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# Strengthening International Economic Cooperation: The Role of Indicators in Multilateral Surveillance *

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Abstract

This study considers the role of policy coordination in strengthening economic performance, and the part that economic indicators can play in this process. It begins by reviewing the objectives of economic cooperation (exploiting positive externalities and avoiding negative ones), and some of the political and economic obstacles to making cooperation effective. The relationship between coordination procedures and international monetary arrangements is assessed, and an analysis is provided of how indicators can be used in a systematic way to judge the sustainability of economic trends.

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## Contents

Summary

This paper is adapted from an essay prepared for inclusion in a volume in honor of H. Johannes Witteveen, former Managing Director of the Fund. The paper begins by noting that effective international economic cooperation involves several steps: a common understanding of the objectives that are being pursued; an appreciation of the nature of the economic environment within which national economies interact; an analytical framework for assessing the international impact of the economic policies and performance of individual countries; and a set of procedures that allow international considerations to be properly taken into account in framing national policies.

Coordination is made desirable by the fact that economies are interdependent, and developments in one country have externalities, or "spillover" effects in other countries. The objective of cooperation is to try and ensure that these externalities are properly taken into account in the policy calculus of individual countries. Obstacles to cooperation can arise from the fact that countries have different objectives, or different conceptual "models" (i.e., views about the ways in which policies are related to economic outcomes). Moreover, the costs in terms of time and political capital can place limits on the coordination process.

Coordination is naturally rather different under "rule-based" arrangements, such as the fixed exchange rate system, than when international monetary arrangements are more flexible. It has become increasingly realized that, under the present international monetary system, deliberate coordination is needed if the desired degree of systemic stability is to be achieved. The use of indicators is intended to help provide a focus for such coordination. Indicators are expected to be used to help analyze international policy interactions, to provide a medium-term framework for monitoring economic developments, and to help establish criteria for judging sustainability and desirability. The analytical framework that would permit indicators to be used in this way must begin with a consideration of the sustainability of external payments patterns, and provide a means of relating changes in payments positions to the setting of domestic policy instruments. In this context, it is important to ensure that changes in domestic saving/investment balances are consistent with the shifts in external positions needed to achieve medium-term sustainability.

# I. Introduction

Effective international cooperation involves several steps: a common understanding of the objectives that are being pursued; an appreciation of the nature of the economic environment within which national economies interact; an analytical framework for assessing the international impact of the economic policies and performance of individual countries; and a set of procedures that allow international considerations to be properly taken into account in framing national policies. The remainder of this paper attempts to explore these issues in more detail. The analysis draws on important recent contributions by Artis and Ostry (1986), Cooper (1986), Horne and Masson (1987), and Polak (1981) amongst others.

# II. Objectives of International Economic Cooperation

## 1. Exploiting gains from coordination

The impetus for international economic cooperation comes from a recognition of the interdependence of national economies. This interdependence creates "spillovers", through which developments in one economy impinge on the welfare of its trading and investment partners in the rest of the world. Spillovers, or externalities, can be of a positive or negative character. Faster growth of demand in one country means higher exports and incomes in its trading partners; equally, lower growth can transmit economic weakness. One important task of coordination is to ensure that external effects on partner countries are adequately taken into account in the decision making calculus of national governments.

A second major reason for economic cooperation is the existence of public goods at the international level. A stable international trade and payments system may be regarded as a public good: all countries benefit from it, whether or not they have contributed to it. Without coordination, countries may be tempted to seek the benefits of stability without paying their share of the burden. The public good of stability may thus be undersupplied.

The more integrated the world economy becomes, the greater the spillover effects that are likely to be generated, and the more important it becomes to recognize international interdependences in national policy-making. Economic integration has increased considerably in the postwar period and is carefully documented by Bryant (1987). It has been particularly significant in financial markets, whose characteristics make the international transmission of disturbances particularly rapid.

The objective of economic policy coordination is to promote the positive effects of international integration, while minimizing the adverse consequences of negative externalities. This is likely to be attained when the international economy is growing at a steady pace, without sudden disturbances to output or prices; when international trade permits individual countries to exploit their comparative advantage in production; and when payments positions permit savings to flow to countries in which most efficient use of these savings can be made. Thus, international cooperation is likely to seek a global environment in which the policies of individual countries are directed toward steady non-inflationary growth of domestic demand and output, open markets, and freedom for capital to move to its most efficient use.

