International Coordination of Fiscal Policies: Current and Future Issues

Vito Tanzi

Coordination means different things to different people. Webster's *Seventh New Collegiate Dictionary* defines it as the "act of coordinating," or the "state of being coordinated," and, perhaps more interestingly, "harmonious adjustment or functioning." Thus, the word coordination conjures up in one's mind the image of an orchestra that is harmoniously led by a talented conductor. In this analogy the members of the orchestra, the players, would obviously be the countries' policymakers. It is not clear, however, who would be in the conducting role. That role could be played by the agreement reached by the policymakers at their latest summit or as a consequence of their latest consultations. Such an agreement would presumably concern only the period immediately ahead, since it is unlikely that the policymakers would or even could commit themselves for a longer period. Or, in a more permanent arrangement, the role of the conductor could be played by a set of specific rules (perhaps based on some "economic indicators") agreed upon by the policymakers. The resolution that set up the European Monetary System (EMS) provides an example of this type of arrangement. Or even, in a futuristic world, where the national authorities have devolved some of their decision-making responsibilities to an international or supranational body, that role could be played by an international organization. In the discussion that follows, only the first of these possibilities is contemplated, since the other two do not seem realistic for fiscal policy at this time.

I. The Case for Policy Coordination

The premise that there is a need to coordinate macroeconomic policies rather than letting countries independently pursue their own economic interests is a relatively radical and novel one, especially with regard to fiscal policy. However, to some extent countries have coordinated policies, especially in connection with
exchange rate arrangements, for a long time (see Fischer (1987)). Although this idea surfaced in the 1970s and was put to an early and not too lucky test following the Bonn summit of 1978, only very recently has it gained wide attention on the part of both policymakers and professional economists. In fact, much of the writing on this subject dates from the past few years.

The recent impetus toward policy coordination has come from at least three directions: first, the belief on the part of many observers that the economic, and specifically the fiscal, policies of the major industrial countries have been widely “misaligned” in the 1980s; second, the growing recognition that the economies of the world, and especially those of the industrial countries, have become much more interdependent than they were in the past; and third, the argument advanced by some economists that there are important externalities in policymaking; implying that when countries act independently and in their own self-interests, policy changes may not be carried to the degree necessary to maximize the collective welfare of the group of countries.

**Misalignment of Fiscal Policies**

The main issue regarding policy misalignment in the 1980s has been the size and sustainability of the U.S. fiscal deficit. The fiscal deficit of the central government of the United States rose by about 3 percent of gross national product (GNP) between 1980/81 and the post-1982 period. This increase occurred even though the U.S. economy was enjoying an unusually long upswing; therefore, the “structural” deficit increased even more. This increase may have contributed to the upswing that started in 1983 and accelerated in 1984, but it created several problems for both the United States and the rest of the world. When the major fiscal policy changes were introduced in 1981, the new Administration had expected that, because of the reduction of marginal tax rates and the introduction of various savings incentives (such as Individual Retirement Accounts), the household saving rate would increase by about 3 percent, and this increase would largely finance the deficit that was seen to be temporary anyway. As it turned out, the rate of saving fell and the fiscal deficit remained very high and would have been even higher if various corrective measures had not been introduced (see Palmer (1987)).

The large increase in the fiscal deficit in a large country with a very low rate of saving was at least partly responsible for the high level of real interest rates that
have characterized the 1980s. The restrictive monetary policy of 1979 and the early 1980s gave the initial upward push to real interest rates, but when monetary policy became accommodating after 1982, real interest rates were kept high by large fiscal deficits. While the structural fiscal deficit of the United States rose sharply after 1981, those of the Federal Republic of Germany and Japan, two countries with much higher saving rates, became somewhat smaller. This reduction may have helped contain the rise in the world’s real rate of interest (see Tanzi (1985a)).

As a consequence of these developments, the current account of the U.S. balance of payments deteriorated rapidly—from a surplus of $6.3 billion in 1981 to deficits of around $140 billion in 1986 and 1987. Japan’s current account balance, which had been in deficit in 1979 and 1980, went into a small surplus in 1981 and 1982 and grew to exceed $80 billion in 1986 and 1987. Germany’s current account followed a similar pattern, running a deficit as recently as 1981, which became a small surplus in 1982–84 and grew afterwards to reach $36 billion in 1986 and $35 billion in 1987.

The worsening of the U.S. current account has affected its international investment position. Table 1 shows that the net position of the United States vis-à-vis the rest of the world changed from a positive figure of $106.3 billion in 1980 to a negative figure of $263.6 billion in 1986. Up to 1981 the United States was the world’s largest creditor nation. It was still a net creditor in 1984. By the end of 1986 it had become the world’s largest debtor nation. By 1987 the net indebtedness of the United States exceeded 8 percent of its GNP. The figures may overstate the real net position of the United States, since the asset side includes loans to developing countries, which have much lower market values than their book values. However, the market value of other private assets may also be greater.

The details in Table 1 are as important as the overall change in the net position of the United States. They show that while direct foreign investment in the United States increased by $126.3 billion, foreign investments in U.S. securities increased by $315.3 billion, and foreign investments in other U.S. bank and nonbank liabilities increased by $324.3 billion. Thus, not only did the net position of foreign investors improve sharply, but it improved in particular in

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3The investment incentives introduced by the United States in 1981 and 1982, as well as policies aimed at deregulating financial markets, may also have played a role (see Tanzi (1985b) and Sinn (1987)).

4By 1987 the Federal Republic of Germany and Japan had become net creditors to the tune of 16.5 percent and 14.1 percent of their respective GNPs.
Table 1. U.S. International Investment Position
(In billions of current U.S. dollars)

<table>
<thead>
<tr>
<th>Type of Investment</th>
<th>1980</th>
<th>1986</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. net position</td>
<td>106.3</td>
<td>-263.6</td>
<td>369.9</td>
</tr>
<tr>
<td>Assets abroad</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Official reserve assets</td>
<td>26.8</td>
<td>48.5</td>
<td>21.7</td>
</tr>
<tr>
<td>Government nonofficial reserve assets</td>
<td>63.8</td>
<td>89.4</td>
<td>25.6</td>
</tr>
<tr>
<td>Private assets</td>
<td>516.6</td>
<td>929.9</td>
<td>413.3</td>
</tr>
<tr>
<td>Direct investment abroad</td>
<td>215.4</td>
<td>259.9</td>
<td>44.5</td>
</tr>
<tr>
<td>Foreign securities</td>
<td>62.6</td>
<td>131.0</td>
<td>68.4</td>
</tr>
<tr>
<td>Other bank and nonbank claims</td>
<td>238.5</td>
<td>539.0</td>
<td>300.5</td>
</tr>
<tr>
<td>Foreign assets in the United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign official assets</td>
<td>176.1</td>
<td>240.8</td>
<td>64.7</td>
</tr>
<tr>
<td>Other foreign assets</td>
<td>324.8</td>
<td>1,090.6</td>
<td>765.8</td>
</tr>
<tr>
<td>Direct Investment</td>
<td>83.0</td>
<td>209.3</td>
<td>126.3</td>
</tr>
<tr>
<td>U.S. securities</td>
<td>90.2</td>
<td>405.5</td>
<td>315.3</td>
</tr>
<tr>
<td>Other bank and nonbank liabilities</td>
<td>151.5</td>
<td>475.8</td>
<td>324.3</td>
</tr>
</tbody>
</table>


those assets that can be disposed of quickly and for which expectations can play an important role. Table 1 also provides some indirect evidence of the relative role of high interest rates and a good investment climate in attracting foreign capital. Although direct investment increased considerably, it was not the overwhelming factor in the change in the net indebtedness position of the United States, as has sometimes been argued.5

The years 1980–87 have also witnessed wide swings in exchange rates. The value of the dollar first rose sharply up to 1985 and then fell equally sharply. The changes vis-à-vis the yen and the deutsche mark have been particularly significant. The rise in the value of the dollar was widely attributed to the increase in U.S. interest rates, although the differential rate of expansion of the three economies may have also played a role. The subsequent fall has often been attributed to the growing reluctance by foreigners to keep increasing the share of dollar-denominated assets in their portfolios (see Marris (1985) and (1987)).

5Some have argued that high interest rates could be a reflection of large demand for capital, owing to a good investment climate. Thus, the large inflow of portfolio capital could itself be a reflection of a good investment climate (see Sinn (1987)).
The earlier sharp increase in the value of the dollar and the continuing large U.S. current account deficit have generated protectionist pressures and other difficulties and have inevitably forced policymakers to attempt to deal with them. The Louvre Accord (1987) was generally viewed as an arrangement on exchange rates, even though it implied some commitment on economic policies by the participating countries. The “Statement of the Group of Seven,” released on December 22, 1987, is more specific in listing the policy intentions and undertakings agreed upon by the finance ministers and central bank governors of the seven major industrial countries.

Growing Interdependence

There is plenty of evidence to indicate that industrial countries have become much more interdependent than they used to be. The most dramatic recent evidence of this interdependence was undoubtedly the behavior of stock markets around the world after the 508-point fall in the New York stock exchange on October 19, 1987 (“Black Monday”). Whether one considers the share of imports and exports in national incomes—shares that have increased sharply for many industrial countries in recent decades—or the size of capital movements, or the attention that policymakers now pay to the economic policies of other countries, the conclusion must be that the fiction of a closed economy—a fiction that is still kept alive in the pages of many economic textbooks—cannot provide useful insights for guiding the economic policy of the real world. The internationalization of the financial and goods markets, together with the wide and immediate availability of information, has guaranteed that what happens in one country, and especially in a large country, will be felt by other countries. What this means is that the domestic fiscal policy multipliers associated with, say, a fiscal expansion by a single country become smaller than they were in the past. Furthermore, the smaller and more open a country is, the lower these domestic multipliers are likely to be.

The Need for Cooperative Policies

Obvious benefits are associated with this interdependence and openness. International trade of products and factors among countries encourages specialization and brings about a more efficient international allocation of resources. Under normal assumptions, international trade raises the level of world income. This interdependence, however, has important implications for the conduct of fiscal and monetary policy as well. Interdependence implies that there are important externalities to some policy actions. These externalities may create inefficiencies, in the sense that policy actions may not be carried to the level that would be considered optimal from an international point of view. In a closed economy, both the costs (political and economic) and the benefits of fiscal policy
actions would be fully internalized. However, in an interdependent world, some of the benefits (and some of the costs) of that action will spill over to other countries.

Assume, for example, that the policymakers of country X wish to pursue an expansionary fiscal policy to stimulate domestic economic activity and employment. Assume also that there are no offsetting actions on the part of other countries or on the part of the monetary authorities. The fiscal policy action on the part of country X is generally assumed to increase its aggregate demand in the short run and, as a consequence, its level of imports. The increased exports by other countries will increase their level of economic activity and employment, while country X will experience a deterioration in its trade account. The smaller a country is and the more open its economy, the greater will be the share of the total increase in demand that will affect other countries.

An example often mentioned to prove the above point is the expansionary fiscal policy pursued by the Mitterrand Government in the early 1980s. It has been maintained that the domestic beneficial effects of that action were largely dissipated by the openness of the French economy and the consequent low fiscal multiplier. The expansion had to be stopped soon after it started because of the deterioration in France’s balance of payments. It can also be argued that a good part of the benefits and the costs of the U.S. fiscal expansion since 1982 accrued to other countries, either because they could maintain a higher level of economic activity because of higher exports to the United States, or because they had to bear the consequences of higher real interest rates or of fluctuating real exchange rates or terms of trade. Countries that export little to the United States but are net borrowers and are closely linked in financial markets would be particularly affected negatively. In these countries, the cost of borrowing (or servicing their stock of debt) would go up. The distribution of costs and benefits may have been unevenly distributed across countries, depending on how close in goods trade their economies were to the U.S. economy and on whether they were net lenders or borrowers.

