Referee Report on

Global Governance of Global Monetary Relations: Rationale and Feasability

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The paper stresses different directions in the development of international trade and monetary integration. Whereas international trade integration in manufacturing goods markets has continued to intensify, international monetary integration seems, with the major exception of Europe, to have taken the opposite direction towards more exchange rate flexibility. Against the (dominating) view that inflation targeting and exchange rate flexibility are the appropriate responses to liberalized capital markets and global imbalances, the author stresses the negative externalities of exchange rate volatility and competitive depreciations. He proposes monetary policy coordination of the world's largest central banks which is surveilled by IMF or BIS.

While the recent discussion about the pro and cons of exchange rate flexibility has focued on bilateral current account balances and the macroeconomic response to asymmetric shocks, the paper takes a more comprehensive and foresighted view of international monetary relations by discussing the national and global welfare effects of international monetary coordination. To this end the paper makes an important contribution to the current discussion about monetary policy adjustment to country-specific shocks. I think that the argument is convincing and propose the following amendments.

(1) The paper acknowledges only implicitly that the world monetary system is asymmetric with a small number of large financial centers (mainly US and euro area) pursuing flexible exchange rates, and large number of small open economies pegging their exchange rates more or less tightly to the dollar or the euro. Although the arguments in favor of fixed exchange rate strategies as listed on page 7 may be straightforward for the small open periphery economies, the author's pledge in favour of international monetary cooperation (as suggested on page 21) may be less convincing for the large financial centers. In the paper it becomes evident comparatively late that the foucs is on the large financial centers. I would propose to stress earlier and more explicitly that the paper disusses the exchange rate strategies of the large countries and apply the arguments primarily to this country group. This may lead to different conclusions.

(2) Although the arguments in favour of fixed exchange rates as discussed on page 7 are straightforward for small open economies (McKinnon 1963), the large financial centers are likely to favor monetary policy independence and exchange rate flexibility for two pivotal reasons. First, following Mundell (1961) monetary and exchange rate policies are needed to address domestic (asymmetric) shocks (as for instance recently in response to the financial crisis). Second, once a monetary integration/coordination of the euro area and the US is considered, the N-1 currency problem has to be resolved. Because a symmetric system of monetary coordiation is unlikely to be stable, one country would have to be in center position with the other one being in the duty of monetary coordination, i.e. exchange rate stabilization.

(3) Although the author acknowledges on page 21 that such monetary coordiation among the large financial centers is unlikely to be forthcoming in the near future, he encourages a debate about such an arrangement. This discussion would be stimulating if it would be based on "stylized patterns" of monetary behavior of potential center countries and the implications for the periphery countries with hard or soft exchange rate targets. Since the early 1980s we have

observed a continous downward trend in interest rate levels of the large financial centers which has been accompanied by rising volatility in world stock, real estate and raw material markets. If nominal and real interest rates in the financial centers continue to decline (which seems likely since the recent financial crisis), nominal interest rates are likely to approach zero and real interest rates will become negative. It would be stimulating to explore the consequences of future price and economic stability in the world under such macroeconomic circumstances. Would countries be eager to coordinate their monetary policies with countries which keep their interest rates at an extremely low level? In an extreme case all countries may coordiate their monetary policies by holding their interest rates at zero...

Minor remarks:
p.7, second para, first sentence: The verb is missing.
p. 7, second para. The discussion concerning the misalignment of bilateral exchange rates is a controversial one (see Cline 2005 against McKinnon and Schnabl 2006).
p. 10, second para: I am not aware that the EMS crisis led to serious pledges in favour of intra-EU market protection. The case that certain currencies depreciated against the German mark was not a new one.

References:

McKinnon Ronald 1963: Optimum Currency Areas. *American Economic Review* 53, 717–725.

McKinnon Ronald / Schnabl, Gunther 2006: Devaluing the Dollar: A Critical Analysis of William Cline’s Case for a New Plaza Agreement. *Journal of Policy Modelling* 28, 6, 683-694.

Mundell, Robert 1961: A Theory of Optimal Currency Areas. *American Economic Review* 51, 4, 657–665.