Monetary Autonomy and Asymmetric Adaptation

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Abstract
International monetary coordination schemes tend towards pronounced asymmetry, reflecting the underlying characteristics of mutual monetary dependence. Coordination among states takes place, but it is not usually a balanced and reciprocal process: instead, followers tend to adapt (more or less completely, depending on a variety of factors) to essentially impassive policy leaders. And the leader’s initial relative autonomy tends to be reinforced by this process, as the transitional costs of adjustment are disproportionately borne by its partners. This chapter advances four broad observations about monetary coordination before turning to a rationalist explanation of these phenomena.

Keywords
monetary relations, economic adjustment, policy leadership.
Introduction

Extensive international economic intercourse threatens national autonomy in two ways. The first, and at present by far the more important, is through each country’s balance of international payments […]

Richard Cooper, The Economics of Interdependence

We must also be careful not to define interdependence in terms of situations of evenly balanced mutual dependence. It is asymmetries in dependence that are most like to provide sources of influence for actors in their dealings with one another. Less dependent actors can often use the interdependent relationship as a source of power in bargaining over an issue and perhaps to affect other issues […] And that is where the heart of the political bargaining process of interdependence lies.

Robert O. Keohane and Joseph S. Nye, Power and Interdependence

International monetary policy coordination often involves some degree of adaptation of domestic policies—that is, the pursuit of policies that differ from the underlying preferences of national authorities in order to accommodate external considerations. A key question, therefore, is whether states coordinate their behaviour because their respective authorities want to do so, or because they feel obliged to do so. However intractable, this question is central to any serious discussion of power.

The liberal institutionalist IPE literature is generally quite optimistic about the possibilities for institutionalized cooperation of all sorts, including a negotiated division of the transitional costs of monetary adjustment. I am not so optimistic, and especially not with respect to international monetary cooperation. As we will see, international monetary coordination schemes tend towards pronounced asymmetry, reflecting the underlying characteristics of mutual monetary dependence. Coordination among states takes place, but it is not usually a balanced and reciprocal process: instead, followers tend to adapt (more or less completely, depending on a variety of factors) to essentially impassive policy leaders. And the leader’s initial relative autonomy tends to be reinforced by this process, as the transitional costs of adjustment are disproportionately borne by its partners.

In this paper I develop a rationalist explanation of this phenomenon. Before doing so, however, it is important to clarify some terminology and then to underline exactly what is it that I seek to explain. I therefore introduce some useful definitions and then advance four broad observations about monetary coordination before turning to the analysis itself.

Coordination, Cooperation, and Convergence

To limit payments imbalances states need to coordinate their policies, at least to some degree. And the demand for coordination is especially intense when capital is mobile. But coordination is different from convergence, which implies sameness, and from cooperation, a term that connotes both individual willingness and joint burden-sharing. In fact much coordination is undertaken more or less
unilaterally, simply because the alternatives are considered relatively costly, and hence is not ‘cooperative’ in the commonsense meaning of the term.\(^6\)

Consider first the distinction between coordination and convergence. Strictly speaking, coordinated policies are policies that are well suited to one another.\(^7\) What this means in practice depends upon context, in terms of both the objectives of governments and the circumstances in which they act on those objectives. For example, the coordination of macroeconomic policies in order to promote exchange-rate stabilization under conditions of advanced financial integration normally requires a substantial subordination of domestic monetary policy, and in particular the short-term interest rate. Under such circumstances, monetary policies that are merely similar (or in other words convergent) may or may not be coordinated—that is, well suited to one another.

To illustrate this point, note that states participating in the exchange rate mechanism (ERM) of the EMS during the foreign-exchange crises of 1992 and 1993 and experiencing speculative outflows of capital needed to raise interest rates to levels not merely matching but in fact far surpassing German rates in order to maintain their exchange-rate pegs to the mark.\(^8\) This constituted an extreme instance of a more general phenomenon that Machlup called ‘compensatory corrections’. Machlup’s term refers to policies designed to reduce the immediate need for adjustment without constituting real adjustment—in other words, without effecting a marginal reallocation of resources. In the case of the ERM crisis, authorities hoped to reverse short-term capital inflows in order to balance external accounts. Accordingly, interest rates in the Federal Republic’s ERM partners diverged from German policy not as a display of policy independence but in order to respond to presumably temporary payments imbalances, hoping to do so without reducing their absorption relative to income.\(^10\) Policy was therefore temporarily divergent, but it was a case of what might be deemed ‘compensatory divergence’: the reason for divergence was specifically to promote coordination, understood in terms of limiting payments imbalances and validating the ERM regime.

A jigsaw puzzle provides a useful metaphor for the distinction between policy coordination and policy convergence. A puzzle’s pieces are coordinated when they go together well, not when they are identical to one another. Analogously, coordination implies convergence only under restrictive conditions, understood in terms of both context and intent.