## 2. Avoiding negative externalities

The avoidance of negative effects of international spillovers is often a more powerful impulse to cooperation. These negative effects can be of several kinds. For example, countries may seek to achieve advantage at the expense of their trading partners. A prominent example of such behavior is protectionist measures. The motivation for trade restrictions is to increase domestic employment and output. Typically, this is achieved at the expense of partner countries. In fact, protection is unlikely to be effective in its aim of preserving domestic employment. As Corden (1987) shows, protectionist measures lead to retaliation and set up forces that militate against the competitiveness of non-protected products, with ambiguous consequences for aggregate levels of output and employment. Even if restrictions were effective in the goal of protecting employment in the country introducing them, however, they would still reduce world welfare. There would be no increase in global output, merely a transfer of production from more efficient to less efficient producers. Avoidance of trade restrictions is therefore an area in which the mutual benefits of a cooperative approach have long been recognized (though not always grasped).

A similar source of competition in a zero-sum (or negative-sum) game is exchange rate policy. The 1930s provided an example of the consequences of a situation in which countries attempted to promote domestic economic objectives through manipulation of the exchange rate. Since additional exports were achieved at the expense of output in partner countries, retaliation ensued and the result was a downward spiral in world trade. Combined with the effects of rising protectionism, the competitive exchange rate policies of the 1930s prolonged the depression and led to reduction of some two-thirds in the volume of international trade.

While protectionism and competitive exchange rate policies are the most blatant examples of national economic policies with negative international consequences, there are others. The adoption of balance of payments objectives that are internationally inconsistent is likely to produce frictions that result in suboptimal economic performance. For example, if countries collectively seek to run current account surpluses (either because they wish to encourage export-led growth, or because their demand for international reserves exceeds the supply) some mechanism will have to reconcile the ex ante inconsistency. 1/ In the absence of a

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1/ Excess demand for reserves can be tackled through a reserve creation mechanism such as the SDR. Excess demand for payments surpluses poses more fundamental problems.

planned and cooperative mechanism, the process is likely to be one in which policies are more deflationary, on an aggregate basis, than is consistent with output and employment goals. Cooperation is therefore required to ensure that balance of payments objectives being pursued by countries do not generate undesired consequences, domestically or internationally.

Another dimension to negative spillovers is when the policy mix pursued by a country is unsustainable, and will therefore have to be reversed at some future time. Sharp policy reversals have implications for the allocation of resources and therefore carry costs. The transfer of factors of production from one application to another may involve temporary unemployment, uncertainty costs, and the obsolescence of specific physical or human capital. To the extent that a policy reversal in one country imposes corresponding reallocation costs on its trading partners, there will be a negative international spillover. With the benefit of hindsight, it seems clear that the expansionary fiscal policy in the United States in the early 1980s, combined with monetary restraint, resulted in high real interest rates, an appreciation of the U.S. dollar and the absorption of real and financial resources from the rest of the world. In itself, the emergence of the U.S. payments deficit was not undesirable. Indeed, the rapid growth of imports into the United States in 1983-84 helped lead the international economy out of recession and mitigate the worst effects of high interest rates on heavily indebted countries. However, the situation was not indefinitely sustainable: that is to say, it was not consistent with other objectives being pursued by the countries concerned. The rapid buildup of domestic and international debt by the United States undermined the confidence of holders of dollar-denominated financial assets. And the growing size of the U.S. trade deficit generated strong pressures for trade protectionism. Thus a policy reversal and/or a change in exchange rates had to occur, and by 1987 both reactions were under way.

The ultimate result of the policy and exchange rate changes that are taking place should be to make the U.S. economy less dependent on net imports (both of goods and of the foreign savings to finance them) and other economies less dependent on net exports. Such a shift in payments positions means undoing deep-seated changes in economic structure that had taken place over the previous five years. A more efficient process would have been to avoid both the initial disturbance and the subsequent need to correct it. Cooperation is thus required to help promote a mix of policies in national economies that is both internationally consistent and sustainable over time.

Another potential negative consequence of uncoordinated policies comes from the reinforcing effects of actions undertaken independently. For a single country acting alone, a significant part of any stimulus to demand (or withdrawal of stimulus) will tend to leak abroad. For that reason, a country that seeks to stimulate (or restrain) output might choose to take stronger action than would be necessary if it were operating in a closed economy context. The world, however, taken as a whole, is a closed economy. When all countries take action together to stimulate or restrain demand, there will be a mutually reinforcing effect that, if not properly allowed for, may result in overshooting of the policy objectives. Cooperation (at least to the extent of exchange of information) is needed to permit individual national authorities to allow properly for the effects of the international environment on their own policy objectives.

