# To coordinate or not to coordinate? Paul De Grauwe

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he need for coordination of macroeconomic policies has popped up regularly in the relations between the major countries in the world. In the late 1970s efforts were undertaken to coordinate macroeconomic policies between the US and Germany. The US authorities exerted great pressure on the German government to act as a locomotive for the world economy by expanding aggregate demand in Germany. The German government duly obliged, but quickly regretted this when the second oil shock of 1979 intensified inflationary pressures in Germany and elsewhere. Similar pressures were exerted, but resisted in the early 1990s.

And recently, in the preparations leading up to the G-20 meeting in Pittsburgh in September, there was again talk about coordination of macroeconomic policies. This time it is not about a coordinated stimulus of national economies, but about exit strategies, i.e. about coordinated restrictions on monetary and fiscal policies. After the massive policies of monetary and fiscal stimulus that most countries have pursued during the last two years, there will soon be a need to turn back these expansionary policies. Will a coordinated strategy allow countries to improve the management of the winding down of monetary and fiscal policies? This is the question that lies at the heart of the debate about coordinated exit strategies.

What does economic theory tell us about the benefits of coordinating national monetary and fiscal policies? I will concentrate here on the question of coordinating *fiscal* policies. I will have a few concluding remarks on monetary policies.

### Fiscal policy: Addressing demand spillovers

The analysis of the benefits (or the lack thereof) of coordinating fiscal policies has usually focused on joint stimulus programmes and is deceptively simple. It is based on the notion of spillovers. If a fiscal stimulus programme in one country also stimulates economic activity in other countries (a positive spillover) and if that country does not coordinate its actions with these other countries it will apply a stimulus programme that is not the right one. The reason is that the other countries benefit from that country's stimulus and thus may decide to reduce their own stimulus effort. In this way, they can profit from the externally generated expansion without having to run costly budget deficits. In other words they will tend to free ride. This free riding behaviour creates a problem for the first country: the benefits of its stimulus programme spill over (partially) to the other countries, while the costs of the budget deficits are fully borne by that country. The country will therefore have an incentive to reduce its own stimulus programme. If all countries reason in the same way, they will apply too little stimulus. Thus when there are positive spillovers of stimulus programmes, the absence of coordination

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will lead countries to restrain their efforts at stimulating their economies. This was the problem that was intensely discussed in the 1970s and the early 1990s.

These very general principles also apply when countries engage in restrictive fiscal policies. But now the cost-benefit analysis is reversed. When one country starts a policy of fiscal contraction this will reduce economic activity domestically but will also negatively affect economic activity in the other countries. In this case part of the cost of the policy of fiscal restriction spills over to other countries, while the benefit of the restrictive policy (which is the reduction of the budget deficit) is enjoyed by the first country only. As a result, the other countries find themselves in a worse situation: economic activity declines and this in turn tends to increase their budget deficits. They are likely to respond by following restrictive budgetary policies, thereby reducing economic activity both domestically and in the other countries. Thus, in contrast to the previous case of stimulus programmes, when countries engage in demand-reducing policies, there is a negative spillover. The reduction of the budget deficit by country A injures country B. The latter will experience a decline in economic activity and an increasing budget deficit. This process triggers further deflationary dynamics that hurt everybody and complicate the task of reducing budget deficits everywhere.

The risk of a non-coordinated exit strategy therefore is that it will lead to self-defeating attempts at reducing national budget deficits. Countries will find it difficult to reduce budget deficits because these attempts trigger a new worldwide deflationary spiral, which in turn tends to increase budget deficits. Everybody loses.

## How large are the spillovers?

The economic argument in favour of a coordinated exit strategy is a powerful one. It is based on the existence of negative spillover effects of budgetary restrictions.

The question that arises here is how important these spillover effects are. If these spillover effects are weak, then we should not worry too much about the lack of coordination. In that case the exit strategies decided by one country will have little bearing on other countries, and each country can find its own preferred strategy. If these spillover effects are large, a lack of coordination of exit strategies may have dire consequences. The empirical issue about the size of these spillover effects is therefore of more than academic interest.

