Comments

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The chapter by Professor Ronald I. McKinnon presents arguments that the international business cycle can be tamed with a better alignment of exchange rates if the principal industrial countries agree to coordinate their monetary policies. The chapter itself, however, is devoted to defending narrower hypotheses: first, that nominal exchange rates can and should be stabilized through the collaboration of central banks, and second, that the U.S. price level would not be any higher had collaborative policies been pursued during the 1980s.

I can agree theoretically with the first of these hypotheses, but only with a number of reservations. I do agree that the exchange rate movements can be largely explained by monetary-financial parameters. I believe that the real exchange rate is primarily driven by real interest spreads. However, I have a great deal of both theoretical and practical trouble with the second hypothesis.

My major objection to the first is that fiscal policy coordination must also be far greater than admitted in the chapter if the McKinnon-requested monetary policy collaboration is to be feasible. McKinnon's law of macroeconomic policy is apparently: "The early bird gets the economic recovery." Specifically, the first nation to pursue expansionary fiscal policy must be given the right (indeed the obligation in the McKinnon regime) to pursue expansionary monetary policy *and* all other nations must pursue symmetrically contractionary monetary policies. I can agree that this scheme would possibly reduce the exchange rate reactions to fiscal policy initiatives by reducing the likely spreads in interest rates. However, I doubt if such a regime would reduce global business cycles, and I am fairly certain that it would augment the cross-country differences in growth rates and inflation rates.

Professor McKinnon's second proposition seems to be that U.S. inflation and the price level would not be appreciably different under alternative monetary regimes as long as global liquidity is similar. This does not seem likely to me. Taking the 1982–85 Reagan-Volcker era as a case study, had monetary policies been as requested by McKinnon, U.S. exports and creditsensitive domestic spending would certainly have been stronger and imports weaker; the reverse would have been true for Europe and Japan. Would this not produce higher U.S. inflation and lower foreign inflation? I believe that the only conceivable way that inflation would not accelerate is if all of the extra demand produced by the fiscal stimulus were met by foreign production. This is an open economy, international version of the old crowding out hypothesis in its most extreme form, perhaps tied to the strictest possible interpretation of the so-called international "law of one price." Only such an extreme theoretical position could avoid inflation and business cycle repercussions in a McKinnon regime.

Moreover, is it conceivable that continental European parliamentary governments and their closely controlled central banks would have acceded to such a regime? Admittedly, since 1981, the U.S. unemployment rate has not fallen below 7 percent, but European unemployment has steadily risen in spite of the strong locomotive effects produced by extraordinary exports to the United States due to the overvalued dollar. I think the United States has been lucky that the European nations have been willing to be as conservative in their monetary policies as they have been in the face of strange U.S. fiscal policies. McKinnon's regime would have asked them to accept an even more intense and prolonged recession than they have faced.

In arguing against a fiscal policy explanation for today's international interest rate spreads and the resultant exchange rate misalignments, Professor McKinnon goes beyond simple devil's advocacy. Given the widespread acceptance in 1985 of the federal budget deficit as the prime source of financial market imbalances, a reminder of the role of monetary policy here and abroad is certainly useful, but his denial of fiscal impacts is extreme. This denial relies on contentions that either monetary policies could offset the fiscal impact or that changes in fiscal policy would induce offsetting shifts in currency demand curves through safe haven and inflation expectation effects.

The first argument certainly misses the point: *ceteris paribus,* fiscal stimulus by one nation requires it to draw a larger share of global savings. This should be expected to require a rise in this nation's real, expected borrowing costs relative to other nations. Technically, a movement along the private savings supply curve to that stimulating nation is required. Professor McKinnon would offset this by calling forth exactly matching increases in central bank supplies of funds. His claim that "there is no *necessary* [emphasis added] relationship between fiscal deficits and movements in nominal exchange rates" is therefore narrowly correct, but thoroughly misleading as a piece of policy advice. There is indeed a "necessary" relationship unless McKinnon's law is followed.

So much for theoretical considerations. What is the empirical evidence, at least as interpreted by the DRI model and associated research? One set of answers is provided by a set of counterfactual simulations of alternative monetary and fiscal policies during the period of McKinnon's exchange rate commentary, namely the Carter and Reagan presidencies. These simulations point to very important roles for both monetary and fiscal policy in the late 1970s drop in the dollar and its subsequent extreme rise. They confirm McKinnon's contention that the exchange rate has had a pronounced impact on domestic inflation, but they also make it very clear that his preferred match-up of stimulative U.S. fiscal and monetary policies would have produced significant added inflation in the United States. Such inflation would be unavoidable unless Europe and Japan had accepted extremely severe recessions. However, in that case, foreign prices would have fallen and McKinnon's nominal exchange rate stabilization program would have still left the United States with a pronounced *real* appreciation of the dollar and hence much the same protectionist pressure he mentions in his opening paragraph. The bottom line clearly is that there must be full consistency in both monetary and fiscal policies if real exchange rate stability is to be achieved.