Let us turn now to the distinction between coordination and cooperation. Robert Keohane’s classic (1984) work\(^11\) on the politics of international policy cooperation introduced a typology of harmony, cooperation and discord. This typology is enormously useful, particularly in its clear distinction between coordinated outcomes that result for good fortune (harmony) and those that result from effort (what Keohane calls cooperation). Indeed, Keohane’s framework has since become the basis of ‘a

\(^6\) Cooperation also has a technical meaning in the public choice literature, referring to circumstances under which agreements are subject to binding third-party enforcement. This, too, is hardly the conventional meaning of the term.

\(^7\) Again, compare Keohane’s terminology as referenced in footnote 13.


\(^10\) By contrast, monetary authorities in the United Kingdom demonstrated their policy independence by refusing to raise interest rates in order to defend sterling’s DM-parity. Somewhat paradoxically, the result was that UK interest rates were (at least temporarily) more convergent with German rates than were those of several of the states remaining within the ERM.

consensus on a definition of cooperation’ within the discipline of international relations. But this consensus is itself in some ways unfortunate, since Keohane’s framework relied on a close identification—indeed, a near identity—between the concepts of coordination and cooperation.

But coordination often results from a process that has nothing to do with cooperation, at least as the latter term is conventionally understood—that is, joint effort towards a common end. Sometimes—and in the case of international monetary relations, often—coordination results from the more or less complete subordination of one country’s policy to another’s, with no hint of reciprocity. Certainly there is no a priori reason to associate coordination with cooperation. I will return to the point later, but for the present I simply draw attention to the distinctive meanings of coordination, cooperation, and convergence.

**Patterns of Monetary Coordination**

Turning now more specifically to monetary coordination, four broad observations follow. These regard the paucity of formal negotiations regarding payments pressures, the tendency of coordination to occur even in the absence of formal negotiations, the different kinds of macroeconomic issues that actually do receive attention in intergovernmental forums, and the tendency of formal monetary arrangements to reproduce underlying asymmetries.

The first such observation is that formal negotiations intended to limit exchange rate pressures are relatively rare. The Canadians do not call for periodic meetings with the Americans to discuss monetary policy coordination; indeed, as Louis Pauly’s contribution to this project underlines, they sought to avoid such meetings if at all possible. Negotiations of this variety would likely be a source of embarrassment for all concerned—the strong because of their strength, the weak because of their weakness—that is inconsistent with diplomatic norms that insist upon formal equality among states. The power dynamic is therefore likely to remain in the background, implicitly understood by the parties to a potential negotiation that never takes place because its outcome is understood by all to be at least substantially preordained.

Exceptions to this rule are possible when the parties are of roughly equal economic size and influence, and hence share roughly symmetrical profiles of sensitivity and vulnerability; these exceptions become more likely when there are other close political connections between the parties, allowing monetary policy to be linked to discussions in other important fields. Examples of the former situation include Benelux cooperation efforts in the run-up to World War Two and especially in its aftermath; examples of the latter situation include policy cooperation efforts between the United States and western Europe in the 1960s, embedded in the larger security and economic frameworks of the Atlantic partnership, and within the European currency ‘snake’ and EMS during the 1970s and 1980s, embedded in the larger framework of what was then called the European Community. But, on the whole, formal negotiations regarding monetary coordination are rare.

Second and relatedly, a substantial degree of monetary coordination is likely to result anyhow. It typically assumes a highly asymmetric form, however, and takes place in the absence of genuinely cooperative processes—that is, processes entailing at least some degree of reciprocity—but it will take place. Indeed if monetary coordination does not take place in the absence of formal negotiations, it is unlikely to take place because of them. States that are sufficiently large to be indifferent, even on occasion, to policy discord are also sufficiently large that they generally find adapting their domestic

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13 ‘Cooperation requires that the actions of separate individuals or organizations—which are not in pre-existent harmony—be brought into conformity with one another through a process of negotiation, which is often referred to as “policy coordination”.’ Keohane, *After Hegemony*, p. 51. The key passages are on pp. 51-55, including the graphic on p. 53.

policies to accommodate joint goals to be an extremely onerous task. Coordination among such parties truly is more likely to result from the temporary and felicitous harmonization of preferences than from negotiated mutual accommodation.\textsuperscript{15}

Thus the last time that the world’s leading economic powers negotiated substantial adaptations of their domestic policies with the aim of reducing payments imbalances, or the effects thereof, was in the 1960s. But if that statement is correct, what are we to make of the periodic (if mostly unsuccessful) policy cooperation experiments at the G7/G8 level of the last thirty years? This brings me to my third observation: \textit{increasingly, monetary coordination negotiations do not even aim at reciprocal policy adaptation in order to limit payments imbalances.} For the most part, such negotiations really are a relic of the Bretton Woods era. Instead, more recent cooperative arrangements amongst the major monetary powers, arrangements such as the Plaza Agreement and the Louvre Accord, simply signal a willingness to tolerate (or resist) exchange rate movements through coordinated intervention in foreign exchange markets. In other words, they entail no adaptation of domestic policy whatsoever. Exchange market intervention works best when it conforms with existing policy, and in this sense can be taken as a commitment to that policy. But there is little evidence that any of the participants in either Plaza or Louvre changed their domestic monetary policies as a result of these agreements.

