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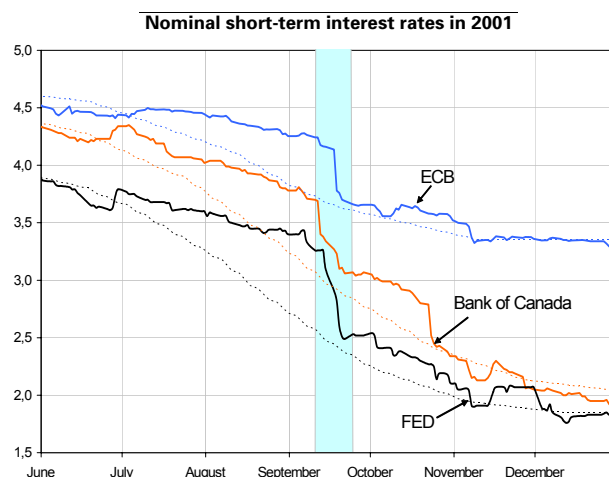
September 2007

TRÉSOR-ECONOMICS

International macroeconomic policy coordination

- Under the Bretton Woods system, fixed parities vs. the dollar required that national monetary policies follow that of the United States. The demise of that system raised the question of the need for some other form of macroeconomic policy coordination.
- From a theoretical point of view, coordination amounts to tailoring each country's policies to match those recommended by an "all-knowing global planner"; at first glance, this would improve their efficiency and, by eliminating their self-centred element, enable policymakers to pick superior policies in terms of resulting welfare for each country. The potential gains from coordination are significant in a certain number of cases, such as fiscal policies in a monetary union, liquidity crises, manifest exchange rate misalignment, or in a balance of payments crisis.
- Despite the existence of a number of coordinating bodies such as the G7 and the Eurogroup, etc., there are constraints limiting extension of the scope for coordination. On the one hand it can conflict with domestic goals, such as domestic policy compromises or the overriding objectives and credibility of central banks. On the other, it is hard to put into practice inasmuch as its own effects are not always observable: defining common goals and verifying the different parties' commitments are no easy matter.
- Over the past three decades, and leaving aside coordination within the European Union and, *a fortiori*, within the eurozone, macroeconomic policy coordination has for the most part occurred in specific circumstances, as in the aftermath of the 11 September 2001 terrorist attacks. To avert any risk of a financial crisis, the central banks undertook on that same day to meet all demands for liquidity on the part of banks. On 17 September 2001, the Fed, the ECB and the Bank of Canada decided simultaneously to cut their respective key rates by 50 basis points (see chart opposite).

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Employment.



Source : Datastream.

Since the demise of the Bretton Woods system, international coordination between the main regions in the fields of fiscal, monetary and financial policy has adapted to the new framework, defined by flexible exchange-rate regimes and full currency convertibility, along with fast-growing international financial markets. In practice, greater emphasis was placed on financial system regulation, especially via the definition and application of common prudential standards, as well as through the exchange of information on the workings of the economy, on the way monetary policy is implemented, on forecasts, and so forth. Coordination gradually took root in all these areas. On the other hand, macroeconomic adjustments in connection with current account imbalances¹ have generally been left to the discretion of the foreign exchange markets.

The desirability of coordination is measured by the potential gain from tailoring the different countries' policies to fit those recommended by an "all-knowing global planner", as compared with a situation in which the different national authorities (i.e. central banks and governments) decide on their respective policies independently of each other regardless of externalities. Although empirical work still has difficulty quantifying the gains from macroeconomic coordination, the economic literature agrees in saying that these gains can be substantial. However, their materialisation is complicated by the existence of powerful constraints limiting the scope for coordination, such as the difficulty of sharing information, and practical obstacles to organising coordination, etc., though without eliminating it altogether.

1. Gains from coordination in "1st generation" models

1.1 International macroeconomic policy coordination in traditional macroeconometric models

A sizeable body of literature in the 1980s aimed at modelling the theoretical gains from macroeconomic policy coordination and measuring its potential gains. This literature was based on Keynesian-type models. The main channels of international transmission were demand effects (imports), financial effects (interest rates) and relative price effects (exchange rates and terms of trade).

