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On the obstacles to international policy coordination

Jonathan D. Ostry *, Atish R. Ghosh

International Monetary Fund, Washington, DC, USA

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ABSTRACT

Notwithstanding a handful of exceptions, examples of international macro policy coordination have been few. Why is this so? We argue that the most compelling reasons are asymmetries in country size; disagreement about the economic situation and cross-border transmission effects of policies; and often policymakers' failure to recognize that they face important trade-offs across various objectives. Coordination works by allowing countries to improve the policy trade-offs they face under autarky. Like most efficiency arguments, welfare gains will not be huge (they are, in fact, very similar to estimated gains from global trade liberalization) but certainly measurable and worth pursuing. Given that uncertainty and disagreements are genuine impediments to coordination, we suggest that a neutral assessor may play a useful role in helping to bridge the divergent views of national policymakers, and that some multilateral rules of the road are likely to be needed to limit negative spillovers when coordination proves impossible to achieve.

1. Introduction

The global financial crisis elicited an unprecedented degree of policy activism centered on monetary and fiscal stimulus as well as policies to stabilize the financial system. While there is broad consensus that these policies helped avert a potentially catastrophic great depression and a seizing

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* Corresponding author. Tel.: +202-623-7405.
E-mail address: Jostry@imf.org (J.D. Ostry).

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up of financial systems, there is also concern they generated spillovers in many dimensions, including output, external balances, capital flows, currency values, and asset prices. Now that major tail risks are largely off the table, the debate has shifted to how best to underpin the postcrisis global recovery. Topics of – at times heated – discussion include when and how to exit from unconventional monetary easing, the balance between short-term fiscal stimulus and medium-run consolidation, and a raft of financial and structural reforms to lay the foundation for medium-run growth, to enhance crisis prevention and resilience, and to address internal and external imbalances. Policies during this recovery phase are just as likely to generate cross-border spillovers, some of which are already in evidence.

The current juncture clearly calls for a cooperative approach to policymaking. Yet – with a handful of notable exceptions, such as the 1978 Bonn Summit, the 1985 Plaza Agreement, and the 1987 Louvre Accord – examples of international macroeconomic policy coordination have been few. The most successful instances have been when the world economy seemed on the brink of collapse: the 1987 stock market crash, when the G-7 coordinated interest rate cuts and liquidity provision, and the 2008 global financial crisis, when the G-20 coordinated fiscal expansions. In more normal times, despite evident stresses on the international monetary system, policymaking seems to take a national rather than multilateral perspective.

In this paper, we examine the reasons why this may be so, with a view to determining whether it should be of concern (that is, are potentially large welfare gains being forgone); whether misconceptions account for the lack of coordination; and whether there may be ways of reducing, if not eliminating, genuine impediments to successful international cooperation. In so doing, we apply the ideas originally developed by Ghosh and Masson, (1994) to the current policy context.

The case for policy coordination rests on the principles of standard welfare economics. Since all policymaking involves trade-offs across targets – for instance, monetary stimulus boosts output but at the cost of greater inflation or financial stability risks – efficient global outcomes require that policymakers internalize both domestic and cross-border effects when setting policies. Because there is no global market in such policies, externalities resulting from cross-border effects imply Pareto-inefficient outcomes in the absence of coordination. When these externalities are positive – meaning the instrument has a beneficial effect on the foreign country – then, from the global perspective, there will be too little use of the policy; when negative, too much. The uncoordinated equilibrium is the best that the country can do unilaterally: moving toward cooperative policies yields a first-order welfare gain to the foreign country but a second-order loss to the home country. When both parties move toward the cooperative equilibrium, there will be first-order gains to each that outweigh the second-order losses and, hence, net welfare gains to each party. Coordination, in this sense, does not require policymakers to act against their national interests, but rather to recognize that alternative policy packages – when pursued by all parties – can allow each to improve national welfare.

So why do we not see more macro policy coordination in practice? Our sense is that the most compelling reasons are three-fold. First, policymakers often do not think in terms of trade-offs across their objectives. All too often, coordination discussions founder on each party refusing to budge from some specific macroeconomic goal, apparently not recognizing that a different trade-off across objectives may be welfare improving. Like most efficiency arguments, welfare gains will not be huge (in fact, they are very similar to the estimated gains from global trade liberalization), but – like the gains from trade liberalization – certainly measurable and worth pursuing. But there can be no such gains if policymakers fixate on one objective (say, closing the output gap), myopically ignoring others (keep in check financial-stability risks). A key role of country surveillance is thus to point out the various trade-offs and to underscore consequences of policies that may be beyond policymakers' horizons.

The second obstacle is disagreement about the economic situation and cross-border transmission effects of policies – "model uncertainty" or deliberate "model disagreements." Such uncertainty, while raising potential gains from coordination, makes it more difficult both to reach cooperative agreements and to sustain them. And the third problem is asymmetries in country size (such that, at the global level, a significant portion of gains from coordination may accrue to countries that are too small to be included in any agreement).

These obstacles lead us to a couple of proposals. Given that uncertainty and disagreements are genuine impediments to coordination, our first suggestion is that a neutral assessor may play a useful role in helping to bridge the divergent views of national policymakers. Our second proposal would establish some multilateral rules of the road when coordination proves impossible to achieve, in order to limit