## 3. Obstacles to international economic collaboration

At the level of generality, there would probably be little disagreement that unsustainable policies need to be avoided or reversed, that policies leading to incompatible external outcomes need to be reconciled, and that balances of payments positions need to be consistent with domestic output and employment objectives. This does not mean, however, that formal policy coordination is universally accepted as the most efficient way of achieving this. There are at least three obstacles to the further development of policy coordination. First, there are differences in economic objectives; second there are different views on the ways in which economies interact in practice; and lastly, there are doubts about whether formal coordination is the most efficient way of achieving mutually agreed objectives.

The main difference in macroeconomic objectives that arises among countries centers on the relative weight to be placed on the danger of inflation against the danger of weakness of economic activity. This depends not only on deep-seated differences in historical experience, and thus in political preferences, among countries, it also derives from the particular conjunctural situation a country finds itself in. In this context different labor market conventions, indexation practices, etc., are important "structural" differences. Further differences can arise from the relative priority accorded to goals in the financial area--for example the desire to reduce fiscal or balance of payments imbalances. A country with a desire to grow faster but to reduce payments and fiscal deficits is inclined to seek an outturn in which its trading partners pursue a more expansionary policy that will produce spillover benefits for its own level of activity and payments position. On the other hand, a surplus country that is fearful of output bottlenecks and inflationary pressures is more inclined to emphasize demand restraint by deficit countries as a means of correcting imbalances that are perceived to be unsustainable. In all this, elected governments will naturally perceive their main responsibility as being to their national electorate, rather than to the wishes to their trading partners.

An equally difficult obstacle to effective coordination is when countries use different models of economic behavior. (The term "model" is used here to denote the views of policy makers about the principal economic forces at work, whether or not formal econometric relationships are specified.) Governments may agree, for example, that faster growth in domestic demand in one group of countries is desirable, balanced by slower domestic demand growth elsewhere. There may, however, be disagreement about the effectiveness of particular policy instruments in bringing about this agreed result.

In the period after 1985, for example, there was little disagreement about the need for strong domestic demand growth in Germany and Japan. But while many observers outside these countries advocated an easing of fiscal restraint as a means of supporting demand, Japanese and German officials and academics did not always agree about the effectiveness and desirability of using fiscal policy in this way (see Fels and Froelich, 1987). This is partly because they viewed private sector behavior as likely to adapt so as to offset changes in government spending or taxation and partly because they were concerned about the medium-term implications of using fiscal policy actively for countercyclical purposes.

Lastly, the sheer costs, in terms of time and political capital, of economic policy coordination will place a natural limit on the intensity of coordination. As Cooper (1986) points out, most negotiations are, at base, a zero-sum game, since the net gains from coordination are quickly assumed and negotiations turns on how the benefits and burdens are to be shared. Market solutions, which are more anonymous and involve less direct commitment on the part of policy-makers, have the advantage of low "transactions costs." Furthermore, even where governments may be prepared to commit the effort needed to reach a multilateral agreement, they may be wary of the consequences of the agreement should circumstances change. Sticking to policy understandings that have been overtaken by events has clear costs; however so too does reneging on an agreement, since it undermines the reputation of the party concerned and therefore makes it more difficult to acquire credibility for future policy initiatives. All in all therefore, as Corden has pointed out (1985) there is much to be said for a system that limits the need for formal and continuous coordination and permits as much decentralized decision making as possible.

## III. Cooperation and the Nature of the International Monetary System

The goal of encouraging constructive international economic relationships, while avoiding the kind of negative spillovers discussed in the previous section, has long been a major consideration in the design of the international monetary and financial system. Two basic approaches are possible. One is to design the system in such a way that the pursuit of national objectives by member countries tends to support the objectives of other countries, or at least does not interfere with them. In this approach, the cooperation comes in designing the system, and operational coordination of policies is not required. The other approach is to have formal rules that do not in themselves constrain policies, but provide for cooperative decision-making in areas of common interest. The history of international economic arrangements in the post-war periods contains examples of both approaches.

