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International Economic Cooperation: Introduction

Martin Feldstein

Although some form of economic cooperation has been a part of international political relations during most of this century, American interest in international economic cooperation has increased substantially in recent years. This heightened desire to coordinate economic policies with the other major economic powers is in part a response to the special problems of the 1980s: the sharp fluctuations in exchange rates, the massive shifts in the trade balance, and the explosive growth of debt among many of the developing countries.

The increased interest in international economic cooperation also reflects the more fundamental changes in the world economy that have been evolving over a longer period of time. The world economy has become more interdependent: international trade has increased relative to production for domestic markets and international capital markets have become larger and more active. In addition, the United States has lost the dominant economic position that it enjoyed in the early postwar years. Japan and the European Economic Community (EEC) have become major economic powers that compete effectively in trade and finance.

How has policy coordination evolved in this changing environment? How have the changes in the world economy altered the problems and possibilities of international economic cooperation? What are the prospects and potential benefits and costs of increased cooperation in the future?

To assess these questions, I asked four NBER Research Associates—Stanley Fischer of the Massachusetts Institute of Technology, Richard Marston of the University of Pennsylvania, David Richardson of the University of Wisconsin, and Jeffrey Sachs of Harvard—to prepare background papers that discussed the academic research and the historic

experience in four areas of international economic cooperation: macroeconomic policy, exchange rate policy, international trade, and developing country debt. I also asked a distinguished group of individuals who have played leading roles in business and government to write personal statements on their own perceptions of these issues. This group then gathered for several days of intense discussions in April 1987.

The background papers and the discussion at the conference made it clear that the first two subjects—macroeconomic cooperation and exchange rate coordination—are very different from cooperation in international trade and in dealing with the international debtors. Cooperation in macroeconomic and exchange rate policies generally means redirecting and increasing the economic role of governments. In contrast, cooperation in international trade involves reducing the interference of governments in private markets. Experience with the international debt problem has shown little explicit intergovernmental cooperation except for the Paris Club negotiations that deal with debts to the governments themselves. It is useful therefore to begin by considering the macroeconomic and exchange rate coordination and then to turn to cooperation in international trade and in dealing with international debt.

Coordination of Macroeconomic Policy and Exchange Rates

Senior economic officials of the major governments talk with each other frequently in the context of Organization for Economic Cooperation and Development (OECD), International Monetary Fund (IMF), and Group of 7 (G-7; i.e., the seven largest economies in OECD) meetings as well as in bilateral sessions. In addition, the heads of the central banks meet monthly at the Basel meetings of the Bank for International Settlements (BIS). These meetings inevitably alter the way officials think about their own macroeconomic policies and increase their understanding of the policies being pursued by other governments. Since all of this is bound to influence each government's own policies, it serves as a type of implicit policy coordination. Such an exchange of information is clearly desirable and can help each country pursue its own policies more wisely.

It is useful, however, to focus on the more explicit types of macroeconomic and exchange rate coordination and, in this context, to consider two extreme positions. At one extreme is the idea that each country should manage its own domestic monetary and fiscal policies with a concern for its own well-being only and without trying to take into account the effect of its policies on the other countries of the world. A government may understand that its economy is affected by

the policies adopted elsewhere and that its own policies affect other countries but still choose to make its policy decisions unilaterally. At the other extreme is the view that each (industrial) country should formulate its economic policies in explicit coordination with every other (industrial) country so that the policies are chosen to maximize world economic welfare as a whole, or at least to achieve a configuration of policies from which no country can be made better off without making some other country worse off.

Although this statement of the alternatives might suggest that international coordination is unambiguously better than the uncoordinated pursuit of national self-interest, it is important to distinguish between the theoretical possibilities of idealized coordination and the realistic potential gains of practical coordination. In practice, despite its aspirations, international coordination may produce results that are not as satisfactory as those that result from each country's uncoordinated pursuit of national self-interest.

One reason why coordination may fail to achieve an improvement in world economic performance is that, as Stanley Fischer notes in his background paper, extensive statistical studies indicate that the monetary and fiscal policies of each country have only a relatively small effect on the level of economic activity and inflation in other countries. The potential gain from even perfect coordination is therefore likely to be small and easily overwhelmed in practice when the policies are less than ideal.

International policy coordination may fail to improve overall economic performance simply because the political officials who participate in these international negotiations choose policies that are politically convenient rather than economically sound. We know that this happens all too frequently at the domestic level. Why should we expect the same officials to follow a higher standard just because they are engaged in an international negotiation?