This generally accepted conclusion should be qualified when the fiscal expansion starts from a situation where there is either a large fiscal imbalance or a large public debt. In such cases, negative confidence effects may neutralize all or part of the expansionary effects. Furthermore, as Corden (1987) has pointed out, with flexible exchange rates it is possible that a country may expand without a deterioration in its current account.

This conclusion is not true in all models. It is conceivable that an expansionary policy in country X may negatively affect other countries through effects on real interest rates and terms of trade. For example, a large fiscal expansion in the United States that increased real interest rates could conceivably have negative effects on developing countries with a large foreign debt. Ironically, if the debt is due to American banks and if it is paid, the United States could end up benefiting from this externality.
The argument presented above has implications for the coordination of fiscal policy among countries, especially when economic activity needs to be stimulated. If, acting independently, countries would be reluctant to pursue expansionary fiscal policies because of the balance of payments effects of these policies, they could all benefit—and they could neutralize the effects on the balance of payments—if they all pursued a fiscal expansion at the same time. However, given different propensities to import, different interest elasticities of investment demand, and different trade connections with countries that are not part of the coordinated group, even in this case the results are not likely to be neutral. Furthermore, the countries would have to consider the inflationary implications of their joint expansion.

The situation gets more complex when one takes into account not just the benefits but also the costs of fiscal policy actions, and when coordination calls for expansion on the part of some countries and contraction on the part of others (see Corden (1986) and (1987)). Experts on policy coordination, using game theory and other analytical tools, have described situations whereby policy coordination may reduce rather than increase the group's welfare. However, much of the literature seems to conclude that in normal circumstances coordination would be beneficial, although the benefits do not appear to be particularly large compared to situations in which countries do not coordinate.

The above example leaves unanswered, however, some important questions. First, is it as feasible to coordinate fiscal policy actions as it is to coordinate monetary policy actions? Second, is there a possibility that short-run and long-run objectives of fiscal coordination may conflict? Third, what does coordination of fiscal policy mean? These issues are briefly raised in the next section.

II. Requirements for Successful Fiscal Coordination

Coordination can have several meanings, which may range from a vague understanding that each country will do its best to keep, or to put, its own economy (and its own fiscal accounts) in good shape (under the belief that, as Fischer (1987) and others have argued, this is the best that each country can do for others), to a commitment by each country to take specific policy actions agreed jointly in coordination with other countries. For example, in a period of slow economic activity, a group of countries—say, the Group of Seven—might agree to pursue expansionary fiscal policies. Alternatively, under circumstances in which the fiscal policies of the countries are viewed as being misaligned, some country, say, the United States, might commit itself to pursuing a policy aimed at reducing its fiscal deficit on condition that other countries, say, the Federal Republic of Germany and Japan, agreed to pursue more expansionary fiscal policies, at least for the short run, than they would otherwise. The discussion that follows focuses on this kind of coordination.
In a world in which the policies of individual countries attract a lot of attention on the part of other countries and international organizations, such as the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), and European Communities (EC), it is safe to assume that some implicit coordination of policies is always taking place, in the sense that countries do pay some attention to the impact that they are having on other countries or to what other countries expect them to do. For example, Article IV and World Economic Outlook (WEO) discussions by the Executive Board of the IMF, together with the preparation and distribution of the relevant documents, must inevitably have some influence on the policy behavior of countries. It would thus be unrealistic to assume that under current circumstances, and in the absence of explicit coordination agreements, the economic policies of countries would be guided by myopic behavior that totally ignores what other countries are doing or are likely to do.

Frequent interchanges among the policymakers of different countries, together with the great amount of information that is available to them, imply that rational and concerned policymakers would take into account both the impact of their policies on others and the impact of the policies of others on them. This strategic behavior is likely to produce better results than would be associated with myopic behavior and that may not, in fact, differ very much in terms of benefits from those achieved through explicit coordination (see Canzoneri and Minford (1988)).

An actively coordinated fiscal policy that aims at demand management on a global scale rather than at correcting major fiscal imbalances in particular countries will have to meet various requirements if it is to stand a good chance of being successful in achieving its stated objective. This section discusses some of these requirements. The discussion focuses on fiscal policy of a demand management type, although there are of course many other kinds of coordination that are not considered here.

Fiscal Coordination and Economic Forecasts

For a policy of fiscal coordination to succeed, a necessary prerequisite would be that the relevant group of countries has jointly recognized that there is a need for a coordinated change in policy. This need would arise from a belief among the coordinating policymakers (finance ministers and central bank governors) that, in the absence of joint policy action, the outcome, in terms of variables measuring some economic objectives, at some future time (say, one or two years ahead) would not be desirable. As already mentioned, the relevant comparison would not be with the alternative of no action but with the one of individual action based either on myopia or, more realistically, on strategic behavior—that is, a behavior that takes into account what other countries are doing and what they expect other
countries to do. Thus, the first basic requirement for successful coordination seems to be a jointly agreed and reliable forecast. Here there are at least two issues: the reliability of the forecasts, and agreement among the countries that one of the forecasts is the right one.

It is a well-known fact that forecasts are partly applied science, partly art, and partly divination. In a recent and stimulating book dealing with the essence of science and with a major scientific revolution now taking place, James Gleick discusses the scientific basis for the forecasts made by scientists in different branches of science, including astronomers, ecologists, weather forecasters, and economists. He says that "by the seventies and eighties, economic forecasting by computer bore a real resemblance to global weather forecasting" (Gleick (1987), p. 20). His assessment of weather forecasts is sharp: "...beyond two or three days the world's best forecasts [are] speculative, and beyond six or seven [days] they [are] worthless" (p. 20). His assessment of economic forecasts is even sharper:

Presumably [governments and financial institutions] knew that such variables as 'consumer optimism' were not as nicely measurable as 'humidity' and that the perfect differential equations had not yet been written for the movement of politics and fashion. But few realized how fragile was the process of modeling flows on computers, even when the data was reasonably trustworthy and the laws were purely physical, as in weather forecasting. (p. 20)

Of course, not all economic forecasts are made by computer models, and Gleick would probably agree that forecasts made for the period just ahead have a far better chance of being right than those made for longer periods. But this is precisely the difficulty with coordination of fiscal policy. As I shall argue below, it often takes quite some time before fiscal policy changes coordinated by a group of countries can be implemented and can have an effect on the world's economies. This time is likely to be somewhat longer than the period for which acceptably reliable forecasts can be made.

Forecasts are likely to be relatively reliable for the next 6 months and somewhat less so for the next 12 months. As the period is extended beyond that, they are unlikely to provide the kind of information on which policymakers would or should base their policy decisions. Of course, we are discussing fiscal policy coordination that aims at demand management, not fiscal policy actions aimed at putting the fiscal accounts of a country in order. For the latter one does not need a forecast, although the pace of adjustment must be determined on the basis of current and expected future economic conditions. The more vigorous is the current pace and the expected future pace of economic expansion, the more quickly can fiscal disequilibrium be corrected.

At this point it is perhaps important to make a distinction between coordination of monetary policy and coordination of fiscal policy. Once an agreement is
reached by the policymakers of the coordinating countries, monetary policy actions can be taken immediately and well within the period for which existing forecasts provide relatively reliable results. For fiscal policy it is different. For fiscal policy, even when an agreement has been reached, it may take a long time before action can be taken. Thus, the issue being discussed at this point is not a major difficulty for monetary policy coordination, but it is for fiscal coordination. In both cases, of course, there might be a long lag between the time the action is taken and the time when the results of that action are felt by the economy.

Examples of economic forecast errors for output growth and inflation for six major industrial countries are shown in Table 2 and Table 3. The tables show forecast errors made by national forecasts as well as by the WEO of the IMF. All the errors refer to forecasts made for a period just one year ahead. Such a period is often far too short for the coordination and execution of fiscal policy.

The tables are largely self-explanatory, but a few aspects may be highlighted. First, the errors may appear small since they are given in percentage points, but not when they are compared to the average values of the variables they are forecasting. Second, the errors would be larger if the forecasts were made for, say, two or three years ahead. Third, the errors appear to be particularly large in periods when economic conditions are changing rapidly, such as 1974 and 1982. But these are exactly the periods when one would want to have fiscal coordination of the demand-management type. Fourth, in some cases, there are significant differences between the forecasts made by the countries’ national authorities (say, the Council of Economic Advisers (CEA) forecast in the United States and the official forecast in Japan) and those made by WEO (see also correlation coefficients in the tables). The differences between the forecasts made by the national authorities and those made by the Fund (or, for that matter, by OECD) tend to be particularly large in exactly those periods when the strongest case for coordination could be made.

In conclusion, one of the basic requirements for successful fiscal coordination—namely, the availability of a jointly agreed and reliable forecast—is unlikely to be met. This has serious implications for fiscal coordination that aims at global demand management through fiscal policy changes, although it is a far less serious obstacle for monetary policy coordination or fiscal coordination that emphasizes either the correction of serious fiscal imbalances in particular countries or structural changes.

But, of course, if there are long lags on the effectiveness of monetary policy, as Milton Friedman has often argued, then the issue is the same.

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Table 2. Output Growth Forecast Errors, Year-Ahead Forecast

<table>
<thead>
<tr>
<th>Year</th>
<th>United States</th>
<th>Japan</th>
<th>France</th>
<th>Federal Republic of Germany</th>
<th>Italy</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Consensus</td>
<td>WEO</td>
<td>Official WEO</td>
<td>Official WEO</td>
<td>Consensus</td>
<td>Five Wise</td>
</tr>
<tr>
<td>1973</td>
<td>0.8</td>
<td>0.2</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>1974</td>
<td>3.2</td>
<td>2.9</td>
<td>4.9</td>
<td>2.7</td>
<td>10.8</td>
<td>2.5</td>
</tr>
<tr>
<td>1975</td>
<td>-1.0</td>
<td>-1.0</td>
<td>0.3</td>
<td>0.9</td>
<td>12.0</td>
<td>42.0</td>
</tr>
<tr>
<td>1976</td>
<td>0.2</td>
<td>-0.1</td>
<td>0.2</td>
<td>-0.1</td>
<td>-0.7</td>
<td>-0.2</td>
</tr>
<tr>
<td>1977</td>
<td>0.8</td>
<td>0.1</td>
<td>0.3</td>
<td>0.9</td>
<td>12.0</td>
<td>15.0</td>
</tr>
<tr>
<td>1978</td>
<td>1.3</td>
<td>-0.0</td>
<td>0.1</td>
<td>1.3</td>
<td>-0.8</td>
<td>12.0</td>
</tr>
<tr>
<td>1979</td>
<td>2.0</td>
<td>1.4</td>
<td>-0.8</td>
<td>1.1</td>
<td>0.2</td>
<td>-0.1</td>
</tr>
<tr>
<td>1980</td>
<td>1.2</td>
<td>-0.7</td>
<td>-1.1</td>
<td>0.2</td>
<td>-0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>1981</td>
<td>-1.7</td>
<td>1.0</td>
<td>-0.7</td>
<td>-3.4</td>
<td>2.0</td>
<td>11.0</td>
</tr>
<tr>
<td>1982</td>
<td>5.1</td>
<td>4.2</td>
<td>2.4</td>
<td>2.6</td>
<td>19.2</td>
<td>12.0</td>
</tr>
<tr>
<td>1983</td>
<td>1.0</td>
<td>-3.0</td>
<td>-1.3</td>
<td>-1.6</td>
<td>-0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>1984</td>
<td>-1.6</td>
<td>-1.1</td>
<td>-1.3</td>
<td>-2.5</td>
<td>-1.0</td>
<td>-1.8</td>
</tr>
<tr>
<td>1985</td>
<td>1.6</td>
<td>1.5</td>
<td>0.7</td>
<td>1.3</td>
<td>0.3</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Average absolute error (1973-79): 1.075, 0.21, 0.143, 1.045, 2.323, 1.414, 1.284, 2.836, 1.667, 1.614, 1.871, 2.029, 2.343, 1.329, 1.629