### 1. Rule-based international monetary arrangements

The fixed rates system of the Bretton Woods period, ending in 1973, was an example of an attempt to set rules in terms of the exchange rate. The exchange rate obligations of the Bretton Woods period were intended to avoid the dangers of competitive exchange rate depreciation, while the commitment of most major countries to the rules and procedures of the General Agreement on Tariffs and Trade was expected to help avoid competitive policies in the area of trade restrictions. Of course, cooperation was required both to agree on the appropriate pattern of exchange rates, and on the policies needed to preserve such a pattern.

The Bretton Woods arrangements served the world well for much of the post-war period, but they were not so well-equipped to manage other aspects of international economic interdependence, which grew in importance over time. For example, the increasing integration of international capital markets made it harder to preserve a given pattern of exchange rates in circumstances when private agents became convinced that such a pattern had become unsustainable. And the implicit requirement that all countries have convergent inflation rates imposed strains. In particular, major countries outside the United States sought lower rates of inflation and a strong balance of payments. The "spillover costs" of the fixed exchange rate system were therefore viewed as being the need to either accept the inflation rate and the monetary conditions of the center country (the United States) or else provide the center country with whatever volume of capital flows was necessary to sustain the given rate.

The tensions inherent in a fixed rate system resulted in the move to floating that occurred in the early 1970s and that was ratified in the Second Amendment to the IMF's Articles of Agreement, formally adopted in 1978. Initially, it was assumed that potential adverse effects of exchange rate flexibility could be avoided through rules that would ensure "clean" floating. The idea was that countries could have freedom to use domestic policies to pursue domestic economic objectives, while leaving the exchange rate free to equilibrate the external payments position. Implicit in this view was the notion that the equilibrium balance of payments was largely independent of domestic monetary and fiscal policy, and that market forces would tend to produce a relatively stable exchange rate consistent with such a payments position.

In the event, it became clear that floating exchange rates could not perform the function of insulating a national economy from a wide range of internationally-generated disturbances. Changes in tastes and productivity, and changes in relative prices among goods and factors of production require changes in real interest rates and exchange rates and thus in the distribution of demand between traded and non-traded goods. Furthermore, when countries pursue divergent domestic policies in the face of a common external disturbance, there are significant effects for exchange rate and balance of payments patterns. Different responses to the oil price increases of 1973-74 and 1979-80 produced sharp exchange-rate movements and caused balance of payments divergences that eventually generated a policy reversal.

## 2. Arrangements for policy coordination

Since neither fixed nor floating rates are capable, in themselves, of protecting countries from negative spillovers from developments in their trading partners, it is not surprising that the focus of recent attempts to improve policy consistency has been more direct. That is to say, mechanisms have been sought to provide both suitable forums for the multilateral discussion of national polcies and also guidelines as to how policies should be adapted so as to be internationally consistent.

Of course, multilateral surveillance was not absent in a rule-based system. Under the Bretton Woods arrangements, a system of regular consultations between the IMF and its member countries helped ensure the observance by all countries of the "code of conduct" of the Fund's Articles. Also regular discussion of economic policies among the main industrial countries, in particular in the forum of Working Party 3 of the OECD, had the purpose of identifying potential difficulties in the operation of the adjustment process and devising cooperative solutions.

Nevertheless, whatever the role for multilateral surveillance under a fixed rate system, it can be argued that it is of even greater importance in a system (like the current one) that gives countries substantial discretion in policies affecting the exchange rate. The need for firm surveillance is formally recognized in the revised Article IV of the 1978 Amendment to the IMF's Articles of Agreement. This reads, in part:

> "Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member [country] undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates...
>
> ...The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies."

In the years since the introduction of the floating exchange rate system, a considerable array of mechanisms for policy surveillance and the discussion of policy interactions has grown up. Within the IMF, twice yearly meetings take place, both at the level of the Executive Board and at the level of Ministers, devoted to a discussion of the world economic situation, prospects, and policy requirements. Annual consultations take place with all member countries, 1/ and there is a continuous review of

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1/ These consultations have a somewhat lesser frequency for small member countries.

national policy developments that have significant external implications. In the OECD, a similar global review occurs in meetings of Working Party 3, the Economic Policy Committee, and at Ministerial level. Beyond this, a tradition of annual economic summits has grown up, beginning with the Rambouillet Summit of 1975. These meetings between the heads of government of the seven largest industrial countries have spawned a more regular process of consultation among finance ministers and central bank governors of the major countries. The gradually increasing role of this process of multilateral surveillance and negotiation received additional impetus in the meetings at the Plaza (September 1985) and the Louvre (February 1987). These meetings resulted in important agreements concerning exchange rates and domestic economic policies, and marked a further intensification in the desire of countries to use the mechanism of surveillance to ensure the mutual compatibility of their policies.

