INTERNATIONAL POLICY COORDINATION: CAN WE AFFORD IT?

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Policy makers and economists today embrace the argument that increased openness among the world's economies justifies--if not necessitates--a closer coordination of nations' economic policies. Their automatic, almost unthinking, acceptance of this idea reflects the undeniable fact that growing trade and capital flows now tightly link the world's markets and an unwavering association of words like "cooperation" and "coordination" with images of harmony, peace and prosperity. Only a fool would question the need for cooperation and policy coordination, contend proponents of international cooperation. Are we not, after all, in the same boat, affected by each other's policies? We must pull together if we hope to progress.

The matter is not quite so simple. In a rush to enumerate the possible benefits of cooperation, we have neglected to recognize some of the potential costs. For those of us who believe that free markets guarantee the highest possible standard of living, the words "cooperation" and "coordination" ring like euphemisms for collusion against market outcomes and sound a threat to a proven source of lasting prosperity.

My concerns stem most recently from attempts at, and continued calls for, close global coordination of macroeconomic policies, but my fears have roots in other international developments, including policies dealing with the international debt situation. To be sure, certain types of cooperation are beneficial--indeed essential--to the smooth functioning of markets, but governments, through cooperation, often attempt to supplant markets and to avoid market discipline. As such, we should keep a wary eye on proposals for global cooperation.

The Function of Markets and The Role of Government

Competitive markets are unique social machines that produce an efficient allocation of the world's resources and the highest possible standard of living. The price mechanism relays information to all components of the market, while the profit mechanism forces prices and costs to their minimum. Through these mechanisms, competitive markets foster a special type of economic cooperation. Participants readily understand the objectives of this cooperation, and markets maintain discipline quickly and without discrimination. This cooperation within markets rewards innovations and efficiencies and removes waste. It confers net benefits on participants in excess of what they could otherwise secure. Economists have recognized these qualities of open, competitive markets since the time of Adam Smith, and realize that the global scale of markets only serves to enhance these qualities.

Markets require an institutional framework to reduce the inevitable frictions that will result as participants interact. In market economies, the institutional structure includes laws that guarantee property rights, including contracts, and laws that protect other rights of individuals. Moreover, a medium of exchange with reasonably predictable purchasing power can enhance the smooth functioning of the market mechanism. These institutions reduce transaction costs and allow markets to achieve economies of scale.

The market machinery, however, does not always work perfectly. Sometimes markets do not fully internalize the benefits, costs, or risks associated with private activities to the responsible parties, or a "free rider" problem exists. Frequently, economic shocks, starting in one market, can disrupt a wide range of economic activity as they ripple throughout the economy. Sometimes the nature of goods or the characteristics of production confer monopoly powers on individuals. At other times, we make adjustments to the market, sacrificing efficiency, to correct for inherent inequities among individuals.

The need to provide the aforementioned institutional framework, and at times to adjust the market machinery, provides a role for governments in market economies. International cooperation can enhance this role in a closely integrated, global market. Government intervention, whether singular or cooperative, can guide an economy towards its ultimate objective of maintaining the highest standard of living when it enhances the functioning of private markets and when it dampens the transmission of severe, disruptive economic shocks.

Unlike the market, however, the machinery of government includes no automatic mechanisms for maximizing output and minimizing costs. Rather than promote efficiency and improve this important social engine, governments often slow and impede the market's proper function. We have come to recognize problems with governmental intervention in markets at the national level, but we often seem unwilling to accept that government intervention at the international level can impede the functioning of global markets, just as easily.

Government Versus Market Objectives

Students of government dismiss the view that elected officials seek to maximize the "common good." Policymakers, in their own self-interests, promote the desires of their constituencies, and these often conflict with market outcomes. The world economy today is tied in a web of tariffs, taxes, subsidies, and regulation that, more often than not, lack purpose other than to secure rents for certain, influential segments of society.

This tendency of elected government officials to define "the common good" in terms of their own self-interest and the interests of their constituencies should cause us to question all government policies. Do these policies strengthen the institutional framework that enhances the market's performance? Do they provide adjustments to the market that help secure a high, sustainable standard of living? Or, alternatively, do these policies serve to supplant well-functioning markets with administrative and regulatory mechanisms that interfere with market discipline and market performance at the expense of real economic growth?

Interdependence and the Benefits from Global Coordination

The current perceived need for global policy coordination stems from evidence that markets for goods, services and capital are now more open, or globally integrated, than in the past.[1] Advances in transportation and in communications have increased the degree of international openness by making production and distribution on a global scale more feasible.[2] The liberalization of trade and capital movements has permitted producers and investors to take fuller advantage of these advances. Indeed, trade flows have increased relative to GNP in nearly all major developed countries, and capital flows can be a large proportion of national savings and investment.[3]

Greater openness has enhanced economic interdependence among nations. Changes in economic variables in one country have a more immediate, stronger influence on economic variables in another. A tendency to underestimate the growing importance of interdependent markets has caused surprises in recent years. Inflows of foreign capital, for example, lessened the expected impact of large budget deficits on real interest rates in the United States.