These transmission channels and the resulting externalities serve as an analytical framework for transmission. For example, a country that embarks on a policy of spending cuts or tax increases naturally prompts a decline in activity and in domestic inflation. In foreign markets, this policy results (1) in a reduction in global demand and hence exports (via the demand effect) and (2) in an appreciation of the real exchange rate owing to an interest-rate differential (the UIP² effect) and adverse inflation (via the relative price effect). These two effects tend to generate a current account deficit in neighbouring countries.

A fall in one country's interest rates generally leads to a rise in domestic demand and to a depreciation of the exchange rate (UIP). The effect on the trade balance is more ambiguous: it all depends on the channels by which monetary policy is transmitted to domestic demand and on the sensitivity of the trade balance to exchange rates. The effects on trading partners' activity levels are ambiguous also. On the other hand, exchange-rate movements do have distinct effects on the allocation of factors (between investment and consumption, between tradable and non-tradable goods, etc.) and on inflation.

Finally, policies aimed at modifying exchange-rate levels without modifying interest rates (for example sterilised foreign exchange market interventions) have substantial external effects, insofar as there is no autonomous modification of domestic demand to offset the foreign trade impact of exchange-rate movements. This then reinforces the impact on the level of activity, prices and factor allocation in other countries.

1.2 According to these models, the gains to be obtained from cooperation could represent between ½ and 1 percentage point of GDP in equilibrium conditions

The best response to another country's macroeconomic policy cannot be known in advance. For example, in response to a cut in public spending by one of its partners, a country may choose either to compensate for the loss of activity by boosting its own public spending (this is a case of strategic substitutability, in which country two responds by doing the reverse of country one), or it can limit the impact on its current account balance by cutting its spending (this is a case of strategic complementarity, in which country two responds by doing the same thing as country one).

The "global saving glut"³ thesis is an illustration of strategic substitutability. In substance, it links the drop in the US saving rate to an extremely accommodative fiscal policy (via a rapid rise in the fiscal deficit), viewed as a reaction to the "Asian growth strategy" founded on an accumulation of foreign exchange reserves (in association with the rising saving rate in Asia, see chart 1). Following on from this theory one could argue that the sharp increase in US demand is consolidating the Asian

(1) Known as "balance of payments disequilibria" in the Bretton Woods system.

(2) Uncovered Interest Rate Parity.

(3) B. Bernanke (2005): "The Global Saving Glut and the US Current Account Deficit", *speech at the Homer Jones Lectures, St. Louis, Missouri*, April 14, 2005.

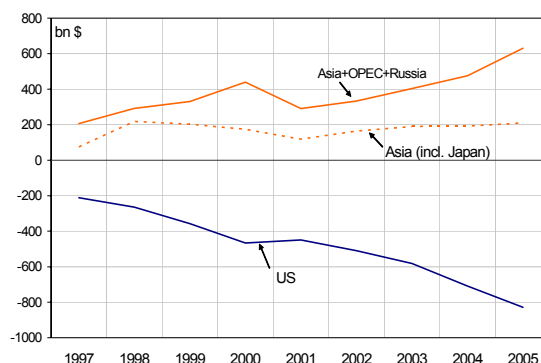
strategy in return. In a substitutability situation, however, if each country does what is most beneficial for itself, the equilibrium achieved is generally inefficient. One possible form of coordination might then be to find a mix of macroeconomic policies that reduce imbalances without affecting global growth.

Since the early work of Oudiz and Sachs⁴ aimed at quantifying the gains from macroeconomic policy coordination, the diagnosis, generally based on international macroeconomic models⁵, and shared by economists, is that the gains from coordination are real but modest. They are reckoned to be on the order of $\frac{1}{2}$ to 1 percentage point of GDP for all countries, at equilibrium, when full information is available on the functioning of the economy and the reactions of the other countries.

