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International policy coordination and transmission

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1. Introduction

My paper overlaps in certain ways with *Marty's* (*Feldstein*), with somewhat different conclusions. I want to talk first about international policy coordination in the monetary sphere. To get back to basics in the old-fashioned way of getting coordination was for two countries to choose a common commodity as their money and let free markets rule, except for the rule that money was that commodity. Gold and silver were the commodities that came to be important and whenever countries chose the same metal, both gold or both silver, and there is free-trade and capital movement and no monetary policy, you got policy coordination in a very decentralized way through the free market.

2. International policy coordination under the gold standard

The gold standard was very much a free-market mechanism, except for the fact of the sovereigns determination of what was money or the definition of money. Gold was not shipped by countries or government or central banks, but by the private market. When the price went above the gold points and moved around them, that is the way you got policy coordination. If you have two countries and each has different commodities for money, like gold and silver, you have flexible exchange rates, corresponding to the flexibility of gold and silver price ratio, and there is coordination along that basis. Of course, that is not as complete a monetary union as when the price of gold and silver

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is fixed. But that is what we had through much of ancient history. You have the bimetallic systems of ancient Persia, Greece, Macedonia, and of the Roman Empire in a very big way.

But we had a very different bimetallism in the 19th century, because gold was always overvalued in those systems and silver or copper became the basic metal that circulated. But in the modern period, with free markets and free coinage systems of gold, the government essentially gave up seignorage rates and established and printed money after the United States monetary union was formed in 1792. You had one country, the United States fixing the price of gold at 15 to 1 silver and France fixing it at 15.5 to 1. Since the United States essentially undervalued gold, the United States had a silver standard up until 1834 or 1836, when it raised the price of gold to 16 to 1 and the country went on to a de facto gold standard. The United States then went off the gold standard in 1862 during the Civil War.

So, when one of the two countries that was fixing the price of gold and silver ended the fixing, the bimetallic system ended. When France went off specie during the Franco-Prussian war and no country was on the bimetallism, bimetallism evaporated as soon as those neighboring countries that France had gotten into the Latin Monetary Union couldn't hold the ratios of gold and silver. With an overproduction of silver from Nevada and other place, the new German Empire went on to the gold standard and dumped its silver. As silver price fell, countries quickly went onto the gold standard and you got a kind of pure gold standard system, except for the few countries like Spain and Mexico that stayed on the silver standard. Throughout this period there was no monetary coordination. You get monetary coordination automatically through the system of free markets and fixing the price of gold.

3. International monetary coordination and fiscal discipline

When Europe went on to a common currency in 1999, that was like countries going on to the gold standard, except that there was a European Central Bank. You have perfect monetary cooperation, and the monetary union worked perfectly for Europe. Of course, maybe you would have some complaints about the monetary policy of the European Central Bank. But the monetary union was perfectly correct. What was causing problems in the monetary union was the fiscal system. There is no fiscal discipline.

The United States faced that kind of problem with monetary union in 1792. You had one of four big changes in the last 2 years of the first presidency: they established the dollar as international money, they established a monetary union, they created the US central bank, and they created the US public debt consolidating the state debts all at once in those two years. So when the Union started off with the 13 states, the states had no public debt anymore because that was taken over by the Union and interest rates and payments were paid from general funding. Forty years later, however, in the recession of 1830 and in the face of secular deflation, 10 states defaulted. Despite great cries for bailouts, no bailouts were given. Many states were sovereign with respect to their debts and in the end only two states wound up paying everything through new tax authorities. Two states refuted everything and paid nothing, while other states made agreements with their creditors. Thus, fiscal responsibility was in the hands of the state after the monetary union was confirmed and this is underlined by the fact that the United States is still in that same situation today.

If California and Illinois default they are in bad shape and the debt situation looks terrible for them. We do not know if the federal government will bail them out. If they kept to the old rule of leaving the responsibility with the states, they would not be bailed out. But in fact I believe that the United States will bail them out and that is going to be a terrible problem for the