1980-85: 2.033, 1.917, 1.250, 1.533, 0.950, 1.167, 0.917, 0.950, 0.767, 0.733, 0.717, 1.350, 1.679, 2.100, 0.800

Whole Period: 1.690, 1.408, 0.977, 1.454, 1.239, 1.792, 1.185, 1.085, 1.477, 1.239, 1.200, 1.631, 1.9003, 2.258, 1.085, 1.392

Correlation coefficient:

<table>
<thead>
<tr>
<th>Year</th>
<th>United States</th>
<th>Japan</th>
<th>France</th>
<th>Federal Republic of Germany</th>
<th>Italy</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>-0.5</td>
<td>-0.1</td>
<td>-0.1</td>
</tr>
<tr>
<td>1980-85: 0.89, 0.83, -0.5</td>
<td></td>
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</tr>
</tbody>
</table>

Note: Forecast errors are defined as forecasts minus realization values.
Office of Management and Budget
Council of Economic Advisers


### Table 3. Inflation Forecast Errors, Year-Ahead Forecast

(In percentage points)

| Year | United States | Japan | France | Federal Republic of Germany | Italy | United Kingdom |
|------|---------------|-------|--------|----------------------------|-------|----------------|---------|
|      | Official      | CEA   | Consensus | WEO                         | Official | CEA | Consensus | Five Wise | Official | NIESR | WEO |
| 1973 | -23           | -27   | -23     | -96                         | -6.3   | -21 | -23      | -0.6     | -0.1     | -0.6  | -0.4 |
| 1974 | -32           | -35   | -47     | -81                         | -8.6   | -41 | -44      | 0.5      | 1.0      | 0.3   | 0.2  |
| 1975 | 23            | -0.2  | 0.5     | 31                          | 9.0    | -30 | -21      | -13      | 2.3      | -1.6  | -1.1 |
| 1976 | 20            | 0.9   | 0.7     | 6                           |        | -19 | 111      | 1.4      | 0.9      | 0.9   | 1.2  |
| 1977 | 0.1           | -0.4  | -0.5    | 16                          | 1.3    | -0.4 | 0.5      | 0.4      | 0.4      | 0.1   | 0.1  |
| 1978 | -11           | 2.3   | -14     | -13                         | 0.9    | -20 | 12       | 0.1      | -0.4     | -0.4  | 0.1  |
| 1979 | -2.2          | -16   | -1.1    | -11                         | 1.7    | -15 | 15       | -0.3     | -0.8     | -0.3  | -0.2 |
| 1980 | -2.1          | -10   | -0.2    | 0.1                         | 1.0    | -24 | -18      | -0.5     | -0.5     | -1.0  | 0.1  |
| 1981 | 0.0           | 16    | 0.1     | -1.3                        | 1.5    | -0.9 | 31       | 0.4      | 0.4      | 0.2   | 0.2  |
| 1982 | 2.1           | 2.6   | 1.9     | 12                          | 1.4    | 11  | 0.5      | 0.3      | -0.8     | -0.6  | -0.3 |
| 1983 | 2.3           | 15    | 1.5     | 18                          | 1.5    | -0.9 | 21       | 0.3      | 0.1      | 0.3   | 0.1  |
| 1984 | 10            | 14    | 0.7     | 0.4                         | 0.2    | -5  | 0.3      | 0.6      | 1.1      | 1.1   | 1.1  |
| 1985 | 13            | 11    | 10      | 10                          | 0.1    | -0.3 | 0.4      | 0.3      | -0.2     | -0.2  | 0.4  |

Average absolute error (1973-79):

- United States: 1.350
- Japan: 1.857
- France: 1.414
- Federal Republic of Germany: 1.517
- Italy: 3.857
- United Kingdom: 3.757

Year on Year:

- United States: 1.257
- Japan: 1.533
- France: 0.900
- Federal Republic of Germany: 0.967
- Italy: 1.083
- United Kingdom: 1.983

Fiscal Coordination and Economic Objectives

Assuming that the coordinating policymakers have reached an agreement on the relevant forecast, the next step must be to agree on the economic objectives that should be achieved through coordination. Should the main objective be an acceleration of economic activity, a reduction in the unemployment rate, a reduction in the rate of inflation, some adjustment in the balance of payments, or a reduction in the real rates of interest? And if, as is likely, more than one objective is important, how should the various objectives be ranked in terms of priority?

There are two issues that are likely to arise: coordination among countries, and coordination within countries. Economic policy in democratic countries must, to a large extent, reflect the priorities of the citizens. If these priorities are ignored, elected policymakers are not likely to remain policymakers for long. This is, again, an area where a large difference exists between monetary and fiscal policy, especially in some countries.

Monetary policy is often made by officials who are somewhat insulated from the political process. They are appointed for a given number of years, or even for an indefinite period, and cannot be removed. When Paul A. Volcker, then Chairman of the Federal Reserve Board, decided to pursue a restrictive monetary policy in 1979 to reduce the rate of inflation, he did not have to worry about the reaction of the U.S. electorate. This freedom, however, is not enjoyed by the elected officials who make fiscal policy and who have to worry about the next election and have to coordinate their actions with the legislature, which is also keeping an eye on the electorate. What this means is that it would be unrealistic to assume that in the fiscal area the policymakers of a country would, to a substantive degree, subordinate the priorities of the country's electorate to those of the policymakers of other countries. It is well known that Germans, reflecting their historical experiences, are more concerned with inflation than with unemployment. For Germans the worst economic experience in this century was the hyperinflation of the 1920s that wiped out the financial savings of that country's middle class. It is equally well known that Americans, also reflecting their historical experience, are more concerned with unemployment than with inflation. Their worst economic experience was the Depression of the 1930s. Those events still cast a long shadow on current economic policy.

10The degree of statutory independence of central banks in conducting monetary policy varies substantially among the Group of Seven countries. In some countries they are required by law to secure approval by the Treasury Minister of key monetary policy decisions. The central banks of the United States and Germany are independent.
The one important example of economic cooperation among countries, the European Monetary System (EMS), has succeeded in coordinating monetary but not fiscal policy. In fact, the evidence so far is that there has been relatively little coordination of fiscal policy among the members of the EMS (see Tanzi and Ter-Minassian (1987), and Russo and Tullio (1988)).

Fiscal Coordination Within a Country

Much of the writing on fiscal coordination has simply assumed that policymakers meet at some important summit meeting and decide on a coordinating strategy that might imply changing the money supply by a given percentage or reducing or increasing the fiscal deficit by a given amount. On the basis of this change in the fiscal deficit, some economic model can then calculate the final effect on the variables that policymakers wish to influence through coordination. In the next subsection, the relationship between changes in instruments (that is, the fiscal deficit) and changes in objectives (for example, growth, inflation) will be discussed. But first, it is worthwhile to discuss the question of what may happen between the time when a decision is made at some international meeting to change the fiscal deficit and the time when that decision becomes, if it does, the specific policy of a country. To paraphrase an old Italian saying: in fiscal policy, between the declaration of intentions and the implementation of actual policies one must deal with the role of the legislature.

Let us start with a summit agreement in which a country, say, the United States, has agreed to reduce its fiscal deficit by 1 percent of GNP. When the policymakers get back to Washington, the first decision that they will have to make is whether they will propose that the reduction be carried out through the revenue side or through the expenditure side of the budget. In either case, all they can do is propose the changes to Congress. If the proposal is on the revenue side, it will have to go to committees: these will deliberate for months and perhaps years, and could, eventually, come out with alternative proposals that may bear little relation either quantitatively or qualitatively to the initial proposal. In this political process, domestic priorities are likely to take precedence over international priorities. Besides, if the changes are important and they are on the revenue side, the question arises of whether the revenue-estimating models now available are good enough to be able to assess, with any degree of precision, the relationship between the changes in the statutory rates and the actual revenue changes. If the changes are on the expenditure side, the question arises of whether they are durable. In any case, the control by the executive branch over this instrument, especially in the United States, is much more tenuous than current writing on coordination implies.

If the proposal is on the expenditure side, the budgetary cycle also has to be dealt with. Table 4 provides some information on this issue for the group of seven
Table 4. Opening Stages of the Annual Budget Cycle in Seven Major Industrial Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Decision Taken by</th>
<th>Nature of Decisions</th>
<th>Months Before Budget Presented to Legislature</th>
<th>Next Step</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>Cabinet Committee on Priorities and Planning</td>
<td>Total spending and broad sectoral targets (envelopes)</td>
<td>6</td>
<td>Ministers submit detailed departmental bids for approved programs, for negotiation with Treasury Board</td>
</tr>
<tr>
<td>France</td>
<td>Prime Minister</td>
<td>Broad guidelines in &quot;lettre de cadrage&quot;</td>
<td>9</td>
<td>Ministers prepare and negotiate requests, leading to a specific ministry target in &quot;lettre de plafond&quot; three months later</td>
</tr>
<tr>
<td>Germany, Federal Republic of</td>
<td>Minister of Finance</td>
<td>Total spending and broad guidelines</td>
<td>9</td>
<td>Ministers submit detailed departmental bids, for negotiation with the Minister of Finance</td>
</tr>
<tr>
<td>Italy</td>
<td>Treasury Minister</td>
<td>Changes required in total and by department</td>
<td>6</td>
<td>Ministers submit budget proposals to Treasury Minister</td>
</tr>
<tr>
<td>Japan</td>
<td>Cabinet</td>
<td>Policy guidelines on budgets</td>
<td>6</td>
<td>Ministries submit proposals to Ministry of Finance</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Cabinet</td>
<td>Planning total set for three years forward</td>
<td>9</td>
<td>Spending ministers submit bids if necessary, for amounts in excess of previously agreed baseline</td>
</tr>
<tr>
<td>United States</td>
<td>President</td>
<td>General fiscal and budget guidelines, sometimes departmental-specific</td>
<td>15</td>
<td>Spending agencies submit bids to OMB</td>
</tr>
</tbody>
</table>

Source: Adapted from Table 1 in OECD (1987), p. 27.
major industrial countries. The table shows that in one important case (the United States), the cycle commences some 15 months before the proposals are sent to the legislature. In three cases, it starts nine months before, and in the remaining three cases it starts six months before. The fiscal year for which the budget applies starts normally some time after the proposals are sent to the legislature. Once again, the proposals that go to the legislature are likely to be modified both quantitatively and qualitatively. Thus, even if the coordinating agreement has been made at the very beginning of the cycle, it is unlikely that it will have much of an effect on expenditure for two years, if not longer. And, of course, as has already been stated, in some countries the final result is likely to differ sharply from the original intention. Furthermore, there will be a lag between the time the fiscal action is implemented and the time its effect is felt in the economy.

Let us summarize the most likely operating scenario for pursuing a policy of fiscal coordination. Presumably, the action would start with a jointly agreed forecast for one year ahead. That forecast would send signals that some policy changes are needed. Thus, after some time, an agreement would be reached (perhaps at a summit). Such an agreement would conceivably ask different countries to reduce or increase their fiscal deficit by agreed amounts. On the basis of this agreement, proposals to change revenue or expenditure would be prepared by each country. Eventually, these proposals would go to the proper committees in the legislature where, at least in some important countries, they would be modified and sent to the full legislature. At some point they might be approved. Between the original agreement by the coordinating group and the enactment of the proposals, and between that enactment and the time when their effect is felt on the economy, a considerable amount of time is likely to have elapsed. That time is likely to be well beyond the period for which reliable forecasts can be made.