True, there have been other arrangements, like those agreed at the Bonn conference of 1978, that aim at parallel demand management—stimulating major economies in tandem so that major new imbalances do not result, as would be the case if demand stimulus were taken in isolation. Such agreements can be important. However, in analytical terms they have more in common with trade negotiations than they have with the far more ubiquitous monetary interactions discussed in the bulk of this paper. Trade negotiators seeking concessions from their partners are unlikely to be successful without promising reciprocal action on the part of their own governments; likewise governments seeking to promote joint expansion must promise action of their own; and oftentimes the promises they offer are not compelling. Hence in both cases a dynamic obtains where the strong cannot accomplish their objectives simply by refusing to act. But, as the following analysis demonstrates, it is precisely the ability of leading monetary powers to bring about coordination by their own inaction that is a central feature of most ‘garden-variety’ monetary interactions.

In sum, while the Bonn summit is generally regarded as a magnificent (if only partial) exception to the principle that governments cannot coordinate their policies; the truth is more complex. While discussions about joint stimulus may constitute a major subset of formal government-to-government macroeconomic negotiations, this is precisely because the most common form of international monetary coordination—adaptation of domestic policy in order to limit payments pressures—rarely rises to the surface of such discussions.

A final observation concerns the form that cooperative arrangements aimed at facilitating monetary coordination, if they arise at all, are likely to assume. Because states differ in the way they assess the benefits of policy coordination, \textit{the institutionalization of shared responsibility for undertaking domestic policy adjustments is unlikely.} Genuine monetary cooperation would require dividing policy adjustment responsibilities (burden-sharing) and then monitoring the implementation of such agreements—not easy matters. Indeed, mutual accommodation is a difficult to maintain even when authorities both strongly favour coordination over discord.

On the other hand, formal policy regimes based on asymmetric adaptation are comparatively easy to organize—for example, by establishing rules governing mutual access to credit\textsuperscript{16}—and relatively


\textsuperscript{16}
straightforward affairs to run. Of course the key to making such arrangements politically palatable is to deny, at least formally, the asymmetric nature of the relationship; thus the exchange rate mechanisms of both the European currency ‘snake’ and the EMS were based on bilateral parity grids in which each party was a formal equal. These systems worked, however, because it was widely understood that Germany would not adapt its domestic monetary policy to accommodate its partners’ behaviour, and because the resulting asymmetry was (for varying reasons) acceptable to Bonn’s partners.17

More generally, the substance of asymmetric monetary regimes generally consists of subordinating domestic policy to an external target. Compliance with this objective can be judged relatively easily, at least as compared with monitoring an agreement where the transitional adjustment burden is shared; in an asymmetric setting, monetary followers either are, or they are not, validating the regime with their domestic policy choices. These qualities help explain why asymmetric regimes exist in such relative abundance.18 The regime’s rules do not create the asymmetries, they simply acknowledge them.

International monetary institutions rarely create power asymmetries; the parties to such agreements would not permit this. But neither do institutional arrangements tend to erase power differentials: they simply clarify the terms under which power is manifested (by policy leaders) and accommodated (by the policy followers).19 Little surprise, then, that even when good will prevails, monetary coordination efforts typically boil down to a contest between potential policy leaders.20 Efforts to share adjustment costs are understandable, but apt to prove unstable. Instead, ‘nature’—the nature of monetary interdependence, that is—favours a hierarchy. The remainder of this paper seeks to understand why this is so.

Preferences, Policies, and Political Methodologies

As discussed earlier, monetary policies sometimes diverge in order to promote coordination. This fact, and the associate discussion of the ERM crisis of 1992-3, should serve as warnings of the difficulties associated with indiscriminate statistical analyses of monetary policy independence.21 While policy convergence may sometimes usefully serve as an initial approximation of coordination, the terms are not synonymous; treating them as such can be misleading. As Clifford Geertz reminds us, though there may be little physical differentiation between a wink and a blink, there is a world of difference in intention and meaning.22 Likewise monetary policy must be evaluated in terms of intent, even if this is

(Contd.)


17 The EMS literature tends to stress the normative and disciplinary desirability of EMS participation; see, (e.g., Kathleen McNamara, 1998. *The Currency of Ideas: Monetary Politics in the European Union*. Princeton, N.J.: Princeton University Press). Surely this persuasive dimension was important in shaping how authorities understood (and explained) their policies. But there was a coercive dimension as well, as Germany’s partner’s had no superior alternatives on offer.


19 Those same institutional arrangements may end up defining the limits of the leading state’s power as well; see Scott Cooper, *Defining the Limits of Monetary Power Within Currency Areas*. EUI Working Paper RSCAS No. 2005/09. But those limits generally derive from changes in the partners’ relative positions, not from the institutional arrangements themselves.

20 The tense Franco-German discussions of 1992-93 attest to this; see Andrews, ‘European Monetary Diplomacy’.

21 This observation may help explain why Rose 1994 finds a weak empirical relationship between policy divergence, capital mobility, and exchange-rate volatility.

difficult to ascertain, if we are to make sense of the political meaning of policy and not simply ascribe behaviour to the political equivalent of physical reflex.