There is a large literature on measuring the spillover effects of macroeconomic policies. The main result of this literature is that the spillover effects of fiscal policies are weak. Sometimes even the sign of the spillover is not known with certainty. This has led to much scepticism among economists about the alleged benefits of coordination of fiscal policies. Ask an economist today whether it makes sense to coordinate fiscal policies (monetary policy is another matter) and he/she is likely to tell you that such cooperative efforts are a waste of time. So, it is advisable that the G-20 heads of state do not waste their time in setting up elaborate cooperative efforts to coordinate exit strategies for fiscal policies.

It should be stressed here that many of the empirical estimates of fiscal policies have been obtained using equilibrium models characterised by Ricardian equivalence. In such models fiscal policies typically have little lasting impact on domestic economic activity. It is therefore also not surprising that the effects of fiscal policies in one country on economic activity in other countries will tend to be weak.

## We are still not near equilibrium and DSGE model relevance

But are these equilibrium models the appropriate instruments to measure the size of spillover effects when the economies are far from equilibrium? I do not think so.

One characteristic of the deflationary forces that have been at work since the crash of 2007 is that at some moment they threatened to pull the major economies into an unstable downward spiral. Individual agents and institutions in a number of major countries were collectively engaged in reducing unsustainable debt levels. This led them to sell assets and to increase savings, both of which induced a deflationary spiral and made these attempts self-defeating. There can be little doubt today that the policies of fiscal expansion (together with monetary expansion) helped to stop this deflationary spiral. Yet the equilibrium macroeconomic models now in use (DSGE models) predicted

that policies of fiscal expansion would have little effect on economic activity and thus should not be undertaken. These models were right to predict that when the economy is close to equilibrium adding more government demand is not likely to have many benefits. Unfortunately, the economies were far from equilibrium, and these models have nothing to say about what happens out of equilibrium. The estimates they generate concerning the effect of fiscal policies on economic activity today cannot be trusted.

The major economies are still far away from equilibrium. Households in the US and in a number of other countries are still in the process of unwinding large debt levels accumulated during the boom years. Financial institutions continue to have inflated balance sheets that will have to be unwound. In such an environment early exit strategies could trigger a renewed downward spiral. These downward spirals are likely to be exacerbated by negative spillover effects between countries. How large these negative spillover effects are, we don't know, but we should not take risks here. Thus one can conclude that in the present situation in which major countries are still far from equilibrium and the threat of deflationary spirals has not disappeared, a coordinated strategy of unwinding national budget deficits and debt levels is likely to reduce the risk of a renewed deflationary dynamics.

#### The G-20

It was predictable that the G-20 would find a consensus on the broad principle that a coordinated approach to fiscal exit strategies is desirable. It will be difficult, however, to implement this principle in practice. The reason is that different countries face quite different economic conditions. Broadly speaking, one can distinguish two types of countries today, the first of which consists of the 'Anglo-Saxon' countries (the US, the UK, Ireland and Spain), which experienced strong growth during the decade preceding the crisis. This growth was based on a consumption and real estate boom made possible by unorthodox finance. Households and financial institutions in these countries now have to unwind their unsustainable debt levels. They have been helped by a massive increase of government debts and deficits. In each of these countries the government budget deficit exceeds 10% of GDP.

The second group of countries did not experience the same kind of debt accumulation of households. They are mainly the continental European countries (with the exception of Spain). In these countries there is no need for households to reduce their debt levels. Only the financial institutions face the problem of excessive debt accumulation. As a result, the budget deficits in these countries are on average only half that of the deficits in the first group of countries.

The 'Anglo-Saxon' countries are likely to face the problem of unsustainable budget debts and deficits sooner than the continental European countries. They will be pressured to exit first, but they are also the countries that can least afford to do so. An early exit strategy by these countries would set in motion the deflationary debt dynamics in a more intense way than in the continental European countries. These differences are likely to make a coordinated approach to fiscal exit strategies very difficult.

# **Monetary Policy**

Having concentrated on fiscal policies, I have not said much about monetary policy. Is there a case to be made for coordinating monetary exit strategies? There can be little doubt that the spillover effects of monetary policies are large. The degree of financial integration is such that actions by the major central banks are felt everywhere. This is also the reason why the degree of cooperation of central banks in providing liquidity during the crisis has been intense, and highly successful. For the same reason these central banks should continue to cooperate when they reverse these policies.

#### References

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