Comment on "G-7 Economic Coordination and Developing Countries," by Richard Cooper

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Richard Cooper has at least three qualifications for addressing the theme of his paper: He was a pioneer in research on international macroeconomic interdependence with his major theoretical and empirical study 25 years ago and he has continued to be a leader in this, now more fashionable, area. As Under Secretary of State to the Carter Administration and in numerous other public offices he has an unusually rich experience in actual efforts at policy coordination. Finally, he is an idealist, not afraid of radical ideas, as his reform proposals for the international monetary system show – stretching all the way, eventually, to a single currency for the industrial democracies.

In the present highly competent and comprehensive survey Cooper draws primarily on his first two qualities. The bulk of the paper is a hard-heated evaluation, based on the best parts of the available empirical literature, of the deficiencies of economic management in the G-7 countries in the 1980s and of the scope for improved performance due to better international macroeconomic policy coordination. The rest of the paper contains insightful comments on two other areas in which policy changes in the G-7 countries would have been helpful to the economic prospects of the developing countries: market access in the industrial countries and larger official and private transfers to the developing countries. The record of the industrial countries is not altogether poor in these other areas, though Cooper finds much to criticise. He also points out, no doubt correctly, that there would have been a positive interaction between better macroeconomic performance in the G-7 countries in the 1980s, and the readiness of these countries to pursue liberal market access policies and maintain higher levels of transfers to developing countries. This makes it natural, also for a discussant, to concentrate on the inadequate, or at least highly uneven, macroeconomic performance of the G-7 countries.

In doing so, I note primarily some points where I would have put the emphasis differently from Cooper. By focusing on the 1981-87 period during which G-7 GDP fell consistently short of potential output and disregarding the final years of the decade when output tended to exceed potential, the back-of-the-envelope estimates in the paper tend to exaggerate the benefits in

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the form of the larger export earnings (US$ 15-45 billion annually) which would have occurred to developing countries in a longer-run perspective. This is true, even if one accepts the somewhat optimistic assumptions of Cooper's calculation, notably that inflation, nominal interest rates and energy prices had remained on the downward course generally observed in the 1981-87 period. The author does question these assumptions in an appropriately critical way, leaving the impression that he too regards the increase in exports from developing countries as an upper bound to what might have been feasible in the 1981-87 period, but he does not say that there was a compensating temporary gain for the developing countries in the 1988-90 period when the G-7 economies were in the aggregate operating at levels in excess of their long-run potential. The fairly cautious macroeconomic policies pursued in the earlier period – with the US budgetary stance as the main exception – ultimately paved the way for the strong boom at the end of the decade. Both periods have to be evaluated jointly.

Implicitly, by not analysing the performance of the G-7 economies in 1988-90, Cooper appears to approve of economic management in this more recent period. Yet it was here, I would argue, that the record in at least some of the central countries became ominous both from the perspective of the industrial countries themselves and from that of the developing countries which depend on exports to the OECD area. By allowing their economies to become overheated and overburdened with debt, the United States, the United Kingdom and Germany in particular, stored up, or failed to correct, imbalances in their economies which have dragged the whole OECD area into a deep and prolonged recession in the first half of the 1990s. Failures of economic management showed up at different times in individual countries: the United Kingdom allowed a strong credit-financed consumer boom to develop from 1988, the United States failed to reduce her Federal budget deficit in the good years – while both endangered the stability of their financial systems – and Germany chose, or drifted into, a policy-mix which relied excessively on borrowing to finance the costs of unification, requiring high interest rates to contain inflationary pressures long into the subsequent recession. Policy mistakes were even more obvious in some smaller European economies, such as Finland and Sweden, where boom conditions marked by over-full employment and rising inflation were allowed to develop. In Japan, the efforts to soften the pricking of a major bubble in asset prices triggered initially excessive weakness of the currency and a prolonged need for subsequent adjustment.