The introduction of intent to the discussion is both necessary and perilous. It is necessary because analysts with an eye towards power relations must remain constantly alert to the possible disjunction between underlying policy preferences and observed policy behaviour. Underlying preferences cannot simply be assumed to be ‘revealed’ by policy behaviour; indeed the existence of disjunctions between ambition and action is amongst the central forms of evidence the analyst requires in order to identify the exercise of power. Such a disconnection between preferences and behaviour does not in itself constitute definitive evidence that power is being exercised, but it is a necessary and substantial form of evidence thereof.

But attention to actors’ intentions is perilous as well, inasmuch as it highlights a central methodological challenge: the difficulty of ascribing motives to behaviour. Motivations are, of course, notoriously difficult to judge. As a mocking Richelieu is reputed to have said upon the death of a rival, ‘I wonder what his motive was’.

The methodologies increasingly central to the mainstream of the discipline (formal modelling coupled with large-N tests) generally reflect the Cardinal’s scepticism. Preferences are generally inferred from behaviour; in more technical treatments, actors’ ‘revealed preferences’ allow the analyst to construct indifference curves.23 Sadly, however, these same methods typically provide little leverage on problems associated with power, including the critical question at issue here: whether states have adapted policy away from desired outcomes in order to accommodate external influences (power). As a consequence, different methodologies—including the close examination of internal discussions relevant to key decisions—will need to be at least occasionally invoked. Perhaps this is one reason why IPE theorists have generally had so little to say about power in recent years.

In short, methodological partiality must not be permitted to undermine serious consideration of the purposes or intentions of national monetary authorities. Why did policy makers adopt particular policies under particular circumstances? What were their objectives? What did they perceive to be their options? What did they believe would be the consequences of their actions, and of other actions that they might have undertaken? Absent consideration of these and like questions, analysis of power relations is not merely hamstrung; it is impossible. Power disappears from the analysis because it has been excluded from the inquiry; all instances of coordination become instances of cooperation, because no other alternatives are seriously entertained.

International Policy Interactions

Attention to actors’ underlying preferences allows us to address a key question in the study of policy coordination efforts. Whereas coordination refers to policies that are mutually well suited—whether or not by design—cooperation suggests at least some degree of intentional action on the part of at least some actors.24 Keohane’s25 tripartite formulation of harmony, cooperation, and discord relied on this distinction. Policies were considered to be harmonious when each actor’s independent choices were already regarded by others as facilitating the attainment of their goals; in other words, coordination was a serendipitous outcome. If this condition failed to obtain, actors could either adjust their policies, resulting in cooperation, or fail to do so, resulting in discord.26

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23 In the case of collective actors, revealed preferences take the form of a reaction function.
25 After Hegemony.
26 Keohane, After Hegemony, pp. 51-54 (see especially the visual representation on p. 53). Once again, this is the passage that Milner, ‘International Theories of Cooperation’, p. 467, refers to this passage as the basis for ‘a consensus on a definition of cooperation’ within the discipline.
As already suggested, this framework tends to conflate coordination and cooperation. Policy coordination and discord are more helpfully understood as possible outcomes that can result from any of a variety of different processes; these processes might be cooperative (that is, they might involve joint effort) or they might not. Here I offer a modest amendment to Keohane’s typology to make this point more clear.

To begin with, international policy interactions can be characterized in terms of two considerations: the role played by domestic policy adaptations and the extent to which resulting policies are consistent with those of key external partners. Here I treat adaptation as a subset of monetary adjustment options. Real adjustment can take place either through changes in the exchange rate or in domestic policies (whether expenditure-changing or expenditure-switching); adaptation, on the other hand, refers to the domestic subset of this broader menu, or in other words to changes in domestic policies that aim at limiting payments imbalances without reliance on exchange-rate flexibility. These considerations, represented dichotomously, are the subject of Figure 1.

Figure 1. International Policy Interactions

| External consistency: Are policies coordinated with those of key partners? |
|---------------------------|---------------------------|
| Yes | No |
| Coordination I: ‘constructed coordination’ (successful adaptation) | Policy discord I: ‘coordination failure’ (unsuccessful adaptation) |
| Domestic adaptation: Were domestic policies altered to promote external consistency? |
| Yes | No |
| Coordination II: ‘spontaneous coordination’, or harmony (autonomous policies felicitously coincide) | Policy discord II: ‘mutual indifference’ (autonomous policies fail to coincide) |

Note that this depiction captures Keohane’s central distinction between two different forms of coordination—that is, between ‘spontaneous coordination’ (or what he termed harmony) and ‘constructed coordination’. Keohane referred to this latter outcome as ‘cooperation’, but as we shall see there are numerous bases upon which successful coordination can be constructed; not all of them are cooperative.

In addition, this typology permits the analyst to distinguish between two very different forms of discord, or in other words the absence of policy coordination. The first of these, ‘coordination failure’,

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27 As discussed previously, the extent and nature of policy coordination required to achieve external consistency depends on the nature of authorities’ objectives.