The gains from coordination would be smaller, however, when lack of information is taken into account (either

because governments are ignorant of how the economy really functions, or because they cannot agree among themselves as to how the economy functions).

Chart 1: Current account imbalances



Source : IMF-DoTS

2. The "new macroeconomics" changes the terms of the debate on monetary policy coordination

The exchange rate is central to the "new macroeconomic" paradigm shift and plays a dual role in the economy:

- (a) In the first place it is an asset price and reflects agents' expectations as to the future value of economic variables;
- (b) It is also a relative price and thus should only depend on contemporary values of economic variables.

Considered as a "relative price", exchange-rate variations stem primarily from those in contemporary productivity levels and make up for the lack of price and wage flexibility. However, when exchange-rate fluctuations stem primarily from their character as an "asset price" (and particularly if there is a degree of price rigidity), they may no longer reflect fundamentals and may keep the economy away from its efficient equilibrium⁶. Such misalignments are strong arguments in favour of either explicitly or implicitly taking account of exchange rates in monetary policies and even in the coordination of monetary policies.

Moreover, new (or 2nd generation) Keynesian macroeconomic models assume that agents maximise their utility intertemporally⁷, that the market for goods is in a state of monopolistic competition⁸ and that prices are rigid in the short term. In these models, normative analysis is not based on an *ad hoc* social utility such as inflation and unemployment criteria but with households' utility.

The canonical model⁹ of this literature greatly simplifies the macroeconomic interdependencies (cf. in particular the quasi-absence of a financial channel and the trivial role of exchange rates¹⁰), and finds that the welfare gains from monetary policy coordination are nil or very small.

However, later work tends to question this initial result. In particular, the gains from coordination are greater when trade balances respond to exchange-rate variations, especially if the financial markets are highly developed (agents use international markets to hedge country specific shocks). In that case, their order of magnitude may be similar to the one of macroeconomic stabilisation policies¹¹.

- (4) G. Oudiz & J. Sachs (1985), "Intertemporal Policy coordination in Dynamic Macroeconomic Models", in *Willem Buiter and Richard Marston, eds., International Economic Policy Coordination*, Brookings Institution.
- (5) W. McKibbin (1997) : "Empirical Evidence on International Economic Policy Coordination", *Handbook of comparative economic policies*, Greenwood Press.
- (6) Friedmann's argument in favour of exchange-rate flexibility rested, however, on the assumption that the exchange rate's character as an "asset price" was less important than its "relative price" nature.
- (7) Agents are said to act intertemporally when they determine today the future trajectories of their consumption and supply of labour. These trajectories result from the maximisation of an "intertemporal utility", defined as the net present sum of future utilities (reflecting their welfare at each date in terms of their consumption and their supply of labour).
- (8) In a situation of monopolistic competition, each producer is both in a monopolistic position with respect to the goods it produces (because these are different from other goods), and in a competitive situation (because consumers can nevertheless substitute other goods for them if necessary).
- (9) M. Obstfeld & K. Rogoff (2001) : "Global Implications of self-oriented national policy rules", *Quarterly Journal of Economics* and G. Corsetti & P. Pesenti (2001) : "International Dimensions of Optimal Monetary Policy", *Journal of Monetary Economics*.
- (10) When the elasticity of substitution between domestic and foreign goods is equal to 1, the trade balance is in equilibrium regardless of the exchange rate, because price effects are offset by volume effects. Moreover, this assumption simplifies considerably the task of calculating the optimum monetary policy rule.
- (11) Sutherland (2002) : "International Monetary Policy Coordination and Financial market integration", ECB Working Paper, No. 174.

Even if today financial markets are still by no means as developed as the theoretical models assume, their rapid growth in recent decades ought to align the global economy more closely with this situation. More integrated markets help to spread risks internationally *via* portfolio diversification, with each agent having interests in neighbouring countries. Economic policies will thus be all the

more effective if they seek to increase global welfare as opposed to welfare in a single country.