## IV. Analytical Framework for Policy Coordination

In the long run, of more significance than the forum of collaboration is its content. Important developments in the content of economic policy cooperation have taken place in recent years. Two significant events occurred in 1985 that have colored the subsequent debate. First, the U.S. dollar reached a level that all major countries agreed was unsustainably high, and cooperative action was undertaken that helped bring it down. The lessons that seemed to follow from this experience were, first, that it was possible for markets to produce exchange rates that were not sustainable in the medium-term, and second, that it was possible for official action to do something about it.

The second event of 1985 was the publication of two reports on the functioning of the international monetary system: one by the Group of Ten industrial countries and one by the Group of Twenty-four developing countries. The G-24 report was sharply critical of the way in which the international monetary system had operated. The G-10 report took a much more favorable view, but it too recognized that there had been significant shortcomings. A point of agreement between the two reports was that large swings in exchange rate relationships among major countries were potentially harmful. A further point of agreement was that the source of such swings lay in divergences of underlying economic policies. The solution, therefore, was perceived to lie in mechanisms that would encourage a more harmonized mix of policies among the major countries.

### 1. Target zones

One way of achieving better harmonization of policies was considered to be the adoption of target zones for exchange rates. This was the approach favored by most developing countries and some industrial countries. In principle, target zones can have several advantages: they can improve the international consistency of policies (via the need to negotiate the zones and surrounding policies); they can strengthen the discipline of macroeconomic policies (since the "easy option" of exchange rate movement is ruled out); and, if credible, target zones can act as a focus for stabilizing speculation on the part of private economic agents. In addition, it is sometimes claimed that the constraints of a target-zone system would increase the scope for effective surveillance to be exercised over the major countries, and would thus contribute to the symmetry and evenhandedness of the system's disciplines. (For a thorough discussion of the advantages and disadvantages of target zones, see Frenkel and Goldstein, 1987.)

It has to be recognized, however, that target zones are an indirect way of promoting their intended objective. The root cause of the deficiencies in international economic performance is to be found in the shortcomings and inconsistencies of national economic policies; misalignments in exchange rates are merely the symptom. Focussing on the symptoms can, in certain circumstances, make the underlying problem even worse. Consider, for example, a situation in which fiscal expansion in one country leads to a strong growth in domestic demand, upward pressure on domestic interest rates and an appreciation of the national currency. Given the stance of fiscal policy, resisting currency appreciation would require an expansionary monetary policy designed to lower interest rates. This, however, would cause the expansionary effects of fiscal policy to be "bottled up" in the domestic economy, giving rise to inflationary pressures. In other words, while the appropriate solution would be to use fiscal restraint to avoid exchange rate appreciation, pursuit of a target exchange rate might result in monetary expansion instead. The exchange rate would be stabilized at the cost of compounding the initial policy mistake.

Of course, it would be possible to obviate this difficulty of target zones by adding to the target zone obligation guidelines concerning the policies to be used to hold exchange rates within the prescribed zones. But once the system is extended in this way, the question arises: why not simply use guidelines for domestic policies, and allow the exchange rates to reflect this? It is the goal of using multilateral surveillance to help improve the compatibility of domestic policies in the major countries that is behind the growing interest in "objective indicators" as the basis of multilateral surveillance.

## 2. Indicators

The idea of using indicators in multilateral surveillance is not new. A working group of the Committee of Twenty on Reform of the International Monetary System, meeting in 1972-74, explored ways in which objective indicators could be used to allocate the burden of adjustment to international payments disequilibria (IMF, 1974). The work of this group, however, was overtaken by events when the major countries moved to a floating rate system, in which it was thought that issues of balance of payments adjustment would loom less large.

The April 1986 meeting of the Interim Committee, which discussed the Reports of the G-10 and G-24 on the functioning of the international monetary system, saw a revival of interest in the use of indicators. In the communique of the meeting, the IMF Board was asked "to consider ways in which its regular reviews of the world economic situation could be further adapted to improve the scope for discussing external imbalances, exchange rate developments, and policy interactions among members. An approach worth exploring further was the formulation of a set of objective indicators related to policy actions and economic performance, having regard to a medium-term framework." Subsequently, the Tokyo economic summit declaration also gave strong support to the use of indicators, and stated that a specific list of indicators would be used in appraising economic development in the seven countries.

