Chapter 3

Counterproductive Monetary Policy Coordination

1. INTRODUCTION

This chapter considers the theory of counterproductive cooperation by examining the actual cases of coordination of macroeconomic policies among the major industrial countries during the 1970s and 1980s. It begins with a bird’s-eye view of some of empirical evidence relevant to the four theories developed in the previous chapter; the evidence is all consistent with the theories. The chapter then presents two case studies, both of which are presumed by at least some observers to have been counterproductive.

In doing this exercise, we find that while there is some evidence to show that all the explanations have some validity, only one is consistently supported: the theory of model uncertainty. In both case studies, there were enough uncertainties about the effects of proposed cooperation. And both cases could be interpreted as counterproductive at least according to some of the models. Thus, it is not surprising that both cases are still controversial.

The appendix to this chapter analyzes the data on the political economy of U.S.-Japan monetary relations more closely. Direct tests of the theories using this data set are difficult to execute, as discussed in the previous chapter. But we can nevertheless detect some patterns in the data that show whether they are consistent with the behavioral implications of the different models.
2. OVERVIEW

There is a strong view, held mainly in Germany, that international monetary policy coordination is inflationary. And there is some evidence that this may be true. Figures 3.1, 3.2, and 3.3 show the growth rates of the money supply in the United States, Germany, and Japan. The left-most bar in each shows the average annual growth rate of M1 in the United States, that of M3 in Germany and that of M2+CD in Japan from 1973 (the first year of the float) to 1996. The center bar in each figure is the average growth of these money supply indicators in each country in 1978 and 1986-87 when monetary policy coordination occurred. All show that in coordination years money supply growth was faster than average; in Germany, however, the difference is less clear.

For the Rogoff model to be empirically valid, inflation has to be higher than without cooperation and unemployment must not be significantly different from noncooperation. This is hard to test because inflation and unemployment are also affected by other factors. Another difficulty is uncertainty about the lag of policy effects. It may take some time for given policy to be reflected in economic outcomes, and cooperation is no exception to this rule. Given this uncertainty, Figures 3.4, 3.5, and 3.6 use different combinations of years to see the effects of coordination.