Finally, other studies show that, with a different specification from the canonical model, notably by taking into account the nominal rigidities specific to each sector, different relative sizes between sectors, etc., gains would again be significantly more important¹².

3. Why is there so little macroeconomic policy coordination ?

The debate over what conditions are needed to achieve high gains from coordination remains undecided, and the practical implications of the result are still hard to assess: the preferred form of coordination (which policies in response to which type of shock?), and the expected gains, still depend to a great extent on the model used, none having yet established itself as the most "reasonable" one. Over and beyond the debate on the scale of the gains to be expected, a certain number of factors make implementing coordination harder.

3.1 The complexity of economic situations prevents the parties from entering contractual commitments

Although the parties involved in macroeconomic policy coordination share the same information on the risks and are perfectly able to observe each others' actions, coordination is hampered by the difficulty, indeed impossibility, of describing the risks entailed and hence its content (i.e. the policies to be implemented). They cannot rely on this information for the purposes of *ex ante* coordination.

One can illustrate this with the risk of a sharp dollar depreciation: all countries have now identified this risk. And yet it is very difficult to imagine the entire range of possible adjustment scenarios: in particular, the way in which central banks react will depend on the rate at which the currency depreciates, on whether or not risk premia rise, on the disconnection between long-term rates on either side of the Atlantic, etc. ***Ex ante* coordination therefore seeks not to organise optimum economic policy responses as from today, rather to reduce the risk of a disorderly depreciation of the dollar, by means of appropriate macroeconomic policies and by announcing in advance (via G7 statements) their determination to engage in *ex post* coordination if the situation so requires.**

In addition, the asymmetry of available information limits *ex ante* coordination (as previously) as well as *ex post* negotiation. That is because the parties' capacity to commit themselves is heavily curtailed when available information is not equally shared during negotiations (typically, one party is always better informed about its own situation than the others are), or when the actions taken by the different parties are only incompletely observable (as it is the case, for example, with complex policies such as structural reforms¹³).

3.2 Internal political constraints can conflict with the need for external coordination

Observation of macroeconomic policies effectively pursued shows that not only are they far away from the cooperative equilibrium (where all areas would choose their policies in a co-ordinated fashion), but that neither do they correspond to the non-cooperative equilibrium (where each area picks the policy most advantageous to it, taking the others as given)¹⁴. Authors¹⁵ that have compared the gains arising from coordination (the transition from non-cooperative equilibrium to a cooperative equilibrium) with the gains from switching from observed policies to the non-cooperative equilibrium suggest that efforts to coordinate macroeconomic policies would have a far smaller impact on welfare than seeking to improve the quality of "egocentric" policies.

Several factors may account for the gap between the policies effectively pursued and the optimal non-cooperative policies. These include the existence of internal political constraints (where the policies pursued are compromises between groups with diverging interests), the lack of information as to the functioning of the economy or the nature of shocks (imperfect information), or the use of macroeconomic policies in pursuit of objectives for which they are not naturally intended, etc.

(12) M. Canzoneri, R. Cumby & B. Diba (2002) : "The need for international policy coordination : what's old, what's new, what's yet to come ?", *NBER Working Paper*, N°8765 ; Z. Liu et E. Pappa (2005) : "Gains from international monetary policy coordination : does it pay to be different ?", *ECB Working Paper*, No. 514.

(13) Tirole (1999) : "Incomplete contracts : where do we stand ? ", *Econometrica*, Vol. 67, N°4, pp. 741-781 for an account of the theories of incomplete contracts.

(14) The Nash equilibrium is the equilibrium in which each area chooses its policy strategy by taking the other areas' strategies as given.

(15) A. Hughes-Hallet (1986) : "International Policy Design and the Sustainability of Policy bargains", *Journal of Economic Dynamics and Control* and M. Canzoneri et H. Edisson (1990) : "A new interpretation of the coordination problem and its empirical significance", in *Financial sectors in Open Economies : Empirical Analysis and Policy Issues*, Board of Governors of the Federal Reserves.