While these statements were intended to signal a commitment to the objective of greater coordination of economic policies, they did not in themselves give a very clear guidance of how objective indicators are to be used to this end. It remains, therefore, to define the purposes for which indicators are to be used and the analytical framework within which they are to be interpreted. Beyond this, a number of practical issues arise, such as the list of indicators that is to be employed, the country-coverage of multilateral surveillance, and the procedures to be employed when economic variables depart from their intended course.

The list of indicators provided in the Tokyo economic declaration comprise the following variables: GNP and domestic demand growth; inflation; unemployment; trade and current account balances; monetary growth rates; fiscal balances; exchange rates; interest rates; and international reserves. These statistics have always been used in the description and analysis of economic developments. There are, nevertheless, ways in which indicators can be used that can give additional focus to the process of international policy coordination. Three aspects of the use of indicators are emphasized in the current debate that have the potential to go beyond the traditional use of statistics for monitoring domestic developments (Crockett and Goldstein, 1987). First, it is the intention to use indicators for the purpose of analyzing the international interactions of economic policies and performance. This means that trends in domestic policy and performance variables have to be viewed in terms of their implications for international variables such as exchange rates and payments patterns. This in turn, requires an analytical framework for relating trends in domestic variables to external objectives. A second aspect of the present interest in indicators is the emphasis on a medium-term approach. This means that short-term developments are assessed in the light of their medium-term implications, in particular the sustainability of these medium-term trends over time. Third, it is envisaged that actual developments in particular indicators will be measured against standards or criteria that would establish a desirable pattern. The communique of the April 1987 Interim Committee, for example, states that "actual policies should be looked at against an evolution of economic variables that could be considered desirable and sustainable".

## 3. Using indicators to judge sustainability

As just noted, a major motivation for a strengthened use of indicators is to improve understanding of international interactions of economic policies and developments. This means that indicators must focus on those variables of importance for analyzing "spillover" effects across national boundaries. The principal point of interaction between national economies is trade and capital flows. These flows are influenced by demand and output growth in individual economies, by relative price and cost levels, by relative interest rates, and more generally by the whole range of economic policies that underlie these developments.

Negative externalities can arise when developments in individual economies give rise to disturbances that create unanticipated shifts in trade and capital flows. Such disturbances are likely to occur when, for one reason or another, current trends are perceived as being unsustainable. For this reason, a central feature of the use of indicators in surveillance must be an assessment of the sustainability of current economic trends. To undertake such an assessment, it is necessary to analyze, first, the implications of current policies for external developments over the medium term and, second, the medium-term position that could be considered sustainable or desirable on efficiency criteria.

To assess the implications of current policies for actual developments in the external field, the implications of these policies for relative rates of demand growth and relative competitiveness must be estimated. This analysis makes use of several relationships involving the indicators listed in the Tokyo declaration: the impact of fiscal and monetary policy on the rate of growth of domestic demand and GNP; the relationship between output and demand growth and trade and current account balances; the implications of monetary policy for inflation and interest differentials; the combined effect of domestic costs and exchange rate developments for international competitiveness; and the relationship between international competitive positions and trade flows. Artus and Knight (1984) have shown how these relationships can be used to provide estimates of a country's underlying payments balance.

What has been described so far is the use of indicators in a forecasting context. It is positive economics. To give the analysis a normative content (and therefore to give it potential utility in the context of surveillance) it is necessary to compare the <u>forecast</u> of the medium-term balance of payments outturn with an estimate of what can be considered sustainable or desirable. A disparity between the "underlying" position and the "sustainable" position would then indicate the need for a shift in policies that would bring the underlying position into line with the sustainable.

This general approach is hard to disagree with in principle, but carries considerable practical difficulties. A sustainable balance of payments position is a hard concept to define and may indeed change with circumstances. One approach is to define the concept historically. It may be observed, for example, that most industrial countries have had, on average, small surpluses on current account over much of the post-war period. If this experience can be taken as indicative of a normal or sustainable position, then surpluses of similar size could be taken as a medium-term "norm." Such an approach, though appealing in its simplicity, is almost certainly insufficiently discriminating to command general approval. For example, changes in the circumstances facing countries (e.g., energy discoveries in Netherlands, Norway and the United Kingdom) can change the desirable payments position from that prevailing in an historical period. Similarly, demographic shifts within countries can influence the extent to which individual countries wish to accumulate or run down claims on the rest of the world.