The process of international negotiation may also be counterproductive because it diverts attention and action from needed domestic policy changes. Governments may explicitly delay painful domestic policy changes as part of an international negotiating strategy designed to induce policy changes abroad that would make the domestic changes unnecessary. The emphasis on international negotiations may also re-channel domestic political pressures away from needed reforms. Recent experience provides ample examples of both dangers. Germany and Japan have failed to stimulate domestic demand enough because of their reliance on expectations of continued exchange rate stability. The U.S. Administration has diverted attention from the need for budget deficit reduction by emphasizing the favorable effects on U.S. exports of greater fiscal expansion abroad.

The ability of international macroeconomic coordination to permit countries to pursue more expansionary policies than would otherwise be possible is both a potential benefit and a potential danger. When a single country tries to expand by itself, it may soon find that rising imports create a balance of payments problem. A coordinated expansion by a group of trading partners can eliminate this balance of payments constraint and permit all of the countries to expand more than any of them could have done alone. When all economies are operating well below capacity, such coordinated expansion can provide gains for all. But the ability of coordination to circumvent the balance of payments constraint on expansionary policies also creates the temptation to overexpand. Without the automatic market check of a deteriorating balance of payments, governments may pursue inflationary policies that would otherwise be avoided. On balance, whether one regards the ability to achieve an expansion that would not be possible without coordinated action as a reason to favor coordination or to oppose it depends on the likelihood that governments will use that ability to pursue inflationary policies.

There is a further problem that arises because it is generally far more difficult to alter budget and tax policies than to change monetary policy. Macroeconomic coordination may in practice be limited to a coordination of only monetary policies. This is particularly the case in the United States because fiscal policy is controlled by the Congress which, even when its majority is of the same party as the President, may be reluctant to enact the tax changes, particularly tax increases, that a President wants. But the reliance on monetary rather than fiscal policy will also be true in other countries because of the greater political attention generated by changes in fiscal policy and the greater difficulty of reversing expansionary fiscal changes if they turn out to be inappropriate.

A monetary expansion or contraction is not generally an appropriate substitute for a fiscal change. For example, while tighter monetary policy in the United States could offset the aggregate demand effect of large budget deficits, it would not reduce real interest rates. More generally, monetary and fiscal policies that have equal expansionary effects at home can have opposite effects on the rest of the world. A fiscal expansion that raises real interest rates and appreciates the currency will unambiguously raise foreign exports and thereby stimulate the foreign economy. In contrast, a monetary expansion that temporarily reduces real interest rates will depreciate the currency and thereby reduce foreign exports.

The need to rely on monetary policy rather than fiscal policy is particularly a problem when the international coordination focuses on exchange rate stabilization. If the United States had been induced to stabilize the dollar in the early 1980s, it would have done so by in-

creasing the money supply rather than by cutting the budget deficit. This in turn would have increased the rate of inflation in the United States. Moreover, although the rise in inflation and in the price level would be sufficient to reduce the nominal value of the dollar, the real exchange rate might soon be back to the level that would have prevailed without any change in monetary policy. A commitment to exchange rate stabilization that leaves real exchange rates unchanged but causes higher inflation must be regarded as counterproductive.

Exchange rate targeting has become a central focus of all discussions of international economic cooperation. The sharp 80 percent increase in the value of the dollar between 1980 and early 1985 caused great distress to American firms that try to export or that compete with imports from abroad. Although the decline in the dollar that began in March 1985 started to shrink the real trade deficit about 18 months later, that deficit remains very large. The cries of pain continue to be heard from adversely affected American industries and regions, but these have now been joined by equally loud declarations of anguish and fear from Japan and Europe. As Richard Marston notes in his background paper, these currency misalignments are much more harmful than very short-term fluctuations in currency values.

But even while recognizing the serious damage caused by the dollar's sharp rise, it is important to ask whether the American economy would have been better off if the dollar had somehow been prevented from increasing in value in the early 1980s. Without the dollar's rise, we would not have had the trade deficit, but we also would not have had the major increase in capital inflow to the United States that automatically accompanied the increased trade deficit. The rise in the budget deficit would therefore have caused real interest rates to rise sharply, crowding out investment in housing and in industrial plants and equipment. The rise of the dollar acted like the opening of a safety valve, permitting the pressures that would otherwise have been concentrated on the domestic capital goods sector to spread to all parts of the economy that compete in international markets.