The study of these "State imperfections" lies outside the scope of this survey. However, the relative weakness of the gains from coordination in relation to those to be expected from better domestic policies may, alongside traditional efforts at coordination, help place greater emphasis on "peer pressure"¹⁶ in international gatherings to urge governments to improve their national policies initially.

This method may prove effective in a large number of macroeconomic policy areas (budgetary and fiscal especially) and structural areas (this is one of the focuses of macroeconomic discussions in ECOFIN meetings, for example). It does not apply in the same terms for monetary policy and for foreign exchange policy.

3.3 The utility of multidimensional negotiations is not always perceived

The literature¹⁷ has only recently stressed the point that the gain from coordinating a large number of policies simultaneously can be large even if the gain from coordinating each of them individually is low. That is because it is generally not possible for a country that would gain from coordination to compensate a country that would lose from it (the utilities are not transferable between countries). On the other hand, it is easier to implement domestic redistribution. In that case, the greater the number of areas included within the negotiation (e.g. macroeconomic policies, trade policies, etc.), the more each country would be able to make concessions in a particular area and obtain compensating concessions in another.

4. What is the relevant area for coordination: examples of successful experiences

International macroeconomic policy coordination is useful in so far as, on the one hand, it can reinforce the effectiveness of policies (as in the case of foreign exchange interventions) **and, on the other hand, can enable policymakers to choose better policies in terms of welfare.** This is notably the case in the following examples:

- **In a monetary union, coordination must, at the very least, seek to avoid a situation in which lack of budgetary discipline undermines the stability of the union.** That is why the eurozone introduced its stability and growth pact (SGP).
- **In a liquidity crisis.** The problems of "moral hazard" associated with the situation of lender of last resort are an obstacle to the announcement of *ex ante* coordination between the G7 central banks. On the other hand, no one contests the idea of *ex post* coordination.
- **When exchange rates diverge from reasonable values.** Here again, there is a far greater discussion over *ex ante* coordination (as in the announcement of "targets", for example) than over *ex post* coordination.
- **In the case of a balance of payments crisis common to a whole region.** In particular, in cases where strategic policies are complementary (see part 1.1), coordination limits the risk of a sharp drop in regional across the region.

4.1 The stability and growth pact

Monetary union does not, *per se*, impose fiscal policy coordination. A certain degree of fiscal heterogeneity may even be a sign that adjustment mechanisms are functioning smoothly, as countries experience asymmetric shocks. However, two risks associated with uncoordinated national fiscal policies impose a certain degree of discipline, which may in some instances lead to coordination, namely:

- In the first place, national policies may cause negative external effects on other countries within the area. This is the case, for example, with inflationary policies. While the country implementing these measures will temporarily benefit from a decline in real interest rates (because of the monetary policy targets average inflation for the area), its neighbours may on the contrary experience higher real interest rates¹⁸.
- Secondly, the risk of a state insolvency and hence debt monetising, bears on all member states through the single currency, even though only one state actually defaults.

The Stability and Growth Pact was designed to contain these two risks. The two main rules, setting a 3% public deficit threshold and a 60% public debt threshold, are designed to avert excess deficits and more generally to keep the public finances on a sustainable path. Moreover, the definition by each member state of its own stability programme, its annual re-evaluation before the Commission and its approval by the Council of Finance Ministers,

(16) La *peer pressure* désigne l'influence exercée par les pairs dans le but, explicite ou implicite, de modifier les actions où les intentions d'un membre du groupe.

(17) L. Meyer, B. Boyle, J. Gagnon & D. Henderson (2002) : «International coordination of macroeconomic policies : still alive in the new millenium ?», *Federal Reserve working paper*, No. 723.

(18) For a detailed analysis of the mechanisms and implications, see Carton (2005) : "Les externalités budgétaires dans la zone euro", *DPAE* n°87

constitute a series of measures that can, *de facto*, lead to greater coordination, notably through the appropriate use of "peer pressure".