More generally, changes in the capacity of the developing world to absorb savings from the industrialized countries can have an effect on the size of the aggregate surplus that the latter group of countries can run. Finally, the shifting size, and uncertain geographical distribution of the discrepancy in world current account balances undermines the basis for judgements about sustainable payments positions.

An alternative approach, which also poses significant difficulties in practice, is to define a sustainable external position in terms of the sustainability of the domestic and external financial balances with which it is associated. Using the national income accounting identity, the current account deficit (or surplus) of a country is equal to the budget deficit, less the excess of private domestic saving over private domestic investment. If an estimate is made of the underlying determinants of domestic private saving and investment, and if the government's objective with respect to the fiscal deficit is known, then the implied "consistent" balance of payments position can be obtained as a residual.

The virtue of an approach which emphasizes savings and investment balances is that it draws attention to the need for mutual consistency of balance of payments developments and trends in domestic economic variables. It therefore underlines the fact that an unsustainable balance of payments position can be dealt with both through measures that have a direct effect on incentives to trade flows (such as exchange rates and competitiveness) and through measures that affect underlying saving/investment propensities in the domestic economy. Indeed, for a durable solution, the two must go hand in hand.

What are the characteristics of the external equilibrium that the foregoing approach is intended to illuminate? It is frequently said that an equilibrium should be "sustainable", and sometimes it is added that it should be desirable. There are basically two dimensions to this: the first is the requirement of short-term arithmetic consistency. The international implications of countries' domestic objectives must satisfy necessary adding up constraints in terms of payments positions and trade flows. If these adding up constraints are not satisfied, ex ante, (if, for example, countries are collectively seeking to curb domestic demand and allow net exports to take up the slack) then intended objectives will not be achieved. Since not all countries can increase net exports together, demand and output will fall short of the desired level.

The second dimension of sustainability is that it be compatible with a medium-term evolution of the international financial system that does not lead to future disruptions. A situation in which one country has a large decline in government and national savings (i.e., an increase in the fiscal and current account deficit) may be internationally consistent in the short term, if there is a counterpart increase in savings among its trading and investment partners. However, the accumulation of debtor/creditor positions may be incompatible with the willingness of private economic agents to finance the implied resource transfer over the medium and longer run. Thus the situation is unsustainable in the sense that it will lead eventually to a policy reversal or a market reaction that brings to a halt the resource transfer.

## V. Policy Coordination: The Way Forward

Despite the various difficulties of policy coordination alluded to above, it seems clear that a cooperative approach to managing the world economy is essential if the pitfalls associated with competitive or incompatible policies are to be avoided. However, to attempt a detailed blueprint for policy formation would be unduly mechanical. It would constrain the flexibility of policy action in ways that might well diminish the capacity to respond appropriately to unexpected disturbances. For this and other reasons, a high degree of precision in managing coordination would probably be rejected by the countries concerned.

The following aspects would seem to be essential ingredients in a strengthening of effective policy coordination.

(i) The existence of a recognized set of forums in which the objectives and instruments of policies could be regularly reviewed. It is important that there be both a forum where a limited number of large countries can make sensitive political "bargains", and a forum in which the rest of the world can effectively communicate its views and concerns to the large countries. The participation of the Managing Director of the IMF in meetings of the major industrial countries offers one way of providing a link between these two forums.

(ii) The establishment of a quantified framework of analysis that commands a broad basis of acceptance among the parties concerned. This involves a common view of the impact of domestic policy instruments on economic variables, and the acceptance of general criteria for judging the sustainability and acceptability of economic outcomes. Considerable progress has been made in refining the analysis in the Fund's "World Economic Outlook" exercise, and adapting it in the light of comments from countries. Obviously, however, more needs to be done in this direction.

(iii) The development of a mechanism for recognizing and dealing with situations in which actual and prospective developments diverge from the intended or desired path. This is an area in which progress will be extremely difficult and will have to take place gradually. One possibility would be to establish agreed criteria for assessing the evolution of economic variables, then to provide for discussions in circumstances where there was a departure from such an evolution.

This last stage is where indicators could be given a larger role in multilateral surveillance. It will be important, however, to use indicators as an instrument for strengthening coordination, rather than as a mechanism for creating conflicts.

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