**Fiscal Coordination and Policy Instruments and Objectives**

Assume that (1) policy changes of the size and structure desired by the coordinating policymakers can be enacted immediately; (2) that policymakers of different countries have agreed on a forecast; (3) that they have agreed on the goals to be achieved through coordination; and (4) that they have agreed in principle on the policy changes to be made. Thus, what remains to be specified is the size of the change to be made to, say, the fiscal deficit or the growth of money. Since much of the literature on macroeconomic coordination has concluded that coordination improves policymaking, it should follow that there would be no reason not to coordinate. Unfortunately, even under these ideal circumstances, the important issue arises of the relationship between the policy instruments and
the final objectives of policy. The issue discussed here is not limited to fiscal policy but extends to all policies.

Economics has not advanced to the point at which it can give definite and precise answers to the question of what effect a given expansion in the money supply, for example, or an increase in the fiscal deficit would have on some basic objectives such as the rate of growth, inflation, the current account in the balance of payments, and so forth. Sometimes even theoretical answers are not easy. Often, governments rely on econometric models to get some of these answers, and quite a few of these models are now serving different governments. If all of these models agreed on the answers and the answers were the correct ones, coordination would be easy. If they all agreed but the answers were the wrong ones, the gains from coordination would be reduced but policymakers might still reach an easy agreement on what to do. A more serious practical problem arises when the models give different answers to the same questions, and the policymakers of the different countries must decide whether to trust the results of their own model or those of others. Just how serious is this issue of conflicting models? An experiment at the Brookings Institution in Washington addressed this specific issue.

In this experiment the people in charge of 12 multicountry models were asked to simulate, independently, the effects of carefully specified policy changes to see how much agreement there would be in the results obtained. Two of these changes concerned fiscal policy: a permanent increase in U.S. real government expenditure of 1 percent of baseline GNP; and a permanent increase, also of 1 percent of baseline GNP in non-U.S. government expenditure. These changes were simulated, while the growth of monetary aggregates was assumed to be exogenous. The results, which are summarized in Table 5, refer to the second year after the policy changes were made and show the cumulative percentage deviation from the baseline estimates.

A remarkable feature of these results is their wide range. The U.S. fiscal expansion is seen to raise: (1) real U.S. income by anywhere between 0.4 percent and 2.1 percent by the second year, and real foreign income by anywhere between zero and 0.9 percent; (2) the U.S. consumer price index (CPI) by anywhere between –0.9 percent and 0.9 percent, and the foreign CPI by anywhere between –0.1 percent and 0.6 percent; (3) U.S. interest rates by anywhere between 0.1 percent and 2.2 percent, and the foreign rates by anywhere between zero and 1 percent; and (4) the value of the U.S. exchange rate by anywhere between –2.1 percent and 4.0 percent. The U.S. current account deteriorates by anywhere between $0.5 billion and $22.0 billion. The results of the foreign expansion on the United States can also be seen from the table. They all show equally broad ranges.
Table 5. Simulation Effect of Fiscal Expansion in Second Year After Policy Change

(in percent, except where otherwise noted)

<table>
<thead>
<tr>
<th>Model</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
<th>Currency Value</th>
<th>Current Account in billions of U.S. dollars</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
<th>Current Account in billions of U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>MCM</td>
<td>+1.8</td>
<td>+0.4</td>
<td>+1.7</td>
<td>+0.6</td>
<td>-165</td>
<td></td>
<td>+0.7</td>
<td>+0.4</td>
<td>+0.4</td>
</tr>
<tr>
<td>EEC</td>
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<td>+0.6</td>
<td>+1.5</td>
<td>+0.6</td>
<td>-11.6</td>
<td></td>
<td>+0.3</td>
<td>+0.2</td>
<td>+0.3</td>
</tr>
<tr>
<td>EPA</td>
<td>+1.7</td>
<td>+0.9</td>
<td>+2.2</td>
<td>+0.6</td>
<td>-20.5</td>
<td></td>
<td>+0.9</td>
<td>+0.3</td>
<td>+0.5</td>
</tr>
<tr>
<td>L NK</td>
<td>+1.2</td>
<td>+0.5</td>
<td>+0.2</td>
<td>+0.1</td>
<td>-64</td>
<td>+0.1</td>
<td>+0.1</td>
<td>+0.1</td>
<td>+0.1</td>
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<td>LIVERPOOL</td>
<td>+0.6</td>
<td>+0.2</td>
<td>+0.4</td>
<td>+0.6</td>
<td>-7.0</td>
<td>+0.6</td>
<td>+0.1</td>
<td>+0.6</td>
<td>+0.1</td>
</tr>
<tr>
<td>MSG</td>
<td>+0.9</td>
<td>+0.1</td>
<td>+0.9</td>
<td>+0.6</td>
<td>-21.6</td>
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<td>+1.1</td>
<td>+0.5</td>
<td>-8.5</td>
<td>+0.1</td>
<td>+0.3</td>
<td>+0.3</td>
<td>+0.3</td>
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<tr>
<td>VAR</td>
<td>+0.4</td>
<td>-0.9</td>
<td>+0.1</td>
<td>+0.5</td>
<td>-6.1</td>
<td>-0.5</td>
<td>-0.3</td>
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<td>-0.5</td>
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<tr>
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<td>+0.6</td>
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<td>+0.4</td>
<td>+0.4</td>
<td>+0.4</td>
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<tr>
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<td>+1.4</td>
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<td>+1.1</td>
<td>+0.2</td>
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<td>+0.4</td>
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</table>

Fiscal Expansion in the United States

<table>
<thead>
<tr>
<th>Model</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
<th>Currency Value</th>
<th>Current Account in billions of U.S. dollars</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
<th>Current Account in billions of U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>MCM</td>
<td>+1.4</td>
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<td>+0.6</td>
<td>+0.3</td>
<td>-7.2</td>
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<td>+0.2</td>
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</tr>
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Fiscal Expansion in OECD Countries

<table>
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<tr>
<th>Model</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
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<th>Current Account in billions of U.S. dollars</th>
<th>Income</th>
<th>Consumer Price Index (CPI)</th>
<th>Interest Rate</th>
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<td>+0.3</td>
<td>+0.3</td>
<td>+3.2</td>
</tr>
<tr>
<td>VAR</td>
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<td>-0.3</td>
<td>+0.2</td>
<td>+0.6</td>
<td>-22.2</td>
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<td>+0.2</td>
<td>+3.2</td>
</tr>
<tr>
<td>OECD</td>
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<td>+0.7</td>
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<td>+0.6</td>
<td>-6.9</td>
<td>+0.2</td>
<td>+0.2</td>
<td>+0.2</td>
<td>+3.3</td>
</tr>
<tr>
<td>TAYLOR2</td>
<td>+1.6</td>
<td>+0.1</td>
<td>+0.2</td>
<td>+0.6</td>
<td>-6.9</td>
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<td>+0.2</td>
<td>+0.2</td>
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<tr>
<td>WHARTON</td>
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<tr>
<td>DRI</td>
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<td>+0.2</td>
<td>+0.2</td>
<td>+0.2</td>
<td>+3.3</td>
</tr>
</tbody>
</table>


1Non-U.S. short-term interest rate not available; long-term rate reported instead.
2U.S. CPI not available; U.S. GNP deflator reported instead.
3Appreciation of non-U.S. currency not available; depreciation of dollar reported instead.
Besides the wide range of what should be similar results, a few aspects merit comment. First, it should be recalled that these are largely demand-driven macroeconomic models. In some of them, expectations do not play much of a role. In those where they do, the issue is how accurately they have been modeled. For example, right now—that is, in December 1987—when the value of the U.S. currency has been falling considerably, supposedly because the financial markets do not believe that the agreement reached by the Administration and Congress to reduce the U.S. budget deficit will be complied with, it is easy to be skeptical about results that indicate that, say, an announcement by the U.S. Government to increase government spending by 1 percent of GNP would raise the value of the dollar. Second, the U.S. fiscal expansion is seen to affect non-U.S. incomes more than the non-U.S. fiscal expansion affects U.S. incomes. Third, the results shown refer to the second year after the policy changes. As one traces the effects beyond that period, some of them (for example, the positive effect on income) would vanish leaving the governments with higher public debt to service.

Finally, when the leading econometric models give results as varied as these, and when none of these models may give the true answer, it is easy to see the difficulties faced by those who negotiate agreements on policy coordination. It is difficult in this case to come up with a package of policy changes that would be accepted by all participants as the clearly optimal one. What we might have is coordination based on intuition. As Branson (1986, p. 176) has put it: “With this range of disagreement on economic analysis, how are the negotiators to reach agreement?” And if an agreement is reached, how can one be sure that it will improve the situation? Once again, one comes to the conclusion that the best form of international policy coordination, especially in the fiscal area, is the one that encourages countries to pursue policies that over the medium run put their fiscal accounts in order while paying some attention to the pace at which changes are made. In a way this conclusion argues in favor of a rule and against a policy of international fine-tuning.

**Fiscal Coordination and Political Leverage**

A successful policy of fiscal coordination would be facilitated if (1) all of the participating countries had the same political and economic influence; or (2) the one country that has more leverage either economically or politically was also the one with an economy that is not facing major disequilibria in some of the areas to be coordinated. One of the reasons for the success of the EMS in reducing the rate of inflation of the member countries has undoubtedly been the fact that the Federal Republic of Germany was the major economic power in the group, and Germany's inflation rate was very low. Therefore, the other EMS countries were forced to pursue monetary policies that became progressively more consistent
with Germany's. Moreover, restrictive monetary policies became more credible. In some sense, the monetary authorities in other EMS countries took advantage of the stock of credibility of the German central bank. But, suppose, for example, that at the time the EMS came into existence Italy had been the major economic power in the group. Given Italy's inflation rate at that time, and its consequent monetary policy, it is conceivable that the other countries would have adjusted, at least in part, to the Italian policy. The result would probably have been a much higher rate of inflation over the longer run and the costs of anti-inflation plans would have been higher since these plans would have been less credible.

We have here what could be called the “fox-without-the-tail” syndrome. As Aesop tells us, the fox that lost its tail tried to convince the other foxes that a tail was a burden after all, and the other foxes would be better off if they cut theirs off. International coordination of fiscal policy inevitably creates pressures on those countries that have been more successful in recent years in correcting their fiscal imbalances to relax their fiscal policy to bring it more in line with that of countries where less adjustment has taken place. These pressures on the former will become stronger the less successful are the latter in putting their fiscal houses in order. If these pressures succeeded, fiscal coordination might not generate over the medium run the desirable results, even if it succeeded in bringing some short-run stimulation to aggregate demand.

III. Fiscal Situation of the Major Industrial Countries

The two previous sections examined various issues connected with fiscal coordination. This section takes a look at the fiscal accounts of the seven major industrial countries that have attracted the attention of experts and policymakers in connection with the coordination of macroeconomic policies. Some economists have suggested that Japan, the Federal Republic of Germany, and, perhaps, the United Kingdom should now pursue expansionary fiscal policies, since these countries have presumably already won their battle against fiscal disequilibrium. The United States, Italy, and Canada, however, should continue with their attempts to rein in their fiscal deficits. The advice to France is less clear cut.

The underlying model on which this advice is based seems to be a kind of global Keynesianism whereby the world is assumed to have and to need a given amount of aggregate demand; therefore, to prevent a recession, if demand is reduced by fiscal restraints in some important countries, the reduction must be compensated by fiscal expansion in others. Of course, monetary policy could be used as a substitute for fiscal policy, but this aspect is ignored in this discussion, although it plays a large role in the current discussions on coordination of macroeconomic policies.
The case for fiscal expansion by some countries has, perhaps, been made most forcefully by Willem Buiter in several articles. In a recent article he writes:

There should be a 'supply-side friendly' fiscal expansion in the fiscally strong industrial countries, such as Japan, Germany, and the United Kingdom. The behaviour of their debt/GDP ratios, their primary deficit and, in the case of Japan and Germany, their current account deficits suggest that these countries have ample fiscal elbow room. In addition there is considerable real slack in all three economies... (Buiter, 1987, p. iii).