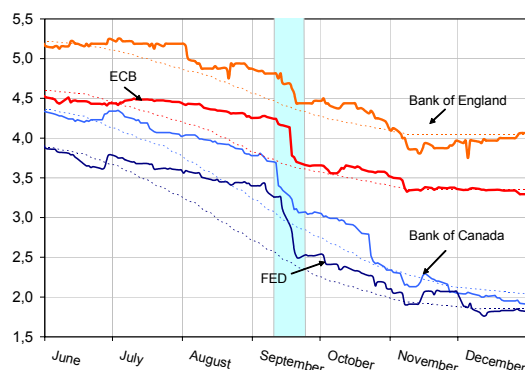
4.2 Liquidity crisis

Liquidity crises emerge when the presence of illiquid agents (i.e. those that hold illiquid assets and short-term debt) triggers a chain reaction leading to their proliferation (the creditor of an illiquid agent may himself become illiquid if he is unable to recover his claim). In general, these crises can be contained if there is a lender of last resort capable of directly pumping money into solvent agents who have become illiquid, or to prevent a financial panic (in the form of a share price fall or a run on the banks) by signalling that it stands ready to play its role.

In theory, a single institution is sufficient to play the role of lender of last resort. But the fact that most of the major central banks announcing in concert their intention to supply liquidity in abundance (a case of *ex post* coordination) serves to reinforce the signal and sharply limit the risk of panic. In this situation, the gains from cooperation via the exchange of information and coordination of measures to supply liquidity are potentially very great, and especially when financial markets are highly integrated.

For example, the central banks engaged in very considerable coordination at the time of the World Trade Center attacks:

Chart 2: Nominal short-term interest rates at the time of the World Trade Center attacks in 2001



Interpretation: the dotted lines represent average key rates observed in the following three months, plus a risk premium. Assuming the markets perfectly anticipate future key rates, the 3-month rate observed ought to be very close to those rates. In September 2001 we find that the observed rates (unbroken line) are substantially above their average level over the following three months, reflecting the surprise effect of their 17 September rate cuts (-50 bp for the Fed and ECB; -25 bp for the BoE).

Source : Datastream.

- On 11 September 2001 the US, European and Canadian central banks simultaneously announced that they would supply all requests of liquidity.
- The next day, the Fed and the ECB signed a currency swap agreement to provide liquidity in both currencies. On 14 September the same type of agreement was signed between the Fed on the one hand and the Canadian and UK central banks on the other.
- On 17 September the three central banks (Fed, ECB and Bank of Canada) decided simultaneously to cut their key rates by 50 basis points (chart 2). They were followed on the next day by the BoE, which cut its rates by 25 bp, and by the Bank of Japan, which cut the rate on its permanent facility by 15 bp to 0.10%¹⁹).

4.3 Currency misalignments

When currency parities are clearly out of line with macroeconomic fundamentals, the authorities can conduct sterilised interventions²⁰ in the foreign exchange rate markets: central banks buy or sell foreign currencies against domestic currency in order to modifying its relative value (i.e. the exchange rate).

These interventions, conducted within the framework of currency flexibility and free movement of capital, can affect exchange rates *via* two main transmission channels²¹ :

- The portfolio channel: when foreign exchange is sold to support the currency, demand for domestic securities rises in relation to that for foreign securities, thereby pushing up its relative price (i.e. the exchange rate).
- The signal effect: if foreign exchange interventions are made public, they supply credible and privileged information from the authorities concerning the economic fundamentals or future monetary policy, which can affect the exchange rate.

The importance of the former channel has probably diminished nowadays owing to the development of financial markets and the size of foreign exchange markets. Conversely, the second channel is probably the main transmission channel today, as shown by the greater efficiency of publicly announced interventions. A third channel has though been envisaged²² :

- The channel of coordination among market operators: even when most market operators consider a currency to be misaligned, mimetic or chartist behaviour can delay the return to equilibrium. Foreign

(19) The rate on the main refinancing operations had already been set at 0% in March 2001.

(20) This takes the form of purchases (or sales) of currencies by the central bank, offset by sales (or purchases) of domestic securities.