29 Of course these two options (domestic policy adaptation and exchange rate flexibility) are not mutually exclusive; here I simply mean to distinguish between these two routes to adjustment.

30 Compare the figure in Keohane, After Hegemony, p. 53. Of course the concepts in Figure 2 are better thought of in continuous than dichotomous terms, but depicting the extreme cases serves a useful heuristic purpose.
suggests genuine unhappiness on the part of at least some governments: policies were adapted but the hoped-for results failed to materialize, whether because of insufficient effort, or model failure, or for some other reason. But the second form of policy discord (‘mutual indifference’) suggests an entirely different state of affairs: policies are mutually inconsistent with respect to some broadly shared objective, but no party cares enough about this to modify its internal policies. In fact this was the sought-after outcome, at least for some parties, of the shift to flexible exchange rates in the early 1970s: states would be able to pursue policies of their choosing without having to worry excessively about either external context or consequences. This would indeed constitute ‘discord’ of a sort, in the sense that policies failed to coincide, but the politics of the resulting situation are completely different from those of a ‘coordination failure’—which, at least in the eyes of US monetary authorities, the Bretton Woods system had become.

Most of the IPE literature since After Hegemony dwells on the left-hand side of Figure 1, and especially the distinction between constructed and spontaneous coordination (harmony). But we ignore cases characterized by the absence of coordination at our peril, and especially the difference between instances of discord that result from mutual indifference and those that result from coordination failure. Monetary relations between the US and eurozone are and likely remain, at least most of the time, as example of mutual indifference: that is, while the Atlantic partners are not completely indifferent to changes in the euro-USD exchange rate, typically neither side will be prepared to alter policy in order to influence this value. On the other hand coordination failure can occur when states alter their policies (at least at the margins) in order to produce greater mutually consistency, but fail to achieve their objectives; this was the case, for example, in the wake of the Bonn 1978 summit. Coordination failure is far more problematic than mere mutual indifference, and yet the distinction between these two broad classes of discord has not received sustained theoretical attention. Nor has the range of possible processes that can be associated with constructed coordination, which is the subject of the next two sections.

**Constructing Policy Coordination: The Role of Power**

Cooperation certainly is one means by which states can arrive at coordinated outcomes. But it is not the only one, and in the realm of international monetary affairs it is not the predominant one. To make this point, it is essential that we distinguish between process and outcome.

Referring again to Figure 1, each of its major elements—the vertical and horizontal dimensions, and the resulting quadrants—refer to outcomes. In particular, Figure 1’s vertical dimension—'adaptation'—refers to whether domestic monetary policy reflects the underlying preferences of people.  

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31 By model failure I mean that the actors performed in a manner consistent with their causal beliefs about the necessary conditions to obtain a given set of results, but that these beliefs were mistaken. This differs somewhat from standard discussions in the literature about model uncertainty. On causal beliefs, see Robert O. Keohane and Judith Goldstein, 1993. *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change*. Ithaca: Cornell University Press; on model uncertainty, for recent discussions of model uncertainty as applied to international monetary affairs, see Keisuke Iida, 1999. *International Monetary Cooperation Among the United States, Japan, and Germany*. Boston: Kluwer Academic; and Thomas D. Willett, 1999. ‘Developments in the Political Economy of Policy Coordination’, *Open Economies Review*, 10, pp. 221-53.

32 Advocates of a shift to flexible exchange rates, or at least some of them, suggested that these frustrations could be avoided by a shift to a regime that would enable greater mutual policy independence. They argued that exchange rate movements would typically be smooth instead of violent, of modest proportions, and correspond to underlying economic fundamentals; furthermore, trade relations would endure the shift to floating because specialized currency contracts allowed both exporters and importers to hedge against the risks posed by these limited rate movements. The result would be a world in which national authorities would be at substantially greater liberty to pursue policies corresponding to diverse domestic preferences, without respect (or at least without undue attention) to external circumstances. For a survey of the early views of academic economists on desirability of floating rates, see the discussion in Thomas D. Willett, 1977. *Floating Exchange Rates and International Monetary Reform*. Washington, D.C.: American Enterprise Institute for Public Policy Research, pp. 15-22; for how those views held up in the face of events, see pp. 32-41.

national authorities, or whether it has departed from these preferences to accommodate external considerations. The figure’s lower half concerns the absence of policy adaptation, which is (by definition) policy independence, or procedural autonomy. But it is the upper half of Figure 1 that interests us most here, and in particular the upper-left-hand quadrant—that is, situations where policy coordination has been successfully obtained on the basis on adaptation. The question is, what was the process that produced coordination? More simply put, who did the adapting, and why?

This outcome—constructed coordination—is close to the hearts of most liberal institutionalist theorists, who tend almost instinctively to associate this state of affairs with cooperation. But it is entirely possible to ‘construct coordination’ on the basis of domination rather than cooperation—that is, on the basis of brute influence rather than mutual accommodation. And in between these two extremes lies the world of coercive diplomacy so familiar to students of international relations. It is, or at least should be, familiar to students of international monetary relations as well.