He considers the recently announced fiscal stimulus in Japan (equal to about $35 billion) "...a step in the right direction but... very small in relation to both the macroeconomic and the structural needs of both Japan and the world economy." He also considers "the German decision to bring forward some already scheduled tax cuts (0.9% of GDP in 1988)... inadequate" (p. iv). Furthermore, "The 'unsustainability' of the current U.S. fiscal position has been much exaggerated" (p. v).

Since at least 1982, the International Monetary Fund has been advising industrial countries with large fiscal deficits to reduce them (see de Larosiere (1982 and 1984)). This strategy was recently outlined in some detail in the April 1987 World Economic Outlook (WEO), the Fund’s yearly assessment of the international economic situation. In that study the Fund reaffirmed its belief in the need for medium-term correction in the fiscal accounts of industrial countries. At the same time, WEO warned that a too-sudden reduction in the U.S. fiscal deficit could reduce government demand faster than the private sectors in the United States and abroad could pick up the slack, thus possibly leading to a worldwide slowdown of economic activity. Nonetheless, "[i]n the case of the United States, the danger in not proceeding promptly and vigorously with fiscal restraint is that financial markets may eventually react unfavorably to continued large borrowing needs on the part of the government" (International Monetary Fund, 1987, p. 20). A reduction in the U.S. fiscal deficit, by reducing interest rates, would stimulate investment in the United States and abroad. Furthermore, the removal of a major worry from the economic scene would contribute to a climate more favorable to an expansion of private sector activity.

The suggestion was made in WEO that Italy and Canada should give consideration to policies "that would achieve cuts in the fiscal deficit more quickly," whereas for the Federal Republic of Germany, "relatively greater concern attaches to sustaining the pace of demand and output" (p. 20). There is thus no doubt about the medium-run direction of the policy advocated by the Fund vis-à-vis fiscal consolidation.

Given these contrasting positions between those who advocate a fiscal activism that minimizes the need for fiscal adjustment (or the potential dangers of fiscal expansion) and those who emphasize the objective of medium-run fiscal

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consolidation, it may be worthwhile to comment briefly on the current fiscal situation in the major industrial countries.

Table 6 gives the fiscal balances of the general governments of the Group of Seven countries as percentages of GDPs or GNPs. The improvement in recent years in the fiscal accounts of the Federal Republic of Germany and Japan is obvious. However, the table shows also that in 1987 the fiscal accounts of all the countries, except Japan, were still running deficits and some (Italy, Canada, the United States, and France) were running relatively large deficits. Furthermore, various fiscal maneuvers (temporary taxes, sales of assets, amnesties, windfall revenues) had temporarily reduced these deficits in some of the countries, so that the “core” deficits were somewhat higher. For example, the U.S. Congressional Budget Office (1988) has estimated that these temporary factors had reduced the U.S. fiscal deficit by $37 billion in 1987. In the United Kingdom the sale of assets generated revenue close to 1 percent of GDP in 1986-87. In the United States the fiscal deficit of the central government was expected to go up again in the absence of significant policy changes.

Table 6. General Government Fiscal Balances
(In percent of GDP or GNP)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>-1.3</td>
<td>-1.0</td>
<td>-3.5</td>
<td>-3.8</td>
<td>-2.8</td>
<td>-3.3</td>
<td>-3.4</td>
<td>-2.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-3.4</td>
<td>-2.5</td>
<td>-2.4</td>
<td>-3.4</td>
<td>-3.9</td>
<td>-2.9</td>
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<tr>
<td>France</td>
<td></td>
<td>-1.9</td>
<td>-2.8</td>
<td>-3.2</td>
<td>-2.8</td>
<td>-2.8</td>
<td>-2.9</td>
<td>-2.4</td>
</tr>
<tr>
<td>Germany, Federal Republic of</td>
<td>-2.9</td>
<td>-3.7</td>
<td>-3.3</td>
<td>-2.5</td>
<td>-1.9</td>
<td>-1.1</td>
<td>-1.3</td>
<td>-1.8</td>
</tr>
<tr>
<td>Italy</td>
<td>-8.5</td>
<td>-11.3</td>
<td>-11.3</td>
<td>-10.6</td>
<td>-11.5</td>
<td>-12.5</td>
<td>-11.4</td>
<td>-10.5</td>
</tr>
<tr>
<td>Canada</td>
<td>-2.8</td>
<td>-1.5</td>
<td>-5.9</td>
<td>-6.9</td>
<td>-6.4</td>
<td>-7.0</td>
<td>-5.5</td>
<td>-4.6</td>
</tr>
<tr>
<td>Japan</td>
<td>-4.4</td>
<td>-3.8</td>
<td>-3.6</td>
<td>-3.7</td>
<td>-2.1</td>
<td>-0.8</td>
<td>-0.9</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Note: A minus sign indicates a deficit.
1Percent of GNP.
2Percent of GDP.

The fall in the rate of inflation has also reduced the nominally measured deficits. Furthermore, large surpluses of the social security systems are, in some countries (such as the United States), hiding large deficits of the rest of the public sector. For example, the U.S. Congressional Budget Office has projected that the federal funds deficit (that is, the deficit net of social security and other trust funds) would be close to $300 billion between 1989 and 1993 (U.S. Congressional Budget Office (1988), pp. 76-77). Of course, the surpluses of these trust funds are accumulated to build reserves to meet future needs and not to finance the rest of the government.
Aggregated data for the Group of Seven countries indicate that their fiscal deficits for the general government, as shares of combined GDPs, reached a peak of 4.1 percent in 1983, fell to 3.3 percent in 1984 and 1985, and declined to 3.1 percent in 1986 and 2.7 percent in 1987. As percentages of aggregate net private savings, the deficits reached a peak of 70 percent in 1983 and fell to 48 percent in 1986, and 42 percent in 1987.

The change in the fiscal situation in the three major countries since the early 1980s implies that the fiscal deficits have fallen in economies with large domestic savings (Japan and Germany), where they could more easily be financed through domestic sources, and have increased in the United States, which has a low and falling saving rate. This has meant that a large share of the U.S. indebtedness had to be financed from foreign sources, which has sharply increased the share of dollar assets in the hands of foreigners.\textsuperscript{11}

The demand for dollar assets on the part of foreigners is likely to depend on the relative rates of return to dollar assets as compared to other assets, and on the perception of risk on the part of the foreign lenders. One type of risk is associated with the depreciation of the dollar. Another closely related risk is inflation in the United States. In fact, the U.S. Government is in the enviable position of being able to inflate itself out of some of its foreign debt, since this debt is held in dollars. However, since much of the U.S. debt is short term, expected inflation would quickly lead to increases in interest rates, thus sharply limiting this possibility. Over the past two years, Japanese and German investors have suffered large losses on their holdings in U.S. securities because of the depreciation of the dollar. A continuation of large (even if falling) deficits in the United States would require that foreigners keep increasing their stock of dollar-denominated assets unless the U.S. savings rate goes up or the U.S. investment rate falls. It does not seem reasonable to assume that foreigners would be willing to accommodate progressively larger dollar balances in their portfolios without demanding higher rates of return. An increase in the fiscal deficit of Japan and Germany, by creating an additional demand for funds, would not make the financing of the U.S. fiscal deficit any easier and would hurt other net borrowers such as indebted countries.

Table 7 gives the total debt of the general government as a share of GDP or GNP. Since the early 1980s the shares are either growing (United States, France, Italy, and Canada) or relatively stable (United Kingdom, Germany, and

\textsuperscript{11}Between 1982 and 1985 the general government fiscal deficit of the United States was absorbing around 20 percent of the total net private savings of the Group of Seven countries. The depreciation of the dollar after 1985 implied that a smaller share of the total savings of the Group of Seven countries was necessary to finance the U.S. deficit. This might help explain some of the decline in real interest rates in the past few years.
Table 7. General Government Total Gross Debt
(In percent of GDP or GNP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States(^1)</td>
<td>37.9</td>
<td>37.2</td>
<td>41.3</td>
<td>44.1</td>
<td>45.2</td>
<td>48.4</td>
<td>51.2</td>
<td>51.6</td>
</tr>
<tr>
<td>United Kingdom(^2)</td>
<td>54.6</td>
<td>54.7</td>
<td>53.4</td>
<td>53.6</td>
<td>54.9</td>
<td>53.6</td>
<td>52.9</td>
<td>50.4</td>
</tr>
<tr>
<td>France(^2)</td>
<td>37.3</td>
<td>36.4</td>
<td>40.1</td>
<td>41.4</td>
<td>43.9</td>
<td>45.5</td>
<td>46.0</td>
<td>47.3</td>
</tr>
<tr>
<td>Germany, Federal Republic of(^1)</td>
<td>32.5</td>
<td>36.3</td>
<td>39.5</td>
<td>40.9</td>
<td>41.5</td>
<td>42.2</td>
<td>42.4</td>
<td>43.2</td>
</tr>
<tr>
<td>Italy(^2)</td>
<td>58.5</td>
<td>60.5</td>
<td>66.3</td>
<td>71.9</td>
<td>77.0</td>
<td>83.6</td>
<td>87.9</td>
<td>91.3</td>
</tr>
<tr>
<td>Canada(^2)</td>
<td>44.7</td>
<td>45.1</td>
<td>50.5</td>
<td>54.5</td>
<td>58.0</td>
<td>63.4</td>
<td>67.2</td>
<td>69.0</td>
</tr>
<tr>
<td>Japan(^1)</td>
<td>52.0</td>
<td>57.0</td>
<td>61.1</td>
<td>66.9</td>
<td>68.4</td>
<td>69.4</td>
<td>69.3</td>
<td>68.6</td>
</tr>
</tbody>
</table>

\(^1\)Percent of GNP.
\(^2\)Percent of GDP.
\(^3\)Does not exclude public sector mutual indebtedness.

Japan). Whether increasing or stable, large public debts bring about large public spending (because of interest payments), which in turn, when other expenditures cannot be reduced, brings about high taxes with disincentive effects.\(^12\) Both Tables 6 and 7 and the related comments in the text indicate that the fight against fiscal disequilibrium is far from over. There are other reasons as well why it might be imprudent to push Japan and Germany to pursue expansionary fiscal policies.

The experience of many countries, both industrial and developing, indicates that fiscal policy is not like a faucet that can be turned on and off. This is another area where the difference between fiscal and monetary policy is considerable. It is relatively easy to create a large deficit, as the United States proved in 1981. It is very difficult to reduce a large deficit, as the United States has been proving since 1982. There is a clear asymmetry in fiscal policy. Most spending programs once in place cannot be easily removed. Taxes are easier to reduce than to increase. These facts should bias the attitude of policymakers toward caution.

Another important factor—the aging of the population—is also highly relevant in this context, especially in connection with Japan and Germany. This factor will, in time, have two major consequences. First, it will bring about substantial...\(^13\) In the OECD countries, larger expenditure for interest payments has been accompanied by smaller capital expenditure by the government. For the Group of Seven countries combined, the public debt ratio to GDP increased from around 40 percent in the 1976-81 period to 58.3 percent in 1987. For the 1984-87 period, the ratios were, respectively, 51.7 percent in 1984, 54.5 percent in 1985, 56.8 percent in 1986, and 58.3 percent in 1987. Because of the depreciation of the dollar, the share of the U.S. public debt in the total Group of Seven countries' public debt fell from 46 percent in 1985 to 37 percent in 1987.
increases in social expenditure. Second, it will reduce the private saving rate of the countries, as the proportion of the population with high propensities to consume rises. Take Japan as an example. In a recent study on the reasons for that country’s high saving rate, Horioka (1986, pp. 25–26) has concluded:

With respect of future trends in Japan’s private saving rate, the dominant influence will be the dramatic changes in the age structure of the population: a decline in the ratio of the young will cause the savings rate to increase slightly until 1995 while a rapid increase in the ratio of the aged will lead to a precipitous decline in the rate thereafter.