If a rise in government borrowing without the offsetting help of a strong capital inflow had caused a sharp rise in U.S. real interest rates, there would also have been strong political pressures on the Federal Reserve System to increase the monetary aggregates, a policy shift that would inevitably have increased the rate of inflation. While some have argued that the rise in interest rates would have forced the Administration and the Congress to reduce the budget deficit, I believe on the basis of my own experience within the Administration at that time that the substitution of the pain caused by higher interest rates for the problems caused by the strong dollar would not have changed the political response to the existing and projected budget deficits.

For those who want to evaluate whether a policy of stabilizing the real value of the dollar during the first half of the 1980s would have been better than permitting the dollar's rise that actually occurred, the relevant question is whether the adverse effects of the budget deficit would have been greater with or without the rise of the dollar. When government borrowing absorbed more than half of all U.S. domestic saving, was it better to attract capital from the rest of the world to maintain the relative level of investment in the United States or would it have been better to permit a sharp fall in U.S. domestic investment? Was it better to spread the crowding-out effects of the increased budget deficit to all parts of the manufacturing sector or would it have been better to concentrate them on the capital goods and construction sectors?

I think these questions are very difficult to answer, whether from the point of view of the United States or of the world economy as a whole. But in the absence of a clear demonstration to the contrary, I am inclined to believe that the market solution is likely to be better than one imposed by government controls. I believe therefore that allowing the dollar to rise, thus permitting the natural inflow of capital in response to the higher interest rates in the United States, was probably the preferable way of responding to the rapid increase in the budget deficit. But I hope that careful future research will eventually provide a more reliable basis for answering these questions.

The debate about the desirability of targeting the real level of the dollar presupposes that it is possible for governments to achieve such targets. The general consensus among economists, as Richard Marston indicates, is that exchange market intervention per se can have only a small and temporary effect on exchange rates. Several speakers at the conference emphasized that the recent expansion of global capital markets has further reduced the potential effects of government intervention. Shifts in monetary policy can have more substantial effects but only so long as monetary changes alone can alter real interest rates. In the longer run, exchange rates will respond only to the fundamentals of national saving rates, domestic investment demand, and trade competitiveness.

The experience during the first half of 1987 has raised some important questions about this consensus view. Although there was and still is wide agreement that the level of the dollar at the beginning of 1987 was too high to be sustainable,¹ the dollar has remained essentially unchanged between then and now (August 1987)—declining for a few months and then rising back to its earlier level. Although some or all of this might be attributed to the rise in the price of oil (which strengthens the dollar because the United States is less dependent on oil imports than Japan and Germany), to the greater than anticipated temporary decline in the U.S. budget deficit, to the reduction in the trade deficit, and to the continued strength of the American economy, the dollar's

strength may also reflect the shift in international government policy toward the dollar.

In the fall of 1986, U.S. Treasury Secretary Baker, after a meeting with Japanese Finance Minister Miyazawa, adopted the position that the United States no longer favored a declining dollar. Subsequent multilateral meetings at the Louvre in February 1987 and at the Venice Summit meeting in June asserted an international consensus that a further dollar decline would be counterproductive. The leading central banks engaged in massive coordinated intervention in the first quarter of the year with central bank purchases of dollar bonds equaling or exceeding the U.S. current account deficit. The Federal Reserve announced that it had “snugged up” on monetary conditions, and U.S. interest rates rose while rates in Germany and Japan declined. It remains for future empirical research to sort out the extent to which intervention and the changes in monetary policies were responsible for the surprising behavior of the dollar during this period.

International Trade

Although the primary source of the unprecedented rise of the U.S. trade deficit between 1982 and 1986 was the increase in the value of the dollar and therefore indirectly the growth of the U.S. budget deficit, the political response to the trade deficit has been an increase in attention to the specific problems of foreign competition and international trade practices. Unfortunately, much of this response has been a harmful backsliding from free trade to various sorts of restrictions on the flow of goods to the United States. Recent years have witnessed the cartelization of key international markets, the introduction of so-called voluntary restraints on a wide range of exports to the United States, and the tightening of U.S. import quotas on textiles with the threat of much more protectionism to come as a result of the pending trade legislation.

Of course, not all of the political response to the trade deficit has been harmful. The concern about the U.S. trade balance has spurred a more assiduous pursuit of policies aimed at reducing foreign import barriers, especially those of Japan and some of its East Asian neighbors. Although these policies cannot eliminate the massive U.S. trade deficit as long as the dollar remains overvalued, they can increase the opportunity for American firms and employees to do more in those areas where they have a comparative advantage.