In its ideal form cooperation is a mode of action that is both voluntary and mutual. Each of these characteristics is important; consider first mutuality. Cooperation entails at least some degree of reciprocated burden-sharing among parties. Indeed the principal meaning of cooperation is to act jointly, or in other words to operate together towards a common end; thus cooperation is characterized, at a minimum, by concurrent effort or labour. If those conditions fail to obtain then, strictly speaking, there is no cooperation. But such burden-sharing is by no means the outstanding feature of international monetary arrangements, including those arrangements that successfully produce policy coordination. Oftentimes policy coordination results from a quite different set of calculations, as national authorities simply conclude that their states would be best served by unilaterally adapting their policies to external circumstances.

Consider now the role of volition. It makes little sense to speak of involuntary decisions as cooperative, except perhaps euphemistically. Thus while reciprocity is a necessary condition of cooperation, it is not a sufficient one. Many reciprocated behaviours are not cooperative either because they lack purpose altogether, or because they take place despite the will of the parties involved. An example of the former is the ebb and flow of tides; though reciprocal, these are involuntary in that they lack volition altogether. An example of the latter, and far more significant for present purposes, is human servitude.

But there is a wide range of action between the ideal types of cooperation, which is mutual and voluntary, and domination, in which outcomes are irresistibly imposed by the strong upon the weak. We can usefully think of the middle ground between these two endpoints as being characterized by some combination of persuasion and coercion. Persuasion is a mode of action in which outcomes are induced by means of argument or entreaty, by appeals to higher principle, or by efforts to change others’ preferences by non-coercive means (e.g., by use of reason). Coercion, of course, is quite different. At least in its active mode, it entails the use of pressure, threats, and intimidation to influence outcomes. While persuasion and coercion are obviously very different, they are not mutually exclusive; that is, political discourse may be and often is characterized by elements of both. Indeed it is the presence of satisfactory persuasive elements that render political discourse legitimate, and that hold the potential to transform mere power preponderance or hegemony into successful leadership.

Indeed both persuasion and coercion are means to exercise power, understood in terms of the ability of \( A \) to change the behaviour of \( B \) with respect to issue \( C \). Thus we must not confuse the mere introduction of coercive elements into discourse with compulsion, understood as an ideal type.

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34 Compare the discussion in Milner, ‘International Theories of Cooperation’, in which ‘cooperation can be imposed’. Even here, though, Milner offers a qualification: ‘if the stronger party also adjusts its own policies and attempts to realize mutual gains, cooperation has occurred’ (both quotes on p. 469) Even accepting for the sake of argument Milner’s suspension of willingness as a condition of cooperation, much coordinating behaviour in international monetary behaviour still fails to meet this corollary condition: the stronger party typically does not adjust its behaviour.

Compulsion, the mode of action associated with domination, implies that successful resistance is impossible; and, after all, coercive diplomacy often fails.\textsuperscript{36} Thus the range of diplomatic discourse, and in this instance the process by which states either agree or fail to agree on joint action, can be said to range from the purely cooperative, through the coercive and the persuasive, to the purely compulsory. This makes for a wide-ranging discourse indeed.

But the discussion in this section has so far focused on coercion’s active mode. Coercion also has a passive mode, in which pressure, threats and intimidation inhere in the system of relations itself rather than in the emanations of any government or other cognizant actor. In monetary affairs the chief difference between these active and passive modes, as Cohen (in this collection of working papers, EUI-WP RSCAS No. 2005/08) makes clear, is the extent to which the powerful state intends its policies to be threatening or is instead simply pursuing its preferred policies without conscious intent to impose its will on others. Thus coercion’s passive aspect corresponds to at least some aspects of what Susan Strange called ‘structural power’ (see the discussion by Eric Helleiner as part of this project).\textsuperscript{37} These passive threats inhere in the operation of the international monetary system; they threaten national autonomy, as Cooper put it in the quotation at the beginning of this paper, simply by the normal operation of the international monetary system, and especially as financial markets have become more integrated. But these passive conditions threaten national autonomy in unequal ways; hence their significance for any discussion of power within that system.

The main point here is that coercion, whether active or passive, has at least the potential to play a crucial role in the construction of international policy coordination. The next section discusses how this can take place.

\textbf{Passive Leadership and Asymmetric Adaptation}

As noted in the preceding section, national authorities sometimes conclude that their states are best served by unilaterally adapting internal policies to accommodate external circumstances rather than relying on negotiated reciprocity. The propensity of national authorities to engage in such actions differs across states; put differently, states differ in their assessments of the benefits of coordinating policies, and of the costs of acting to coordinate policies. In a well-known treatment of this problem (quoted at the outset of this paper), Keohane and Nye (1977) focused attention on the extent to which differing assessment result in asymmetric interdependencies.