(21) L. Sarno & M. Taylor (2001): "Official intervention in the foreign exchange market : is it effective, and, if so, how does it work?", *CEPR Discussion paper*, No. 2690.

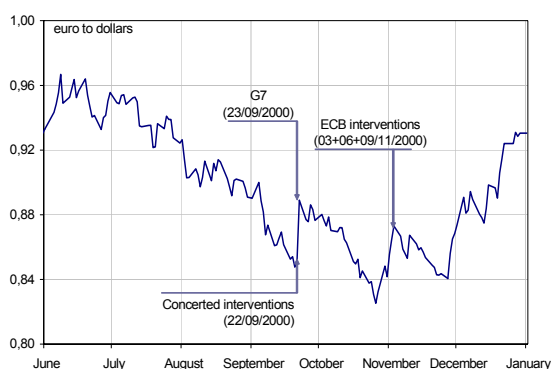
(22) K. Dominguez et J. Frankel (1993): "Does Foreign Exchange Intervention Work?", *Institute for International Economics*.

exchange interventions serve to coordinate agents in the direction of the new equilibrium.

For both the second and the third channels, coordinated foreign exchange interventions in principle increase the likelihood that they will have an effect. Studies of interventions carried out in the early-1990s (for which data are far richer than for earlier interventions) do not refute their efficacy in the very short term (from a few hours to a few days), and in general they validate the claim that multilateral foreign exchange interventions are more effective than unilateral ones²³. Moreover, the effectiveness of interventions (coordinated or otherwise) generally depends on whether or not exchange rates are blatantly misaligned.

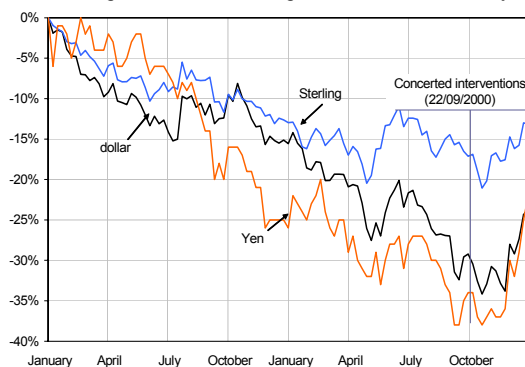
The foreign exchange interventions of September 2000 provide a recent example of successful coordination. After trending downward for more than a year and half (see charts 3 and 4) and some months of contradictory and scattered declarations regarding the strategy the Europeans ought to be following, the members of the G7 agreed to bring the European currency back into line with its fundamentals.

Chart 3: Euro-dollar interventions in late-2000



Source : ECB.

Chart 4: Changes in the euro exchange rate relative to 1 January 1999



Source : ECB.

Taking the markets by surprise, these interventions took place on September 22nd, on the eve of the G7 meeting in Prague on September 23rd. 4,6 billion euros were mobilised on that occasion, of which 2.5 billion by the ECB. A few weeks later, the European Monetary Institute intervened again, acting alone this time, but on a similar scale (1 billion euros on November 3rd, 1 billion on the 6th and 2.5 billion on the 9th)²⁴

4.4 Les déséquilibres macroéconomiques

Even if, *a priori*, the authorities ought to be concerned solely with domestic macroeconomic components such as the level of activity and inflation, a variety of reasons may encourage them to monitor trade balance and exchange rates also:

- The trade balance and the exchange rate are the main variables by which the externalities of macroeconomic policies are transmitted between currency areas (see above). In particular, the exchange rate is a short-term determinant of activity and inflation.
- Even in the absence of any target for their desired value, they serve as a measure of the appropriateness of macroeconomic policies.
- The level of current account balances may figure among macroeconomic policy objectives **(i)** when external sustainability is in doubt, or **(ii)** when sudden and unexpected variations entail substantial adjustment costs.
- A country experiencing a sharp deterioration in its trade balance generally experiences protectionist pressures also.