A concern most often cited by advocates of coordinated macro-policies is that global interdependence has increased the risks of "systemic failure." This term eludes precise definition, but it implies a complete collapse of the financial system, currency markets and so forth, emanating from the actions of only one country or events in a single market. In an integrated world economy, individual countries might not be able to insulate themselves against such contagion and their enormous costs.

Observers often point to two recent events as evidence of the increased risks of systemic failure in the world today. One is the international debt crisis, which gained wide recognition in late 1982. The debt crisis threatened not only large banks, but also many middle-sized regional banks and small banks through their lending arrangements with debtor countries and through their domestic and international correspondent banking relationships. The repercussions of widespread defaults could have had serious global implications. The stock market collapse of October 19, 1987 offers a second, more-recent example of the risks of systemic failure. This collapse spread rapidly through stock markets around the world, posing a threat to global economic growth and stability. Although unscathed from these recent experiences, we remain vulnerable to similar types of events.

In listing the arguments for closer international policy coordination, I also should note that this global interdependence, which complicates economic interactions and increases the risks of systemic failure, often serves to discipline policymakers. Nations that have adopted inflationary policies have seen the market's disapproval quickly reflected in capital flows, exchange-rate movements and, with some delay, trade patterns. Similarly, the increased ease with which manufacturing and financial firms can move about the globe places a check on regulation and taxation. Simply stated, greater international interdependence increases the opportunities for investors and traders to protect their wealth from the misguided policies of individual countries.

Proponents of global policy coordination argue that because of increased economic integration, the chances of achieving substantial benefits through mutual cooperation are greater now than at any other time. In many respects, they are correct. The potential benefits from the mutual reduction of trade restraints and from the further liberalization of capital movements undoubtedly grow as markets expand. I applaud such market-enhancing international cooperation as GATT and the U.S.-Canadian Free Trade Agreement. The removal of artificial restraints on markets can increase the standard of living worldwide. Moreover, one cannot deny the value of shared information, common purpose, and coordinated efforts during those rare periods of clear economic crisis. In today's economic environment, such shocks can ripple through markets quickly and forcefully.

In contrast to these efforts, many of the recent proposals for global policy cooperation call for a detailed harmonization--a "fine tuning" on a grand scale--of monetary, fiscal and regulatory policies among the major developed countries. Recent meetings of the Group of Seven countries, for example, have focused on developing a set of "objective indicators"--including unemployment, inflation, current-account balances, exchange rates, and money growth--that could trigger policy changes in participant countries. Others have recommended target-zone arrangements or fixed-exchange-rate regimes, which presuppose a willingness to coordinate basic macroeconomic policies closely.[4] Some advocates of coordination have sought solutions for the international-debt situations that involve greatly expanded roles for governments and quasi-governmental international organizations.

Market Adjustments and The Costs of Cooperation

The evolving importance of globally integrated markets creates both the enormous potential for nations to benefit from cooperation and the great danger that such cooperation could entail substantial costs by subverting markets for political ends. Consider, for example, recent allegations that the G7 countries are relying on a loose system of "reference zones" for exchange rates and on a set of indicators of economic performance to guide their decisions about the compatibility of macroeconomic policies and about the appropriateness of adjustments. One can find little concrete evidence that these reference zones and indicators actually have influenced macroeconomic decisions in the separate G7 countries. This judgement might not be entirely fair. The G7 has never announced a complete set of "indicators" along with their relative weights in policy discussions, nor have they revealed their reference zones for exchange rates. Furthermore, we do not know what policy would otherwise have been.

To date, most of the cooperative efforts have attempted to stabilize exchange rates; the industrialized countries have not focused their attack on the fundamental problems underlying their current-account imbalances. Under the guise of cooperation and exchange-rate stabilization, the United States and the other major industrialized countries have financed a growing share of the U.S. current-account deficit through official reserve flows. While some might contend that this slowed the adjustment process to a manageable pace, one could argue just as forcefully that this official financing has avoided the adjustments that the exchange market ultimately will demand--specifically, an increase in U.S. private savings and a substantial reduction in the U.S. budget deficit. I doubt that the rubric of cooperation has led countries to adopt markedly better policies, or that it has reduced exchange-market uncertainty. Failing this, it has imposed substantial costs.

Similar arguments apply to the developing-country-debt situation. To be sure, quick actions by the United States in providing bridge loans helped to avoid outright defaults in some instances, and the cooperative efforts of governments and of the International Monetary Fund helped to initiate adjustment programs in many debtor countries and to secure rescheduling agreements from banks. These actions reduced the risks of systemic failure.

Many have argued, however, that this "cooperation" between debtor and creditor governments also has helped many banks to avoid the re-pricing of their assets, but has done little to ease developing countries' debt burdens or to foster a lasting adjustment in debtor countries. Substantiating this appraisal, developing country debts trade far below their book values in secondary markets, as does the stock of highly exposed banks in equity markets. These policies have not significantly reduced uncertainties associated with the long-term prospects for uninterrupted debt service and probably have increased the overall, real resource costs of adjustment.