It is only six years until 1995. A Fund study on aging and social expenditure observes that the “impact of demographic change on the Japanese economy is likely to be the most extreme among the Group of Seven” (Heller and others (1986), p. 8). The study forecasts a rise in the elderly dependency rate of 65 percent in the 15 years from 1986 and a rise in the social expenditure ratio of almost 40 percent by the year 2000, which “would imply the need for considerable fiscal adjustment” (p. 8).

Given these factors, and the inertia of fiscal changes, it would seem prudent not to create a fiscal situation that in a few years might generate problems that would be difficult to solve.

In policymaking there is another bias to worry about: the one that leads policymakers to apply much higher rates of discount to benefits that come further in the future than to benefits that come immediately. In other words, there is a tendency to alleviate current problems at the cost of more serious future problems. Larger fiscal deficits might bring immediate benefits in terms of higher economic activities but at costs that may be considerable over the longer term.

Table 8, based on the Federal Reserve Board Multicountry Model, helps make this point. The results in the table were part of the Brookings experiment reported earlier. The table traces the effects of fiscal expansion, both by the United States and by other OECD countries, through a period of six years. It indicates that an increase in U.S. real government expenditure equal to 1 percent of U.S. GNP would increase U.S. GNP by 1.6 percent in the first year and 1.8 percent in the second year over the baseline. After that, the benefits from the fiscal expansion begin to fall. By the sixth year the fiscal expansion would leave the United States (1) with GNP no higher than it would have been without the fiscal expansion; (2) with a price level that is 2.3 percent higher; and (3) with a government expenditure (and presumably a fiscal deficit and a public debt) higher than it would have been. Presumably, though this result was not reported, the impact of the fiscal expansion on the GNP for periods beyond the sixth year would be negative. Thus, if one believes the results of this exercise, short-term benefits have been bought at long-term costs. The table shows also that a foreign
Table 8. The Impact of Fiscal Expansion Over Time
(Cumulative percentage deviations from baseline)

<table>
<thead>
<tr>
<th>Fiscal Expansion</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States¹</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. GNP</td>
<td>1.6</td>
<td>1.8</td>
<td>1.4</td>
<td>0.9</td>
<td>0.5</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>U.S. prices</td>
<td>0.1</td>
<td>0.4</td>
<td>0.9</td>
<td>1.4</td>
<td>1.9</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td>Foreign GNP</td>
<td>0.3</td>
<td>0.7</td>
<td>0.9</td>
<td>0.9</td>
<td>1.0</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Foreign prices</td>
<td>0.2</td>
<td>0.4</td>
<td>0.6</td>
<td>0.7</td>
<td>1.0</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Foreign²</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. GNP</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
<td>0.2</td>
<td>0.1</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>U.S. prices</td>
<td>—</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.6</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>Foreign GNP</td>
<td>1.1</td>
<td>1.4</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.1</td>
<td></td>
</tr>
<tr>
<td>Foreign prices</td>
<td>—</td>
<td>0.3</td>
<td>0.6</td>
<td>0.9</td>
<td>1.2</td>
<td>1.6</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adopted from Table 1 in Edison and Tryon (July 1985), p. 6.
¹A permanent increase of U.S. real government expenditures of 1 percent of baseline GNP.
²A permanent increase in foreign real government expenditures of 1 percent of baseline GNP.

fiscal expansion would have a relatively small impact in the short run on the
United States and none over the medium run.

IV. Concluding Remarks

In this paper some major issues related to international macroeconomic policy
coordination have been surveyed. The focus has been on the coordination of
deposition of fiscal policy. Issues that arise specifically in the context of the coordination of
monetary policies or exchange rate policies have been largely ignored, even
though they are obviously important. The relatively negative conclusions
reached here about the coordination of fiscal policies may not be equally relevant
to these other forms of coordination.

Two aspects have been highlighted. First, many practical difficulties would
arise in any attempt to coordinate fiscal policy among industrial countries. Some
of these difficulties have been ignored by proponents of fiscal coordination.
Second, the paper has taken issue with those who maintain that countries such as
Japan, the Federal Republic of Germany, and the United Kingdom have fully
overcome their fiscal difficulties and are now in a situation where they could, and
should, pursue more expansionary fiscal policies. Such a policy, these advocates
of expansionary policy claim, would help pull the world economy from its low-
growth path and bring the current account balances of the major industrial
countries closer to a sustainable path. What is being proposed is, in fact, some sort of fine-tuning on a global scale.

Those who were skeptical in the past about attempts by some countries to fine-tune their economies are likely to be even more skeptical at this proposed internationalization of policies. The connection between expansionary fiscal policies and faster growth rates is tenuous at best. There is simply no convincing evidence that the countries that have pursued more restrictive fiscal policies have grown any less fast than those that have pursued expansionary fiscal policies. The United Kingdom, for example, has done relatively well in recent years in spite of a conservative fiscal policy. In the United States the rate of growth of the economy accelerated in 1987 in spite of a sharp reduction in the fiscal deficit. In Denmark the general government fiscal balance changed from a deficit of 9 percent of GDP in 1982 to a surplus of 3 percent in 1986. This remarkable change was accompanied by a very fast increase in demand. In Belgium the fiscal deficit was reduced by 2.7 percent of GDP in 1987 without any negative effects on the economy. All these reductions in fiscal deficits were the result of explicit government policies and not the natural outcome of fast-growing economies. Yet, the fiscal expansion of the second half of the 1970s in many industrial countries did not make them grow any faster than the others. Often the opposite was true.

Where coordination of fiscal policy may be highly relevant is with respect to some structural aspects, particularly tax reform. Well-designed major reforms of the tax system, even when they are revenue-neutral, are likely to have an important impact on growth as well as on the movements of financial capital and factors of production. This is an area where coordination would yield large dividends, since tax reforms can be used by countries to gain a competitive advantage over other countries. However, in this area there are also serious practical difficulties in coordination. If “supply-side-friendly” tax reforms could be coordinated, they would help promote faster world growth and more efficient economies (see Tanzi (1987)). In this respect, the recently proposed reduction in tax rates by Germany is highly welcome, even though it may not have gone far enough in reducing marginal rates and removing tax-induced disincentives. That reduction, however, is welcome for its efficiency aspects more than for its demand-promoting effects.

The same can be said for the recent commitment by the Japanese Government to increase its spending for public works. The final consumption expenditure of government as a percentage of GDP is much lower in Japan than in other OECD countries—9.7 percent, as compared to 17.2 percent for total OECD in 1985. An increase in this expenditure, if directed toward bottlenecks in infrastructures,
could give important returns, regardless of whether or not it increased Japan's fiscal deficit. A full discussion of these structural aspects must be left for another opportunity.

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Comment

Rudiger Dornbusch

The occasion of discussing Vito Tanzi’s stimulating and provocative paper provides a welcome opportunity to express professional acknowledgment and appreciation for the important research effort on fiscal policy over which he has presided at the International Monetary Fund. The work is welcome not only in the area of data development, but also on the side of analysis. Tanzi’s own contribution and his openness to discussion are an excellent example in an otherwise overly closed institution.

I will first take issue with some detailed points. In some instances, I wish to highlight a particular point Tanzi makes; in other there is a need to comment and disagree. Then, I shall take up the central point of my discussion—the world economy after U.S. budget cuts.

One point needs to be raised before the details come. Tanzi’s paper is wide-ranging, and it is a vehicle for letting off steam on a number of issues, principally the U.S. budget deficit. Tanzi’s beliefs are very catholic. In fiscal matters there is only one precept: get your house in order—the sooner the better. Budgets should be balanced! There is at best a reluctant recognition of a cyclical role for fiscal policy. If hard-pressed, I suspect Tanzi would confess that he thinks that, too, is an exaggerated concern.

This view leads him to argue that the U.S. fiscal expansion of 1982 and beyond was misguided, not only on domestic grounds, but also because of adverse effects on the world economy. This view is controversial. Surely it must be recognized that the monetary tightening of 1981-82, together with the fiscal expansion, brought about the high interest rate-strong dollar configuration that hurt, for example, commodity exporting debtor countries. But imagine that there had only been tight money. Interest rates would still have been high (though perhaps not quite as much), but there also would have been a deep recession. That, too, would have hurt countries abroad. Indeed, this was the case in 1982, before the tax cuts pushed the United States on a growth path. The simple fact is that the world economy was going to be hurt by the unanimous demand for an end to inflation. You cannot make an omelette without breaking some eggs.

I shall return to this point, but I want to register here my disbelief in the proposition that a U.S. recession is a good thing for the world economy. The
direct effects are undesirable, and the inevitable protectionist consequences would be even more so. The problem is to find a world monetary-fiscal mix that is sustainable and consistent. I shall argue below that a world real interest rate reduction is the most likely step to reconcile the need for more balanced budgets and the overriding concern for growth.

I. Technical Issues

Tanzi argues that coordination is difficult if not infeasible because of coordination issues. These issues are already hard enough at the national level. They are even harder when considered at a multilateral level. He highlights in particular two aspects; both, I believe, are vastly exaggerated.

The first concern is with lags. Fiscal policy, he argues, unlike monetary policy, cannot be part of coordination, because the decision and implementation lags are far too long. Two responses are appropriate. Although it may be true that the decision lags for monetary policy are short, it takes far longer for monetary policy to exert any effects. The mean lag is more than three quarters, whereas fiscal policy becomes effective within the quarter of policy change. At best, there is a trade-off between implementation and reaction lags.

But, in fact, decision lags for fiscal policy can be dramatically short, as in the U.S. experience in 1975 when tax cuts were implemented retroactively within a single quarter. Furthermore, the special pressure of international coordination provides far more clout in persuading legislatures to take difficult fiscal measures. The reason is that coordination is a positive sum game—there is something to be gained! I would also add that if fiscal lags are believed to be as long as Tanzi makes them out to be, then there is even more of a need to coordinate. This is so in order to avoid catastrophic mismatches in policy that cannot, because of the alleged lags, be corrected in time. I do not wish to minimize either lags or difficulties in coordination. I simply find Tanzi’s argument unpersuasive on this point.

I note in passing that Tanzi’s argument about forecasting problems is at least as unpersuasive. Often, as for example, in the Great Depression, it is enough to know the level of the current aggregates in order to determine the direction in which the policy thrust should move. The risk of overshooting is remote. It may be true, and I would agree, that the room for fine-tuning is very small. But, today, the question is what will the European offset there will be to a massive U.S. fiscal contraction. That is not fine-tuning. Either the other major industrial countries respond or they will experience a deep recession.

Rather than being a question of forecasting, I would have thought the chief problem in coordination was a quasi-religious one: differences in the perception of how the world works and what the state of the respective economies is. U.S.
policymakers think of Europe as a land of devastating unemployment and pervasive rigidity of mind and institution. Europeans believe the U.S. economy is recklessly overheated by deeply unsound fiscal management. Coordination in such circumstances is genuinely difficult because there is no place for the dialogue to start. That highlights above all a deficiency in leadership. The Federal Republic of Germany, through hyperinflation histrionics and under the guise of disinflation, has failed by turning Europe into a stagnation area. The United States has failed by not offering a serious assessment of its fiscal and saving problem.

Tanzi takes issue with the persistent effects of fiscal expansion. Econometric models predict that any effects of a sustained fiscal expansion (near full employment, without monetary accommodation) are soon dampened and in fact undone by crowding-out due to increased interest rates. But that is a red herring. In all cases I can think of, fiscal policy should, quite explicitly, give only transitory stimulus. A case in point might be helping economies recover from a slump or lifting them out of a depression. Combined with the right monetary policy, there is simply no issue. Of course, one might argue that fiscal discipline cannot be endangered by such yo-yo use. But the counterargument is that recessions, even though they ultimately may be self-liquidating, do leave important hysteresis effects. This point is altogether clear in comparing the United States and Europe today.