As a result of the policies of the 1988-90 most of the G-7 economies have since found themselves trapped in a down-turn of unexpected severity and duration. Some of the mistakes may have been triggered by, in retrospect, excessive fears of the impact of the stock market crash of October 1987,

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others by exogenous events, such as German reunification. Whatever the original inspiration, the consequences are extremely serious and damaging also to others in the world economy. Cooper might therefore have been more critical and more topical in his evaluation of G-7 countries if he had focused on a later period than 1981-87 which now appears a relatively successful experience. After all, some loss of output was unavoidable following the 1979-80 oil price hike, and high priority had to be given to bringing inflation down from the double-digit level reached in many industrial countries. This time round there are fewer excuses for inadequate performance. Even the failures of policy coordination are less obvious than they were in the early 1980s (for which Cooper offers a vivid summary).

Could better coordination among the G-7 countries have improved macroeconomic performance in a major way then – and can it do so now? I share Cooper's scepticism that anything significantly could have been achieved in the first half of the 1980s when economic policies diverged widely and while divergence in economic philosophies appeared to be at a peak. Now both the economic fundamentals and strategies seem closer to one another. The sad, even dramatic, fact is, however, that the freedom of action which may have existed in some earlier phases of unsatisfactory performance, including 1981-87, has disappeared, because it has been absorbed by earlier imprudent policies in the budgetary area. In OECD Europe public sector deficits have risen to historical peaks as a result of the legacy of large structural deficits from the 1980s and the weakness of demand which prevails almost everywhere. To propose a stimulus through tax cuts and/or larger public expenditures seems counterproductive in the present context, since it could prevent some further decline in long-term interest rates which remains desirable. In the United States and Japan public finances have also been stretched to the limit – and so has the capacity to lower short-term interest rates. The Clinton Administration and any European government are currently faced with the next to impossible task of assuring longer-term budgetary consolidation in a situation where the public debate is naturally more concerned with overcoming the present recession.

In the European Community which is the region most seriously affected by the current recession – and the most heavily marked by structural deficiencies in the functioning of their labour markets – the emphasis in the policy debate shifted in the course of the 1980s from coordination of economic policies outside the monetary area towards a longer-run strategy of leaving as much autonomy in budgetary policy as possible to individual member states, but subject to careful monitoring by the Community of strongly deviant behaviour with respect to deficits and debt. This philosophy is embodied in the so-called convergence requirements of the Maastricht Treaty which set upper reference values for the deficit and for public debt, both expressed as

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ratios to GDP. These provisions seem to many, particularly non-EC, observers strangely out of date in an environment of low activity and employment. Departures from them as the cyclical components of deficits widened have indeed been accepted, though not openly advocated. Yet in looking back on our experience during the 1980s, something like rules of the Maastricht type would have served most European countries, as well as the United States and Canada, rather well now if they had been applied vigorously in the relatively successful decade of the 1980s.

Rules to prevent strongly deviant behaviour, contain the wisdom that some freedom of action has to be preserved for when it is really required. If we had started the decade of the 1990s without structural public sector deficits, as would surely have been warranted in the OECD area while most countries were operating their economies at or above potential output, more vigorous action to contain recession would now have been possible. It is essential that, when the upswing finally comes, resources be devoted to durable budgetary consolidation. Without that no efforts at international coordination of demand management can be successful and industrial countries will be condemned to relive their own powerlessness in the face of a serious downturn.

It might be healthy, also from the perspective of the developing countries anxious to see a recovery in the G-7 economies, if the future debate on the scope for international macroeconomic policy coordination in that form would put those longer-term considerations in focus. Coordination efforts which focus more narrowly on the shorter-term issues of eliminating departures from potential output are certainly desirable, but the major purpose of coordination has to be more modest, i.e. to preserve an international regime in which the kind of cyclical instability we have seen since the early 1980s is reduced and some essential public goods are better preserved for the international economy: a free trading system, the avoidance of major currency swings which trigger a mixture of protectionist measures in some countries and efforts at competitive depreciation in others, and stable economic growth conducive to an efficient international division of labour. The record of the past decade and a half is not encouraging in these respects.

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