Coordination and the Costs of Uncertainty

In addition to the potentially large real-resource costs, which I have thus far attributed to the tendency of governments to supplant markets, international coordination could create additional costs by generating market uncertainty. Private market participants base decisions, in part, on the expected actions of governments. When future policies are uncertain, market participants attempt to hedge by raising prices or by avoiding actions that might leave them vulnerable to policy changes. Recent proposals for detailed international policy coordination could actually increase uncertainties, if they create doubt about the willingness and ability of governments to implement them.

Nations willingly cooperate when all benefit. Mutual gains most likely result when cooperation is narrow in scope, when the number of participants is small, and when the resulting policies promote the smooth functioning of markets. Bilateral trade agreements are an example. When cooperation is more complex, however, as in the case of macro-policy coordination, success often requires that countries take actions contrary to some of their individual interests. Compliance then entails burdens, which countries historically have attempted to avoid or to shift. Consider our experiences with macroeconomic policy coordination since 1985. In light of the sparse progress that the United States has made towards lowering its budget deficits, our part of the bargain, one could argue that the dollar's depreciation has shifted more of the adjustment burden onto our trading partners--an outcome that was not completely the result of international coordination and cooperation. Because international policy coordination--unlike markets--often lacks a credible system for enforcement and burden-sharing, it can create uncertainties about the extent of compliances.

Even if nations are willing to coordinate broad policy objectives, many observers doubt that they can. The sharp differences among economists about the true state of the economy, about the near-term direction of the economy, and about the interrelationships among policy levers and economic variables are almost legendary. If economists cannot agree on how the economy works, can we expect governments to agree on and implement coordinated, effective macroeconomic policies? One also might wonder about the outcome if the world cooperated, but adopted the wrong model of how the world works. This, of course, is a problem at the national level, but international cooperation could greatly increase the costs of an error.[5]

Many of the proposals for detailed international coordination remind me of policymakers' "fine tuning" efforts of the 1960s and 1970s, when they attempted to achieve many targets simultaneously. The thrust of policies shifted frequently, and those policies generally missed on all accounts. The markets' mistrust of policymakers was reflected in an inflationary psychology that complicated and extended the fight against inflation. If we now make domestic objectives subject to international targets and events, economic agents once again could lose confidence in the willingness and the ability of policymakers to pursue important domestic goals.

Conclusion

I don't want my point to be misconstrued. Obviously governments play an essential role in a market economy. That markets today extend across national boundaries does not alter this role; indeed, global markets enhance it. We should explore opportunities for international cooperation that enhance the performance of markets and reduce the risks of systemic failure, but we must consider both the benefits and costs of such policies.

Recently many have advocated a greatly expanded role for international policy coordination. They argue that as markets become increasingly integrated, the potential benefits from such coordination become enormous. I caution that such policies often seek to supplant markets and to avoid market discipline. Such policies, therefore, run the risk of carrying with them enormous costs in terms of real economic growth and efficiency.

Much of the current thrust towards global cooperation is concerned with macroeconomic policy coordination. Given the political and economic realities of the world today, I believe that a move toward detailed coordination of macroeconomic policies would not improve, but could very well jeopardize our standards of living. Instead, I would urge countries to adopt, to announce, and to steadfastly maintain long-term nominal targets for policy, consistent with zero inflation and long-term real growth potential. This would not stabilize exchange rates, but it would remove much of the uncertainty about future policy which contributes to exchange-rate volatility. Exchange rates would adjust making the plans of individual nations compatible, and flexible exchange rates would provide a buffer to external policy errors and shocks. Such broad, individually instituted targets would be credible, predictable and--most importantly--would maintain the integrity of private markets.

[1] A perceived need for policy coordination is not new. For a discussion of central-bank cooperation in the 1920s, see Stephen V.O. Clarke, Central Bank Cooperation 1924-31. New York: Federal Reserve Bank of New York 1967.

[2] For a discussion of factors increasing world integration, see Richard N. Cooper, "Economic Interdependence and Coordination of Economic Policies," in Ronald W. Jones and Peter B. Kenen, eds., Handbook of International Economics, Vol. 2. Amsterdam:North-Holland Publishing Co., 1985: 1195-1234.

[3] On the growth of trade and capital flows, see Norman S. Fieleke, "Economic Interdependence between Nations: Reason for Policy Coordination?" New England Economic Review. Federal Reserve Bank of Boston. (May/June); 21-38.

[4] John Williamson, "The Exchange Rate System," Policy Analyses in International Economics, No. 5. Washington,D.C.: Institute for International Economics, 1985. Ronald McKinnon, "Monetary and Exchange Rates Policies for International Financial Stability: A Proposal," Journal of Economic Perspectives, Vol.2, No.1, (Winter 1988): 83-103.

[5] See Jeffrey A. Frankel and Katherine Rockett. "International Macroeconomic Policy Coordination When Policymakers Do Not Agree on the True Model," The American Economic Review, (June 1988): 318-340.