National monetary authorities rationally differ in the degree of their attentiveness to particular exchange rates and in their capacity to influence these exchange rates without interfering with other important policy objectives.\textsuperscript{38} In particular, authorities from relatively large and closed economies are likely to draw markedly different conclusions about the costs and benefits of adapting their domestic policies than are authorities from relatively small and open economies. For example, while it is widely recognized that small, relatively open economies are more sensitive to exchange rate movements than

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are large, relatively closed economies, it is less widely understood that states differ in their capacity to target exchange rates effectively. Small states are typically better able to use domestic policies to target exchange rates than are large states (ceteris paribus), since their higher marginal propensity to import means that changes in domestic demand will have relatively greater consequences for the national payments position. Thus small states will, on average, be more attracted to exchange-rate stabilization schemes than are large states; the smaller states need the benefits more, and they are better suited to adapt their policies to attain these benefits.\footnote{39}

The result of these differing assessments is likely to be asymmetrical demand for coordination. These differences can be significant even when considered in terms of comparative statics; but the demand for coordination efforts is likely to become even more asymmetric in a dynamic context, where strategic considerations obtain. The result is typically asymmetric adaptation of domestic policies.

Figure 2 depicts this dynamic in stylized fashion. Assume two states, one quite small (A) and one very large (B), with a substantial degree of economic interaction between them. The initial macroeconomic policies of these two states (A\textsubscript{i} and B\textsubscript{i}) can be represented as points on a continuum; the existence of a space between the two points indicates a degree of mutual unsuitability between their policies, defined in terms of the generation of a payments imbalance between them. Barring for the moment any possibility of financing this imbalance either from reserves or from external sources, the result will be a movement of a given magnitude in the bilateral exchange rate. By adapting their internal policies, however, either one of these states (or both acting together) can reduce this space, and hence the resulting payments imbalance and associated exchange rate movement. In order for the bilateral exchange rate to remain completely stable, policies would (by definition) have to be fully coordinated, represented by elimination of the space between the policies: the two states’ policies would then occupy the same point on the continuum.\footnote{40}

\begin{figure}
\centering
\begin{tabular}{c}
\textbf{Figure 2. Differing Propensities to Coordinate Policies: Three Scenarios} \\
\hline
\hline
&A\textsubscript{i} &B\textsubscript{i} \\
\hline
&Initial positions & \\
&A\textsubscript{i} &A\textsubscript{1} &B\textsubscript{1} \\
&Scenario 1: State A in a static environment & \\
&A\textsubscript{2} &B\textsubscript{2} &B\textsubscript{i} \\
&Scenario 2: State B in a static environment & \\
&A\textsubscript{i} &A\textsubscript{3} &B\textsubscript{3} \\
&Scenario 3: States A and B in a dynamic environment & \\
\hline
\end{tabular}
\end{figure}

\footnote{39} Of course exchange-rate stabilization is only one possible object of international monetary coordination; other objectives are discussed in the conclusion to this paper.

\footnote{40} In accordance with the preceding discussion of compensatory divergence, the definition of coordination here is mutual suitability, not sameness; hence occupying the same point on the continuum need not imply policy convergence.
Consider then the likely behaviour of these two states, given the characteristics outlined above, under three different scenarios. The first scenario treats A’s policy decisions as taking place in a static environment; in other words, there is no possibility of reciprocity or response of any kind from B. Given the substantial sensitivity of A to movements in their mutual exchange rate, and given the relative ease with which A can manipulate its exchange rate by adapting its internal policies, A chooses to substantially coordinate its policies with B. A does not fully subordinate policies to B, as (by assumption) some modest movements in the bilateral exchange rate are regarded as an acceptable price to pay for a degree of autonomy in policymaking; but a fairly straightforward tallying of the costs and benefits of coordination leads the authorities in A to conclude that substantial adaptation of internal policies is in order. This is represented in Figure 2 by a correspondingly substantial reduction in the space between $A_1$ and $B_2$ (which, by assumption, is being treated as a fixed point identical to $B_2$).

Turn now to a second scenario, where B faces a static external policy environment; there is no possibility of adaptation on the part of A. Because of its relatively greater economic size (and correspondingly reduced level of economic openness), B is less sensitive to movements in the state’s bilateral exchange rate than is A; likewise it is more costly for B to adapt its internal policies in order to target the exchange rate. This does not mean that the authorities are completely indifferent to the bilateral rate; but they are much more likely to regard it as a residual of their domestic policy calculations rather than as an important input into those calculations. On many and perhaps even most occasions, they will therefore simply turn a blind eye to their currency’s external value. Occasionally, however, they will engage in modest adaptations of internal policy when the effects of payments imbalances become too great a nuisance to ignore; this is represented by a modest movement in $B_2$ towards A’s policy position (which, again by assumption, is treated as fixed and identical with $A_i$).

The final scenario is the most interesting one, in which both A and B are at liberty to adapt their policies to one another. But its result is represented as identical to the first scenario: A has substantially adapted its behaviour, while B has made no policy changes whatsoever. Why? Because authorities in B are relatively tolerant of movements in the exchange rate, and the adaptations engaged in unilaterally by A have substantially eliminated whatever little incentive there might have initially been for B to change its policies at all. Even faced with a static external environment, the authorities in B were rationally complacent about the considerable policy space that divided the two states in their initial positions, and they will likely be quite content with the greatly reduced space that divides them after A’s self-interested decisions. And if for some reason exchange rate pressures between the two states grow to levels that are genuinely disturbing (a very high threshold for B, a much lower one for A), authorities in B can generally rest assured that their counterparts in A will rush to do something about it.

