannini's (1989) distinction between a symmetric and an asymmetric exchange-rate system rests on the structure of preferences of countries that participate in a system whose rules are fully symmetric. In the context of a simple model, we have a symmetric system when each central bank has a domestic target, say the nominal interest rate, and a foreign target, say reserves. In an asymmetric system, the central country targets its domestic nominal interest rate, while the others (periphery) target reserves. The peripheral countries give up domestic targets, and international portfolio shifts affect their interest rates but not that of the centre country.

'Hegemonic stability theory' is the related but quite different hypothesis that international economic stability requires a single dominant power. It conventionally starts from the alternative view that hegemony derives from unequal economic and political strength which gives the rules of the policy interaction 'game' an asymmetric structure: there is a leader that acts on the assumption that other countries will adjust to

its policies; the other countries, followers, do in fact adjust on the assumption that the leader will not respond to their actions.

For the EMS, it is usually maintained that Germany does not have the economic or political weight vis-à-vis France and Italy to dominate as a hegemon; nor does the Deutschemark function as an important reserve currency, another possible source of hegemony. Hence the operational hypothesis is asymmetry (of preferences): Germany trades off growth against monetary stability, and its targets are real effective exchange rate stability and the inflation rate; while the others trade off growth against balance-of-payments equilibrium, so their targets are exchange rate stability and reserves.

Capital controls then play a key role. The strict 'rules' of the asymmetric system require peripheral countries to follow the centre's monetary policy fully, but capital controls give them some degree of monetary independence. In practice, they avoid full monetary policy 'coordination' with the centre by maintaining different degrees of sterilization of intervention, which would not be possible with full capital market integration (Mastropasqua et al., 1988). Some suggest that since the others do maintain domestic monetary independence now with capital controls, while Germany too may lose some of its autonomy when it can no longer sterilize so freely, there is in fact no asymmetry, now or prospective (de Grauwe, 1989). This reasoning explicitly ignores the significant difference between the two cases. Spaventa (1989) maintains somewhat more plausibly that asymmetry has already disappeared because there is no longer any great

difference among preferences themselves: all EMS central banks have greater independence in pursuing anti-inflationary monetary policies, because all politicians now give top priority to keeping inflation down.

A proposition analogous to the hegemonic stability hypothesis is that fixed-exchange-rate regimes always operate asymmetrically. Giovannini (1989) tests this proposition. He investigates the timing of discount rate changes under the Gold Standard; uses event studies of interest rate behaviour around devaluations in the Bretton Woods and EMS periods; and tests how domestic targets varied with reserve flows under each of the systems. The data accept the asymmetry hypothesis for only two of the three - surprisingly, the evidence on Bretton Woods is weak.

Others have tested for asymmetry in the EMS: Giavazzi and Giovannini (1987, 1989); Artis and Nachane (1989); Cohen and Wyplosz (1989); and de Grauwe (1989). These tests look at relations between forward premia and offshore interest rate differentials, as well as between forward premia and domestic interest rate differentials; cross-country transmission effects between domestic interest rates and between money supplies; and cross-country relations between inflation rates and wage-setting behaviour. The evidence is mixed. I would assess it overall as supporting the centre-country role of Germany and the interpretation of it above, although the data cannot reject the hypothesis that there is some reciprocal influence of the 'periphery' on Germany (and to test Spaventa's symmetry proposition would require more recent data).

Despite the evidence of asymmetry for the period up to 1988, there is none in the rules governing the operation of the EMS - indeed, the 'divergence indicator' and the prescribed responses to its movements were specifically intended to act symmetrically. They were never implemented. In practice, the system operated asymmetrically, and this is clearly the general perception among practitioners and the informed public. If the asymmetry lies not in the rules, nor in German hegemony, it must lie in preferences regarding policy targets.