Cooperation in international trade requires not active comanagement of the economic environment but a negotiated reduction in government interference with private flows of trade and investment. The golden rule of international trade is the double negative injunction: “Do not unto others what you would not have them do unto you.”

The major trade rounds of the past quarter century have been successful in achieving sharp reductions of tariffs and quotas. But now, as several of the conference participants noted, improving the international allocation of resources requires a reorientation of the trade negotiations.

Government subsidies to domestic industries engaged in international competition must be reduced. This is true of agricultural policies in every major industrial country. It is also increasingly true of a wide range of manufacturing industries in Europe as well as in many developing countries. Progress in these areas will be difficult not only because such subsidies restrain powerful domestic political interests but also because it will involve extending international trade negotiations outside traditional lines into subjects previously regarded as domestic concerns.

A similar extension of international trade negotiations into domestic policies is required to reduce purchasing restrictions of government buyers in transportation and telecommunications and to improve the international allocation of investment, the production of services, and the protection of patents and other forms of intellectual property. The current Uruguay Round of trade negotiations has recognized the importance of these issues. Only time will tell whether the potential gains from a better international division of labor and the negotiating skills of the parties will together be powerful enough to overcome the powerful domestic interests that stand in their way.

Developing Country Debts

Despite the conference's overarching theme of international cooperation and coordination, a striking feature of the presentations and discussion about the less-developed countries' (LDC) debt problem was the virtual absence of explicit references to intergovernmental coordination. That aspect of the conference is of course just a reflection of the way the international debt problem has been handled in practice.

Despite the desire of some commercial bankers, academic economists, and others to get governments individually and collectively to play a larger part in the resolution of the debt problem, the governments have been understandably reluctant to assume such a role. When governments have acted, they have generally acted in a largely independent role. The United States provided several "bridge" loans at an early stage in the debt crisis until commercial bank and IMF funding could be arranged. The Japanese government is now proposing to provide longer term credits on a unilateral basis and through the IMF, the World Bank, and the regional development banks. Individual governments have modified domestic banking rules to strengthen their domestic banks

and to encourage those banks to continue lending to the debtor countries, with an informal, ad hoc coordination of these banking "reforms" through the regular meetings of central bankers at the Bank for International Settlements. The only explicit intergovernmental coordination of policy was through the Paris Club meetings at which the governments acted in their roles as creditors of the specific borrowing nations. The IMF was the only official participant that played an explicit major role in dealing with the debts to private creditors.

Despite the very limited official government coordination in this area, there has been extensive private coordination among the commercial banks around the world. The coordination committees of representatives of the major commercial banks have negotiated with the individual debtor governments on behalf of all the creditor banks. The debt problem has been managed by private international cooperation rather than by government coordination.

Looking ahead, the key role for official international cooperation in dealing with the debt problem should be maintaining open markets for the exports of the debtor countries. To service their debts while maintaining politically acceptable economic growth, the debtor countries must export. An increase in their exports will require a reorientation of domestic policies by the debtor nations, but it will only be possible if the creditor nations keep their markets open. Since the open markets of each creditor nation help all other creditors, and since the creditor nations as a whole have strong financial, economic, and political interests in the successful evolution of the debt problem, there is a powerful case for a coordinated agreement to maintain open markets for the products of these countries.

Concluding Comment

Economic cooperation is part of the more important process of international political cooperation. Successful coordination of policies in the economic arena can strengthen political and national security ties. Unfortunately, however, all too often the process of international economic negotiation creates new sources of conflict and tensions as each participating country seeks to impose its own preferences and judgments on the economic policies of the other governments. In recent months some governments have resented U.S. pressures to pursue more stimulative fiscal and monetary policies than they thought prudent, and they have complained about the implicit threat of using the exchange rate as a weapon to force compliance with American views. There is a danger that the process of international cooperation in macroeconomic and exchange rate management, despite its lofty aspirations, can be harmful politically as well as economically. While economic

coordination and negotiation can, under the right circumstances, make a positive contribution to worldwide economic well-being, it is important not to exaggerate the potential gains from such coordination nor to pursue it in ways that threaten broader political harmony.

Note

1. For a nontechnical discussion of this, see Martin Feldstein, "Correcting the Trade Imbalance," *Foreign Affairs*, Summer 1987.