Tanzi also argues that there is pervasive uncertainty about the exact effects of a fiscal expansion program. Fiscal policy has uncertain effects; hence, do not use it. The literature has long rejected this argument. The correct view is that policymakers must take into account the nature of the uncertainty—lags, multipliers, reactions—in structuring the policy. There are two further arguments against this exaggerated skepticism. One is that much of the uncertainty about fiscal policy in an individual country may stem from uncertainty about foreign responses. Hence, coordination cuts down on uncertainty. The other argument, forcefully developed by Diamond (1985), is that there is no such thing as “no policy.” What is the counterfactual? Even a policy rule of a full employment-balanced budget may have to react to current developments to stay on course. It is interesting that Tanzi is not reluctant to recommend putting one’s house in order, even though, by his own arguments, the consequences of such a policy are unpredictable.

In concluding the discussion on these more detailed points, I would like to take issue with Tanzi’s sweeping assertion:

The connection between expansionary fiscal policies and faster growth rates is tenuous at best. There is simply no convincing evidence that the countries that have pursued more restrictive fiscal policies have grown any less fast than those that have pursued expansionary fiscal policies. The United Kingdom, for example, has done relatively well in recent years in spite of a conservative fiscal policy (p. 33).
In the case of the United Kingdom, as is well known, oil revenue and significant asset sales were used to finance a shortfall of taxes relative to current outlays. The European Economy (November 1987, p. 108) comments as follows:

The buoyancy of non-oil revenues and the acceleration of the privatization programme enabled the long-term objective of bringing the public sector borrowing requirement down to 1% of GDP to be achieved ahead of schedule. . . .

In fact, the decline in the central government's financial balance using Organization for Economic Cooperation and Development (OECD) measures was smaller than the revenues from privatization, which were close to 1 percent of gross domestic product (GDP). A macroeconomic specification of the thrust of fiscal policy would look for the aggregate demand side effects of balancing the budget. Asset sales do not have a restrictive demand effect and, hence, are a clever way of keeping books balanced while exerting an expansionary fiscal policy stance. The U.K. example thus serves poorly to make the point that fiscal restraint is a source of growth. I hasten to add that I favor U.S. budget balancing and am not suggesting that budgets should be in deficit. I simply point out that there is no shred of evidence to support Tanzi's assertion that budget balancing is easily achieved with growth. On the contrary, the European experience contradicts it squarely. Budget balancing may be necessary, but let nobody try to persuade us that it does not make a difference in short-run growth. For the individual country it is possible to export unemployment; at the world level there is a serious adding-up problem when a major country starts cutting the budgets.

II. U.S. Adjustment and Real Interest Rates

Aesop's fox leaves footprints all over Tanzi's paper. The tailless fox of the fable, making the best of a bad situation, is trying to persuade all other foxes that not having a tail is true chic. Tanzi's fox is the United States, seeking to spread worldwide fiscal laxity. But all the foxes know better: The United States needs a good recession, a "Reinigungskrise" as it is called at the Bundesbank.1 I do not concur in this view. The "crying wolf" strategy of Europe over all and any policy-induced growth will backfire when the imbalances created by U.S. adjustment put Europe into a bind.

The U.S. fiscal problem has been by and large resolved through the tax reform of the past years. The broadening of the tax base and the reduction in the deficit

1The same view was expressed in The Economist (January 26, 1988), in an article entitled "How to Crack Japan."
to around 3.5 percent of gross national product (GNP) assures that the path of the debt-income ratio is not explosive. Table 1 reports OECD data for the United States.

Table 1. U.S. General Government Fiscal Deficit and Debt
(In percent of GDP)

<table>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget deficit</td>
<td>3.3</td>
<td>3.3</td>
<td>3.5</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Noninterest deficit</td>
<td>1.4</td>
<td>1.0</td>
<td>1.2</td>
<td>0.1</td>
<td>—</td>
</tr>
<tr>
<td>Net debt</td>
<td>23.4</td>
<td>26.5</td>
<td>26.3</td>
<td>26.6</td>
<td>—</td>
</tr>
<tr>
<td>Gross debt</td>
<td>65.4</td>
<td>69.4</td>
<td>69.2</td>
<td>69.5</td>
<td>—</td>
</tr>
</tbody>
</table>


There is considerable year-to-year fluctuation in the U.S. budget deficit due to summity masquerading of deficit cuts. But the basic message is that of a gradually (if too slowly) declining nominal deficit and hence a falling deficit GDP ration. The latest forecast of the U.S. Congressional Budget Office (CBO) shows a federal deficit averaging 3.13 percent of GDP in 1988-90. What does this imply for debt dynamics? The growth of the debt/GDP ratio is given by the familiar equation:

\[ x = (r - y) x - v, \]  

where \( x \) is the debt/GDP ratio, \( r \) and \( y \) are the real interest rate and the growth rate of output, respectively, and \( v \) is the noninterest budget. The noninterest budget is nearly balanced and on a path to surplus. But the real interest rate exceeds the growth rate of trend output, which is about 2.5 percent. But the excess applies to only a moderate debt ratio. Thus, even with a 5 percent real interest rate and a balanced noninterest budget, the debt ratio would only rise by 1.5 percent a year. With reasonable real interest rates (say, 2 percent) the debt ratio would be more than stabilized. In this sense, there is no longer a fiscal crisis in the United States. There is simply no explosive debt situation. Figure 1 shows the CBO's forecast of the stabilization of the federal government's debt ratio toward 1990.

Now consider the question of U.S. budget balancing. Why should the budget be balanced and what is the monetary policy that should accompany the budget correction? The first point has a clear answer. U.S. saving is very low, for any number of reasons; my own explanation is that financial liberalization has removed credit constraints even from the last worker. The interaction of full employment and financial liberalization shows up in powerful spending effects and, as a result, in low personal saving. This interpretation is borne out by a glance at the behavior of the saving rate and consumer credit.
The low saving rate in the United States implies that high investment is possible only at the cost of sustained external imbalance. But sustained budget deficits might well carry a price in terms of a loss of control over the dollar, interest rates, and inflation much further down the road. Thus, I see budget correction as the essential step for raising national saving, making up for the far too low private saving. In raising national saving, budget correction frees resources for investment.

The next question is how to sustain growth in the face of a major budget cut—say, 3 percent of GDP over three years. A critical ingredient here is a major reduction in interest rates. The interest rate will have to be reduced, not cyclically as a result of recession, but actively to accommodate growth. Crowding-in of investment to offset the impact of budget cuts is a delicate task in respect to timing. Ideally, interest rate cuts should run ahead, since their lags are quite long. But, unfortunately, poor leadership in the United States has precluded superplay, allowing the country to get to full employment without initiating the appropriate policy corrections. More attention must be paid at this stage to international coordination.
A full-employment policy in the United States does require much lower interest rates and/or a much lower value of the dollar. Since lower interest rates are compatible with a stable dollar only if they fall significantly abroad, there is a clear interdependence problem. If the rest of the world does not catch on, it is bound to end up in a deep recession.

It is clear that correction of the two deficits requires major adjustment abroad. A U.S. recession would be the worst possible outcome. Europe and Japan would lose exports, just as they would with dollar depreciation. But with a recession, an ambitious program of fiscal correction in the United States would become impossible.

A sharp deterioration in economic conditions would, of course, lead to a deterioration in the fiscal climate. Recession and high real interest rates (as Europe has been experiencing) do more havoc to budgets and debt than do a few years of reckless tax cuts. The numbers provided by a recent CBO analysis are revealing. Table 2 shows the impact of different economic scenarios for the U.S. federal budget.

**Table 2. Rules of Thumb: Effect on Budget Deficit**

<table>
<thead>
<tr>
<th>Change</th>
<th>1988</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 percent lower growth</td>
<td>-2</td>
<td>48</td>
</tr>
<tr>
<td>1 percent higher unemployment</td>
<td>3</td>
<td>29</td>
</tr>
<tr>
<td>1 percent higher interest rates</td>
<td>-2</td>
<td>57</td>
</tr>
<tr>
<td>1 percent higher inflation</td>
<td>3</td>
<td>20</td>
</tr>
</tbody>
</table>

Table 2 shows the impact of different economic scenarios for the U.S. federal budget.

The table highlights the central role of growth and interest rates in shaping the U.S. budget. The wide tax base assures that growth has a powerful effect on revenues. Higher interest rates, because of the relatively high federal debt ratio, have an adverse effect. The data in Table 2 make clear that a policy of budget balancing that sustains growth by reducing interest rates carries extra payoffs in terms of the budget: direct budget balancing effects and an important bonus in terms of reduced interest payments.

My conclusion is that a major reduction in real interest rates worldwide is an essential ingredient for a soft landing of the world economy. The United States could have a soft landing without cutting interest rates and allowing the dollar to fall so as to stimulate net exports. Clearly such a beggar-thy-neighbor policy can do the job, but it does so at the expense of recession abroad. Strangely, the problem posed by the U.S. deficit will be almost entirely that of adjustments in the rest of the world.
Tanzi's paper does not pay much attention to real interest rates, except to note that they are high because of deficits. Insufficient liquefaction in the aftermath of world disinflation does not appear as a hypothesis. But even Friedman (1983) has argued that liquefaction is essential in the transition to a low-inflation regime.

If a reduction in monetary growth leads to a decline in inflation, and that decline is embedded in anticipated inflation, the resulting lower cost of holding money will produce an increase in the quantity of real balances demanded. Velocity, which rises because of the reverse effect when inflation accelerates, and stabilizes when inflation stabilizes, will tend to decline when inflation declines. An ideal policy would therefore involve an initial decline in monetary growth, a subsequent rise when declining inflation reduces velocity, and a final decline to the desired long-run level when velocity stabilizes (pp. 5–6).

In these terms the world economy has not experienced sufficient monetization to reduce real interest rates to the habitual levels (see Figure 1). Further monetization becomes essential to achieve a soft landing when fiscal correction is undertaken. Failure to heed Friedman's advice on monetization (prudently, moderately, but certainly) is now the chief danger for the world economy. Long-run fiscal frugality is essential for growth in the standard of living, but getting there on a course of full employment is as essential, and easy monetary policy is the critical complement.

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Comment

Patrick Minford

I very much agree with Vito Tanzi's general attack on activist fiscal policy coordination. I will comment first on some details of his analysis and then develop a case—implicitly supported by Tanzi's paper—for nonactivist fiscal coordination, in support of monetary rules for price stability.

First, the details. Forecast inaccuracy may undermine ambitious attempts at fine-tuning, but it does not destroy the general case for rough-tuning, since, plainly, forecasts are able to track the direction of output relative to capacity with some success—even with all the errors shown in Tanzi's tables. Nor is model disagreement fatal. Policy instruments, or some aspects of them, directed at specific targets, can generate improvement, according to a large spread of models, including those used by the coordinators. Holtham and Hallett (1987) recently explored this possibility and found a few hypothetical examples.

Of course, we have not as yet worked out measures of how large the gains could have been in practical cases. In our recent study (Canzoneri and Minford (1988)), Canzoneri and I concluded that even with a single model with large spillovers, coordination yielded gains that were small relative to the accuracy with which policy could be implemented—a form of forecast error. In practice, the objections Tanzi raises may be impossible to overcome.

Tanzi mentions the absence from many models of rational expectations, which he feels—and I agree—are the best available modeling tool for expectations. Although this situation is changing—a number of the models presented at the Brookings conference Tanzi mentions embodied rational expectations—it remains true that the models in widespread use by forecasters and policymakers do not. Again, this is a relevant problem for practical coordination.