Giavazzi and Pagano (1988) have pushed this further to suggest that the peripheral countries (or at least their central banks) wish to 'tie their hands' to fixed exchange rates in the EMS so as to be forced to follow the German monetary lead, or at least to maintain that appearance - in this way, they can 'import' the anti-inflation credibility of the German monetary authorities. (Most recently, the extreme anti-realignment position of France since mid-1988 might be so interpreted.) This may be efficient, too, insofar as it counteracts the strategic interaction (and consequent time-inconsistency problems) in the relation of domestic monetary authorities with their own public, which otherwise would generate inflation.

This is a strong form of monetary policy coordination. It accords, however, with the observation that there is often greater cross-country cooperation among officials in the same domain than internal cooperation between officials with different responsibilities (central bank international cooperation contrasted with domestic conflict between central bank and

finance ministry).

Mélitz (1988) argues that 'monetary discipline' is not a sufficient attraction for the peripheral countries to stay in a System led by Germany; a convincing explanation must go back to the direct gains from policy cooperation. Conversely, one must also ask what are Germany's motives to stay in the EMS, apart from the initial political impetus. Giavazzi and Giovannini (1988) assert that the main benefit has come in the form of a stable real effective exchange rate for the Deutschemark. Others (e.g., Rieke, 1989) suggest German satisfaction with the general adoption of anti-inflationary policies and the role of the Deutschemark as an anchor.

Do we want asymmetry in the longer run? Herr Pöhl amusingly spoke of the 'Franc fort' just at the time that the French became totally determined to keep it so. Others have less facetiously suggested everything from modelling a European Central Bank on the Bundesbank's structure to locating it in Frankfurt and giving it a German president; the latest version has the operational arm in London, consciously recalling the American analogy. All this confirms that asymmetry does indeed transfer an anti-inflation reputation and general conservative rectitude from Bundesbankers to other central bankers.

Perhaps this is just symbolic and short-run - surely if credibility is borrowed long enough, it is ultimately perceived as being on permanent loan, and the actual convergence of inflation rates to low levels should support a corresponding shift in attitudes. That the EMS has been asymmetric need not

mean it must remain so, even if one accepts the contention that all past fixed-rate systems have been asymmetric, since according to that argument they have all been maintained by capital controls (Giovannini, 1989). These are to go. Some aspects of asymmetry must go with them - in particular, there will be less scope for sterilized intervention all around. The consequence may nevertheless be asymmetric: there is nothing to preclude total surrender of monetary sovereignty by the periphery to Germany. Preferences would then be fully revealed: this would have to be a much more conscious and transparent decision than tacit following of Germany hitherto. And it is not impossible that Germany will adjust somewhat too - one role for explicit policy coordination would be to bring that about.

Although discussions of asymmetry have so far focused on monetary policy, it is highly likely that the Internal Market programme will limit some aspects of German fiscal policy freedom like that of all other EC countries and hence give less scope for asymmetry. Goods market, capital market and labour market integration will enforce some degree of convergence of VAT, capital taxes, and possibly even income taxes, even without any Brussels-inspired harmonization. But this can be overstated, as it often is by both proponents and opponents. We need much more research in this poorly understood area.

The major fear that must be faced squarely is that any remaining asymmetry will limit the growth potential of the periphery. The growing current account imbalances within Europe - in particular, the inexorable rise of the German surplus - may indeed require explicit fiscal policy coordination, if not a substantial

realignment. If this were asymmetric, it might be unacceptably deflationary in its overall impact. Policy coordination and 'convergence' cannot act as a permanent drag on the growth of the periphery.

This line of argument assumes, however, that the imbalances cannot be financed indefinitely by voluntary capital flows. Financial integration may offer an escape from the constraint - a full substitute for policy coordination - if it facilitates the accommodation of current account imbalances by private capital flows, as in a monetary union with sufficiently flexible factor prices (Siebert, 1989). We know very little about how to promote this outcome consciously, other than with relatively crude tools of 'regional policy'; this is a further high-priority topic for research and policy discussions.