I turn to the implications of this analysis for monetary cooperation efforts (that is, the negotiation of mutual accommodation) in the conclusion. But the preceding discussion should suffice to demonstrate that, in the absence of cooperative arrangements, the distribution of transitional adjustment costs will reflect relative indifference to the consequences of policy discord. Absent some formal or informal agreement to subvert this outcome, asymmetric monetary interdependence leads inexorably to asymmetric policy adaptation—and the asymmetry tends to be enhanced, not reduced, in a dynamic

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41 A more refined version of this model would have both A and B with fixed but differing reaction functions to movements in their mutual exchange rate. For example, A might respond to movements in the exchange rate of a certain magnitude by moving 80% of the way towards a fixed point B, and B might respond to the same exchange rate movement by moving 10% of the way towards a fixed point A. The resulting dynamic equilibrium would be for A to move roughly 78% of the way, and B roughly 2% of the way, towards one another’s initial positions.

policy environment. The capacity of economically larger and more insular states to act independently both shapes other states’ choices and, consequently, renders the resulting environment still more permissive for themselves. Autonomy begets influence which in turn begets enhanced autonomy.

Monetary Policy Cooperation and International Politics

We turn now to the question of cooperation: that is, government-to-government negotiations regarding mutual accommodation with the ultimate objective of policy coordination. As we have seen, policy coordination need not imply such cooperative efforts; coordination may instead result from self-interested, unilateral action absent negotiation. But policy negotiations do at least occasionally take place, and it is important to understand their underlying characteristics.

To begin with, monetary relations resemble other forms of joint interaction in certain key respects. One such similarity is that the potential rewards of joint action, as well as the potential costs of failing to act (whether jointly or singly), are likely to vary across parties. This observation lies at the heart of multiple theories of negotiation. While sharing this important characteristic inherent in all bargaining situations, however, monetary relations have certain distinctive characteristics as well. One important way in which international policy negotiations differ from certain other realms of bargaining—for example, international trade negotiations—is that the strong can typically accomplish their objectives simply by failing to act.

As mentioned earlier, when negotiating access to another state’s markets typically some form of reciprocity is required; the same is not true of most instances of monetary negotiation. As long as some party to those negotiations regards the costs of policy discord as high, there is a considerable likelihood that some degree of coordination will obtain. It will obtain because this relatively sensitive party will (in all likelihood) unilaterally undertake the actions necessary to reduce discord—including actions desired by stronger, or more indifferent, parties. The outcome will be a substantial coordination of policies, albeit an asymmetric one.

The likely distribution of the transitional costs of adjustment therefore hinges upon differences in the costs of failure to act unilaterally. A strong bargaining position derives at least in part from relative indifference to the possibility of monetary policy discord: parties that are better prepared to endure the consequences of policy discord will typically be able to avoid them simply by failing to act, obliging their more sensitive partners to bear the transitional costs. This does not mean that successful bargainers must regard policy discord as without cost. But since states vary substantially in the range of outcomes to which they are indifferent, and since international monetary relations are strategic in nature (exchange rates being mutual phenomena), variation in sensitivity will normally translate into bargaining power.

Of course, such calculations are necessarily contingent, leaving extensive room for posturing, bluffing, and collusion—the essence of negotiation. But the room for creative solutions in adjustment negotiations should not be overestimated. Since the chief variables identified by optimum currency area theorists as crucial to informing national monetary authorities’ policy preferences are fairly easily surmised by officials

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43 That is, B has greater autonomy in scenario 3 (dynamic interaction) than in scenario 2 (where it responds to a static environment).


45 See again the quote from Keohane and Nye, Power and Interdependence at the outset of this paper.

46 For example, sincerity is no guarantee of genuine cooperation (i.e., mutual accommodation). In an examination of multilateral bargaining situation under incomplete information with strategic characteristics similar to those examined here, Roger Myerson 1979, ‘Incentive Compatibility and the Bargaining Problem’, Econometrica, 47, pp. 61-74), concludes that honest revelation of private information by individual bargainers—for example, the sharing of national economic data—is incompatible with Pareto efficient outcomes.
from neighbouring states, the prospects for bamboozling one’s partners appear dim. In other words, officials from a small, economically open state (for example, Belgium) are unlikely to persuade their counterparts from a much larger, more economically closed state (for example, Germany) that the latter has a pressing national interest in stabilizing the mutual exchange rate of the two countries’ currencies.

Asymmetric adaptation may be a general characteristic of complex interdependence, but it is particularly acute in the field of monetary relations. There, policy leaders can achieve their objectives simply by failing to take into account the preferences of their followers. What Thucydides said of international politics generally is therefore particularly true of its monetary domain: the strong do what they can while the weak suffer what they must.  

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47 Nevertheless, the subjective element of these assessments remains important. Contemporary perceptions (rather than ex post appraisals) must inform ex ante analysis of bargaining power. While contemporaneous perceptions may subsequently prove inaccurate, the result of information updating will be to change future, not present, bargaining positions.