Of the four remaining problems Tanzi lists, I rate two of them as serious. The other two—disagreement on objectives, and asymmetry of power—are not strictly problems. Coordination brings gains to participating parties, whatever their objectives, because of spillovers; the spillovers are the opportunity of trade, as it were, and the objectives define the offers to trade. Asymmetry of power will affect the noncooperative equilibrium, making it, for example, a Stackelberg equilibrium, rather than a Nash one, but cooperation will still yield gains if there are spillovers.
The inside lag of domestic policy seems to pose an insuperable problem for fiscal policy as a stabilization tool. True, it may be easy to get quick agreement from the U.S. Congress or the Italian Parliament for tax cuts and expenditure rises, but not for measures in the opposite direction.

And finally, the possibility of negative fiscal multipliers should be taken very seriously. This problem is linked to the point made earlier about expectations, in that adverse confidence effects (or their opposite, which Walters (1986) contends occurred in Britain in 1981 when the budget contraction took place in the recession trough) may well offset the usual direct effects. Of course, if the multipliers were reliably negative, we could simply change the sign of the fiscal response. But the multipliers can move around, depending on the precise future policy pattern expected, and this expectation will generally be independent of policy intentions and announcements. Our models cannot yet deal with this dimension.

I would add two arguments against coordinated fine-tuning. First, it might provide vested interests with greater opportunities to expand the size of public programs in the name of action to stimulate the economy; yet once started for this purpose, such expansions are hard to reverse, imparting an upward bias to public spending and fine-tuning.

Second, time-inconsistency is likely to be worsened by such coordination. Whereas a domestic rule can be monitored by the public, an international agreement introduces the loophole of a foreign party’s views. As for monitoring by the foreign power, what sanctions could the foreign power apply? We have seen recently how difficult it was for the rest of the Organization for Economic Cooperation and Development (OECD) to persuade the United States to reverse its budget deficit, following the expansionary spirit of the early 1980s. Essentially, coordinated fine-tuning is just discretion exercised jointly by two or more parties; and is as much prey to time-inconsistency as discretion by one government. I fear that such fine-tuning would produce stagflation, as people began to anticipate the mutual exploitation of Phillips curves (see Rogoff (1985)).

I. Non-Activist Fiscal Coordination

The case for fiscal rules at the international level is the same as that underlying the Medium-Term Financial Strategy in the United Kingdom. To build credibility for monetary control, deficits must also be limited; otherwise, monetization comes to be seen as the politically irresistible option for holding down the ratio of debt to gross domestic product (GDP). So, if major countries all wish to achieve price stability and, as a by-product, can stabilize their exchange rates, fiscal rules are the corollary, and they might as well be coordinated—that is, mutually policed—to reinforce the commitment to stability. The benefits of this regime
would be the reduction of monetary uncertainty and transaction costs in international trade.

The rules would impose ranges for deficit/GDP ratios, outside which corrective action would be required for monetary reasons. The ranges would not interfere with the normal fluctuations associated with the business cycle or with unpredictable public finance needs (such as those arising from strikes or wars). For countries far from fiscal equilibrium, such as—dare I say it—Italy, there would be a transitional range, as there has been in the United Kingdom from 1979 to date.

This type of coordination is better able to confront the above-mentioned difficulties associated with fine-tuning. Forecasts and models are needed, but in an appropriate role—that of determining ranges large enough to permit appropriate flexibility, their midpoints set to reflect the savings propensities of each country. Public choice pressures and time-inconsistency should be reduced by the policing of agreed international rules. The inside lag becomes an advantage, because once agreed on, fiscal policies are less easy to tamper with.

The key obstacle is the residual political desire for freedom to inflate. I say "residual," because most major countries played with that freedom in the 1970s and early 1980s, and have learned that it only buys trouble. Recently, we heard from some U.S. politicians that they wanted this freedom in 1988—an election year. What an irony that a supposedly conservative government should demand such a freedom! But following the dollar's plunge in the free-fall reaction to such wants, wiser counsels have prevailed. Could it be that the United States is at last genuinely interested in playing by a set of world rules for price and exchange rate stability? If so, the last major obstacle to a proper Louvre Accord has probably been eliminated, since other OECD governments have learned—often the hard way—to prize stability. But I wonder: since John Connally tore up the Bretton Woods Agreement, the United States has always resisted allied attempts to impose half-agreed new rules whenever domestic political pressures called for such resistance. Clearly, any new framework would have to be set up and led by non-U.S. governments, and U.S. participation would have to be accepted as a bonus.

II. Conclusions

Tanzi rightly criticizes those who demand coordinated fiscal activism at the present time; notable demands for fiscal expansion have come from the Centre for European Policy Studies group originally associated with Rudiger Dornbusch (see Blanchard, Dornbusch, and Layard (1986)). Even the inclusion of "supply-side-friendly," "right-handed" measures does not make the package seductive, since deficits today will have to be paid for later, presumably by supply-side-unfriendly fiscal contraction or by higher inflation.
I would merely add that if surpluses are likely to result from public sector reforms, for example, then tax cuts and fiscal loosening are the right actions to take. This is the situation now in the United Kingdom where privatization revenues have been used to pay for tax cuts, but only against a strongly improving trend in public finances (itself partly the result of privatization).

Tanzi favors the coordination of supply-side policy. I am not so sure; cutting top tax rates has been greatly stimulated by the United States leading the way on tax reform. But certainly there are areas, such as protectionism, where cooperation is good for consumer interests.

To conclude, coordinated fiscal discretion falls into essentially the same traps as independent fiscal discretion. Just as the latter has given way in most of the OECD countries to limits on fiscal deficits, so should discretion at the international level give way to rules, so as to extend the greater national price stability across frontiers. The Louvre Accord may be the first sign of such a tendency. Vito Tanzi’s paper points us in that direction too, and is an encouraging index of where International Monetary Fund thinking may be going.

References


Comment

Antonio Pedone

Inherent in both fiscal policy and international cooperation are many limitations having to do with design, implementation, and effects. It is thus no surprise that the international coordination of fiscal policy will embody many more limitations than fiscal policy within a country or the international coordination of monetary policy.

Tanzi's paper contains a complete list of the issues facing any attempt at coordinating fiscal policy that aims at demand management on a global scale, rather than at correcting major fiscal imbalances in particular countries. Tanzi thinks that “where coordination of fiscal policy may be highly relevant is with respect to some structural aspects, particularly tax reform” (p. 33). I agree that structural fiscal policy should play an important role in international economic coordination, but I think that we must also confront the difficulties and find solutions to the problems of short-term fiscal policy coordination.

This last point becomes more evident if we look at fiscal policy coordination in the context of the coordination of monetary policies and exchange rate policies, and if we recall, as Tanzi does, the impetus toward policy coordination coming from the need to reduce the large external imbalances of the three leading industrial countries. Econometric studies have shown that any substantial reduction of the external imbalances undertaken by major industrial countries, while maintaining a stable and high growth rate and a sufficient volume of world trade so as not to aggravate the situation of the most indebted developing countries, could not be the result of a single economic policy measure, however effective or timely, nor of the domestic policy of a single country, however important and influential.

The distribution of the adjustment process over a broad range of measures in different countries would reduce the costs involved in drastic and uncertain changes in economic policies and would make it possible to reverse them should the results differ widely from those expected. This pragmatic approach assumes that wide fluctuations in exchange rates are costly, because they increase the uncertainty of trade and investment operations, and because they may make it worthwhile to shift from foreign markets to the domestic market and from free sectors exposed to international competition toward more protected sectors;
and because the coverage of risks connected with exchange rate fluctuations is expensive, unequal, and incomplete.

If it is assumed desirable to avoid "excessive" variability in exchange rates, while at the same time keeping the objectives of growth and reduction of external imbalances, then the economic policies of the major industrial countries require some coordination. Of course, the inconsistency of national economic policies is not automatically reduced by international economic cooperation. But international cooperation may be necessary to avoid unilateral actions, which could be disruptive of world trade and financial markets.

The role of international economic cooperation cannot be defined—nor dismissed—independently of the role assigned to monetary policy and to exchange rate and trade policies. Viewed in this way, international economic cooperation could make a positive contribution to the reduction of inconsistencies in national economic policies. But we must all be aware of its practical difficulties, which are rightly emphasized in Tanzi's paper.

We all know how weak the statistical foundations of many international comparisons and financial variables are; but here, the International Monetary Fund and other international institutions could help to improve the standards used. Tanzi also emphasizes the difficulty of agreeing on a reliable forecast, and argues that "this has serious implications for fiscal coordination that aims at global demand management through fiscal policy changes, although it is a far less serious obstacle for monetary policy coordination or fiscal coordination that emphasizes ... the correction of serious fiscal imbalances in particular countries ..." (p. 16). The problem arises because the implementation lag of financial policy is longer than the period for which acceptably reliable forecasts can be made. But the long-term fiscal adjustment process also requires (long-term) economic forecasts. And what if the errors become larger when the forecasts extend across longer periods?

I think that an agreement on forecasts could be made easier if they met three commonsense requirements: agreement of evidence should come from a host of indicators rather than a single forecast; less attention should be given to exceptional values and more to well-defined trends that are potentially cumulative and destabilizing; and only quantitatively significant deviations from the target values should be selected.

The difficulty of reaching an agreement on the economic objectives that should be achieved through international economic cooperation can be overcome by the choice of an appropriate set of indicators. Tanzi argues that even clear signals from different indicators may be conflicting and subject to different, if not contrasting, interpretations. I think that this real danger can be mitigated in many ways: by separating the different indicators into homogeneous groups; by setting a range of target values for each of them; by varying the list of the
indicators according to their use and to the frequency with which target values are updated; and by adapting the procedures on the use of indicators to the extent of the deviations from the various agreed-upon target values.

It must be said that disagreement on economic objectives and economic analysis would also affect discussion on the desirability and timing of changes in medium-term fiscal policy, and on economic policy in general. Is the "zero-economic policy" advocated in the end by Tanzi preferable to the inclusion of "commonsense international economic cooperation" with structural and medium-term fiscal policy?

It is true that the problems of shortening fiscal policy lags (particularly the decision lag) and improving the budgetary process remain crucial to the success of international economic cooperation. They become more crucial if one of the objectives of international economic cooperation is to reduce exchange rate variability. In fact, independence in monetary policy is somewhat reduced if target values for exchange rates are fixed; so it becomes more important that public budget instruments regain full flexibility and efficacy. As the experience of the European Monetary System has shown, any kind of managed exchange rate system implies that monetary policy is no longer completely free for domestic objectives. When monetary policy is mainly assigned to an exchange rate objective, some other instrument is needed to influence domestic demand and to offset the effects at the micro level of external shocks and large swings and relative prices. The effective use of fiscal policy toward these ends becomes crucial. But here, some fundamental problems arise that, in practice, may hinder the whole process of international economic cooperation.

Fiscal policy decisions usually require a long time to be taken, since, unlike decisions about monetary policy, they must have parliamentary approval. In addition, fiscal policy decisions are often asymmetrical and not reversible; it is much easier to cut taxes or increase public expenditure than to increase taxes or reduce public expenditure. Thus, as Tanzi suggests, when an expansionary fiscal policy is called for, the risk of compromising the medium-term sustainability makes some governments overcautious about adopting all the expansionary measures required. Conversely, when a contractionary fiscal policy is called for, most governments find it difficult, if not impossible, to get parliamentary approval for all the proposed tax and public expenditure changes.

These are the practical difficulties that could prevent any progress toward fiscal policy coordination, as underlined in Tanzi's paper, but these same difficulties could also hinder the implementation of a medium-term financial adjustment. Some appropriate institutional changes must be adopted to increase the flexibility of fiscal policy. These changes could include the use of tax regulators tied to the values of some economic international and/or domestic variables; the indexation of public expenditures to macroeconomic variables; and some changes
in the budgetary process, so as to take into account the short-run adjustment needs and medium-term sustainability of fiscal policy. Without some improvement in these institutional areas, governments cannot effectively control the policy mix and are unable to commit themselves fully to the adoption of the domestic policies required by international economic cooperation—be it aimed at demand management or medium-term fiscal adjustment.