To the extent that asymmetry does persist as (we assume) exchange rates become more rigid, might not progressive currency substitution among EMS countries tend to eliminate it? Indeed, currency substitution might affect both the internal policy of the Bundesbank and its long-run capacity to exercise leadership in the EMS. It would also create an externality across the monetary policies of member countries that would be a strong additional motive for monetary policy coordination (Casella, 1989). Currency substitution, too, is a key area for future research on the evolution of European monetary institutions.

Finally, the greatest imponderable: the effects of the eventual entry of sterling into the exchange rate mechanism of the EMS. At a stroke, Frankfurt is no longer the dominant financial centre

of the System, at least in the short run; and conscious monetary and fiscal policy coordination both become much more complex. Asymmetry disappears, at least in its existing form. This might be a decisive argument for letting exchange-rate targetting serve indefinitely as the surrogate for explicit policy coordination.

4. Absolute policy coordination and EC external macroeconomic policy

This is a much less well explored area, and we can be correspondingly brief, although the issues are of great importance for research and policy-making. A fixed-exchange-rate system may enforce policy coordination within a regional bloc like the EC, but the EMS is not global for any practical purpose. We must still consider how policies at the aggregate level interact with those of countries external to the system. This raises problems of both absolute and relative policy coordination within the EMS and in a global context.

The EMS is just one component of a wider set of agreements on trade, industrial and agricultural policies among EC member countries. It is often argued that many of those other agreements themselves require exchange-rate stability to function properly, hence the need for discipline and the EMS. An alternative view is that it is easier to get agreement in the EMS (or on any other single area of policy) when it is possible to offer tradeoffs in other areas - this is the sort of bargaining that led, for example, to the Bonn summit accord in 1978. It is relevant not only within the EC but also in its dealings with the rest of the world. EC exchange-rate policy is closely related to

EC trade and agricultural policies, and any intra-EC policy coordination needed to get a common external macro policy must take this into account, as well as the possibility that EC-US-Japan negotiations might do so too.

One reason for absolute policy coordination is simple and clear. Tighter economic integration will make uncoordinated responses to external (from outside the EC) shocks more costly, because the spillovers that are ignored in framing those responses will be greater (Wyplosz, 1989). In general, both fiscal and monetary policy coordination will be desirable.

A second argument is somewhat more involved. Aggregate EC monetary policy will have to be devoted to fixing the aggregate EC effective exchange rate. Therefore a more active fiscal policy will be needed to give internal balance (stabilization), and it will have to be used consistently, with coordination if not necessarily convergence (Kenen, 1988).

A third reason is subtle and requires formal demonstration, to which the reader is referred (Cohen and Wyplosz, 1989). The essential point is that the need to take account of the trade balance of the exchange-rate union as a whole generates an externality in the interaction among its members as they adjust to external (from outside the EC) shocks. Monetary union and the constraints it imposes set only the aggregate inflation rate of the Community. If external shocks affect members asymmetrically, or if such shocks are transitory, responses to them taking account only of the exchange-rate rules and corresponding monetary constraints will result in an inappropriate real

exchange rate and trade balance for the union as a whole.

There have been some detailed discussions of the 'assignment rules' that the EMS might use to bring about both internal and external balance (Russo, 1989, and Russo and Tullio, 1988). These follow similar lines to those considered in the literature on international monetary reform and exchange-rate management (see Miller, Eichengreen and Portes, 1989).

Both the 'trade balance externality' and EC assignment rules need further study. Such work should recognize that one impulse behind calls for absolute policy coordination among EC members is the same as a fundamental motive for economic and monetary union itself: the desire that the Community should be able to negotiate as a macroeconomic unit with the US and Japan, just as it does as a trading partner. This is believed to require absolute policy coordination as well as the creation of a single EC currency that will function jointly with the dollar and yen as a reserve currency.

Any such approach towards comparable bargaining power will mean, however, that the EC will not be able to set the ecu/$ or ecu/yen rate unilaterally. That too will have to be the subject of a direct bargain, which may be quite symmetrical. There is no '$(n-1)$ rule' in a symmetrical game as it is played in practice.

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