Cohen-Outline: The triad and the unholy trinity: Lessons for the Pacific Region, in: Richard Higgot/ Richard Leaver/John Ravenhill (eds.): Pacific Economic Relations in the 1990s: Cooperation or conflict? 1993 (pp.133-158), outlined by Nadine

Question: What are the prospects for successful monetary cooperation in the Pacific Region in the 1990s?
Answer: International monetary cooperation is difficult to sustain. The "unholy trinity" (p.134) [freedom of capital flows – stable exchange rates – independent monetary policy] operates cyclicaly to erode collective commitments to monetary collaboration. The pacific region lacks furthermore the features and sense of a "community of states" that commonly values and identifies itself with policy cooperation across multiple policy fields. In Cohen's opinion this sense of community is a necessary precondition for the unification of monetary policy, after which government defections form monetary commitments are not possible any more.

The paper is organized in 5 parts:

1. Why is international monetary policy cooperation desirable?
2. What do empirics tell us? Experience of the G-7 countries
3. Theory: Hypothesis and explanatory mechanism that explain cooperation cycles
4. Working against the cycles: tools to make cooperation commitments more credible
5. Lessons for the Pacific Region

Definition of cooperation: mutual adjustment of nations policy behavior in a particular issue-area, achieve through an implicit or explicit process of inter-state bargaining.

1 Why is international monetary policy cooperation desirable?

Cost-Benefit-analysis:
Benefits: Internalization of externalities resulting from economic openness and interdependence by giving each government partial control over the action of other governments
1 policy-optimizing approach: welfare-seeking governments bargain to achieve a Pareto-optimum
2 regime-reserving/public-goods approach: mutual compensation vis-à-vis economic or political shocks
(*Kenen* 1989, *Currie et al.* 1989: "on balance very large gains should not be expected (p.136)"
Costs: the magnitude of cost vary dependent on
1 the number of participating states among which coordination ought to be achieved
2 the costs attributed to the continuum of coordination frameworks: ad-hoc bargaining – fixed rules – integration
3 degree to which policy autonomy has to be surrendered
4 time-inconsistency problem probability of reneging and defection
5 distortion of incentives through moral-hazard: cooperation allows participants to collectively pursue politically convenient (particularistic), but economically (collective welfare) inefficient policies
6 "model uncertainty": problem of action under uncertainty of causal mechanisms and appropriate policy tools

Cohen et al.' general judgment: costs depend on further specifications of respective cooperation agreements, while potential gains and the prevention of shocks provide an incentive to "optimize" the institutionalization of agreements.

2 What do empirics tell us?

In short: Experience of the G-7 countries display commitment cycles
Round 1: Plaza Agreement (1985) – Louvre Accord (1987): the G5 (from '86 on the G7) agree on a process of "multilateral surveillance of one another's policies" (p.140) to fight speculative bubbles on exchange markets. National preferences are in "harmony" at the time: the common goal is to promote an appreciation of non-dollar-currencies relative to the dollar in a multilateral attempt to prevent the damaging resurgence of protectionism in the US caused by an overvalued dollar. Dilemma: The appreciation of non-dollar-currencies increases inflationary pressures in the respective countries and worsens their export competitiveness, both of which become incentives to defect (Germany & Japan).
Round 2: Feb '87- Oct '87: the G7 reaffirm their intention to stabilize their exchange rate levels reasonably successfully, however not by internal fiscal or monetary adjustments but by way of massive exchange market interventions. Germany insists on prioritizing inflation stability over exchange rate stability. Japanese and German defection leads to the steepest meltdown of global stock values since '29 as a result of global rises in bond rates.

Round 3: Oct 87- Sep '90 : "Telephone Accord" reaffirms the monetary cooperation of the G7 and their common attempt to support the dollar after is crash. Cooperation is achieved until Feb '89 when increasing inflationary pressures in Germany and US deter their governments from a concerted rate cut as requested by Japan.
Round 4: Sep ' 90 – 93: the participating countries reaffirm their monetary cooperation and intended stabilization of their exchange rates after Hussein's invasion in Kuwait and the resulting shock in oil prices. The decline of the dollar continued and from '91 on conflicts over interest rates dominated the relations of the Triad.

3 Theory: Hypothesis and explanatory mechanism that explain cooperation cycles

According to the theoretic assumptions of Robert Mundell (1968) there exists an intrinsic incompatibility of exchange-rate stability, capital mobility and monetary policy autonomy = the "unholy trinity": *"over time, the three goals cannot be attained simultaneously* "(p. 147). With an international consensus on capital mobility, there exists therefore a direct trade-off between exchange-rate stability and monetary policy autonomy.

Based on these assumptions, **Cohen 's hypothesis** is that,
1 *"For each participating country both cost and benefit vary systematically with the degree of policy cooperation* [from full monetary integration over "automatic rules" to absolute monetary independence]*, and that it is through the interaction of these costs and benefits that we get the episodic quality of the cooperation process we observe in practice" (149).*
2 Initial moves toward coordinated decision-making may be treated ad virtually costless, whereas further steps may be seen as increasingly threatening. "*Thus, the marginal cost of policy cooperation for each country tends to rise systematically even as the marginal benefits may be assumed to fall*" (149). Cohen's logic grounds in the assumption that benefits from exchange-rate stabilization accrue at the beginning of monetary cooperation (reduction of TAC, positive market expectations), whereas costs (exogenously given by domestic processes) increase as policy makers are confronted with tradeoffs between external stabilization and domestic policy goals like high employment. While costs can be taken as stationary (exogenously given, direct reflections of policymakers' domestic policy preferences), the costs can be considered as rather dynamic reflecting shifts in market expectations over time, thus that policy makers tend to defect when the (domestic) costs of monetary cooperation increase until opposing domestic and international pressures [shocks in market confidence, which are by definition unpredictable] prompt policy makers to resume exchange rate cooperation. Once confidence is restored, growing discrepancies between the perceived costs and benefits of exchange rate cooperation will again undermine governments' commitments. This dynamic process thus leads to cyclic movements in the degree of cooperation.

Cohen's interpretation of the empirical findings is therefore: " *In all four instances the collective commitment to cooperation was initially stimulated by an exogenous or policy-induced, confidence-shaking shock. And in each instance the commitment was eventually undermined, once confidence was restored, by a growing discrepancy between the perceive costs and benefits of that commitment" (151).*

4 Working against the cycles: tools to make cooperation commitments more credible

To prevent policy-makers effectively from defecting from exchange rate cooperation, Cohen points at possibilities like monetary integration and/or the centralization of monetary policy with a supranational authority (EMU), a "hegemonic" leadership which takes on the necessary responsibilities (Germany during the snake and the EMS) and/or a self-disciplining regime of norms and rules accepted as binding on all participants based on the principle of automaticity (what the G7 (8) could become).

5 Lessons for the Pacific Region

Cohen makes out incentives for cooperation: *"even without such a commitment most regional governments will find their policy autonomy increasingly eroded in the coming decade – and in a manner that may seem even less appealing to them than formal cooperation' (155)*

His outlook on the Pacific region is rather skeptical however, since he thinks that a sustained commitment to monetary cooperation requires a sense of community among the countries involved and multiple cooperation on a range of issues, while the Pacific area has problems in defining its territorial scope in the first place and has been affected by sustained antagonisms, ethic and cultural conflicts and border disputes.