It thus appears that the policies to be applied will differ depending on the origin of the demand imbalances²⁵ and that coordination is not automatically necessary:

- Coordination is not necessary, *a priori*, when the cause is localised within a single area, and the priority should be to implement policy solely within the area at the source of the imbalance. However, it may be that "first best" policies (eliminating the cause of the imbalances) are not always feasible, and that the implementation of second best policies requires coordination.
- When the origin is located in more than one area, coordination is essential in order to prevent imbalances in one area from aggravating those in the other areas. That is because, in this case, it is not in any area's interest to correct its imbalance sufficiently on its own initiative. Conversely, when the causes of the imbalance in a given area are independent of the imbalances caused by the other areas there is no need

(23) See notably Sarno et Taylor op. cit.

(24) C. Henning (2006) : "The External Policy of the Euro Area: Organizing for Foreign Exchange Intervention", *Institute for International Economics, Working Paper No 06-4*.

(25) We do not discuss in detail here the policies to be adopted depending on the nature of the imbalance.

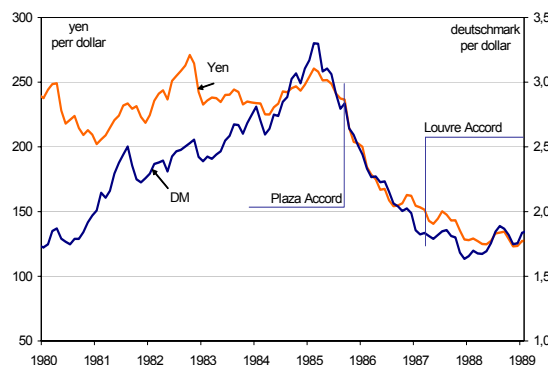
for coordination, provided each area adopts measures to remedy the causes of their domestic imbalances.

The Plaza Accord of September 1985 and the Louvre Accord of February 1987 furnish an example of economic policy coordination aimed at limiting the risk of a sudden adjustment of current account imbalances. Since the beginning of the 1980s, US macroeconomic policy had combined high interest rates to combat inflation with a widening fiscal deficit. US trade deficit widened as the counterpart to Japanese and German surpluses, the US currency appreciated sharply, peaking against the DM and the yen in February 1985.

In September 1985, the G5 aimed to set off a significant dollar depreciation. Members of the comity promised to adopt economic policies bringing economic fundamentals in line with such a depreciation. In particular, policies designed to curb demand in the US (by cutting the Federal deficit) and supporting demand in Europe (by cutting taxes in Germany and France, and easing interest rates and liberalising the financial markets in Japan), were envisaged. However, these policies were not very far-reaching when implemented.

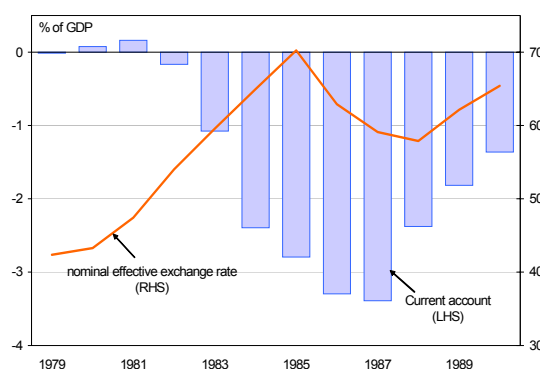
Moreover, the central banks engaged in sterilised interventions in the foreign exchange markets, aiming to support the DM and the yen (involving more than 10 billion dollars with immediate effect). These interventions appear to have achieved their goal, since in the space of two years the dollar lost nearly 40% against the yen and 45% vis-à-vis the DM (see chart 5); in early 1987 the risk of a further slide in the dollar led the G5 to meet again, this time to support the US currency. In the Louvre Accord, the members of the G5 deemed it to be correctly valued and announced they would be adopting policies aimed at keeping it close to the then prevailing parities, albeit without announcing precise target values.

Chart 5: Yen and DM movements against the Dollar



Source : Bank of England.

Chart 6: US current account (% of GDP) and dollar



Source : OCDE Economic Outlook.

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