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MANAGING THE WORLD ECONOMY: WILL WE EVER LEARN?

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Managing the World Economy: Will We Ever Learn?

To be invited to give the Frank D. Graham Memorial Lecture is not only a great honor; it has provided me with a welcome opportunity to try to make some sense out of my close involvement in the management of free-market economies over the past thirty years.

Looking back, two things strike me forcibly. The first is the fickleness of conventional economic wisdom. The second is the very close relationship between economic orthodoxy as it relates to domestic economic policy and economic orthodoxy as it relates to the need for—and particularly the nature of—international economic cooperation. Having traced these out, I shall try to set out some of the lessons I believe we should draw from this experience. I shall conclude with some somewhat unflattering remarks about the economics profession.

The Fickleness of Conventional Economic Wisdom

The fickleness of conventional economic wisdom can be caricatured by a set of antitheses. When I began my career at the Organization for Economic Cooperation and Development in 1956,[1] conventional wisdom had it that the government's primary responsibility was to provide the right level of aggregate monetary demand; if it did so, the supply side would look after itself. Before I left the OECD, it was increasingly being argued that if we got the supply side right, demand would look after itself.

I refer not so much to the extreme form of supply-side economics associated with the name of Arthur Laffer but to the much more intellectually respectable arguments, based on neoclassical economics, that underlie much recent German economic thought and policymaking and are exerting a spreading influence. To get the supply side right, according to this school, it is necessary to raise the rate of return on investment by slowing down the growth of real wages and to lower the real rate of interest by reducing budget deficits. These moves, it is said, will in time lead to more demand, whereas, according to earlier conventional wisdom, they would lead to less.

A second antithesis. During the first half of my career, it was increasingly accepted that fiscal policy was by far the government's most powerful tool

[1] Then the Organization for European Economic Cooperation.

for influencing the course of aggregate demand. For example, in a 1966 report Working Party 3 of the OECD stated:

> In the field of demand management, it is agreed that it should be a general objective of fiscal and monetary policies . . . to promote a continuing expansion of total national expenditure in line with the trend growth of productive potential. There is also agreement that, in general, fiscal policy should play a major role in the mangement of demand. (par. 42)

Monetary policy was assigned a subordinate role. The monetary authorities were expected to maintain an appropriate level of nominal interest rates, given the fiscal-policy stance, and it was assumed—sometimes explicitly, often only implicitly—that such rates could be achieved without injecting excessive liquidity into the system. The influential Radcliffe Report (1959) observed:

> Fiscal measures have the advantage over monetary measures in having a more certain impact. (par. 516) . . . We envisage the use of monetary measures as not in ordinary times playing other than a subordinate part in guiding the . . . economy. (par. 511) . . . Control over the 'money supply'—whatever that may be made to mean—is not by itself a reliable policy measure. (par. 504) . . . The more flexible the fiscal measures can be made the less it will be necessary to rely on monetary measures. (par. 517)

But, in a premonition of things to come, it went on:

> On the other hand, if the authorities are unable to manipulate taxation with sufficient flexibility, there will have to be more reliance on monetary measures. (par. 517)

Again, by the time I left the OECD these propositions had been more or less turned upside down. In several of the major industrial countries, policy has come to be based on the view that control over the rate of growth of the money supply is virtually the sole instrument that a government should use to discharge its responsibility for the level of prices and aggregate demand. Current conventional wisdom about fiscal policy is somewhat less clear-cut, although there is a distinct tendency in some countries to subordinate it to monetary-policy objectives. In the United Kingdom, for example, the path set out for fiscal policy in the Medium Term Financial Strategy has been determined explicitly in terms of the need to achieve a given outcome for the growth of the money supply. The same role reversal is evident in Germany, where the main thrust of fiscal policy is to reduce the structural budget deficit in order to reduce real interest rates.

The academic profession has gone even further. Enthusiastic followers of the rational-expectations hypothesis have demonstrated, very elegantly, that if everyone understood the ultimate consequences of fiscal action as well as

they did, then, logically, such actions could have no effect at all on the level of aggregate demand. It is true that this view has not been widely embraced by the profession and, despite much empirical work, it does not appear to fit the facts (see Feldstein, 1982).[2] But, with this amount of confusion being generated by the academic profession, it is perhaps hardly surprising that certain very highly placed policymakers in the United States should currently be arguing that there is no relationship between budget deficits and interest rates—at the same time that they claim credit for the expansionary stimulus generated by those deficits.

These changes in conventional wisdom about the conduct of macroeconomic policy have been accompanied by almost equally dramatic changes in views about the nature and even the direction of many key behavioral relationships. In earlier days, it was widely held that the Phillips curve was a reasonably stable relationship that provided the touchstone for steering the economy between the pitfalls of inflation and deflation. Today, it is not only accepted that this relationship is distinctly unstable, but it is also argued by some that over any period relevant to policy making the curve is actually vertical. In other words, for all practical purposes it does not exist.

Take another example. Twenty years ago, we believed that investment was largely driven by the accelerator. Evidence was marshaled to show that the influence of actual and expected demand very largely dominated any influence coming from interest rates or rates of return. The same Radcliffe Report (1959, par. 464) commented, "It does not seem that changes in interest rates . . . have had much ultimate effect on the demand for goods." Today, as noted, policies in some countries are implicitly or explicitly based on the assumption that the reverse is true.

This reversal relates to another area where there has been a significant change in conventional wisdom. Throughout the whole period, academic theory concerning the distribution of income between labor and capital has been in a somewhat confused state and has generally not performed well when it came to empirical verification. The field was thus left open to pragmatists. So during the 1950s and 1960s it came to be accepted wisdom that businessmen were always in a position to set prices at a margin over costs that would provide them with a rate of return at which they would be happy to invest more. The Organization for European Economic Cooperation, in a 1961 report, stated: "The share of labor, apart from cyclical shifts, has remained remarkably constant in almost all countries since around 1950.

[2] As so often happens with economic thought, the rational-expectations hypothesis is not a new idea. Feldstein (p. 2) attributes the revival of what he calls the "pre-Ricardian equivalence hypothesis" to, among others, M. J. Bailey, R. Barro, and J. R. Tanner.

With high employment, business has been able to maintain profit margins . . ." (OEEC, 1961, p. 53; see also Dow, 1964, Chap. XIII).

This meant that, with generally low or negative real interest rates, investment would respond very strongly to increased demand, as, indeed, it did. In one way, this was a good thing. For, once we had got through the immediate postwar reconstruction period, we found ourselves for about twenty years in a world in which output was not constrained by capacity limitations, only by the supply of labor. But the other side of the coin was that demand-induced bursts of investment were one of the principal reasons why inflation originating in the labor market was steadily ratcheted up from one cyclical peak to the next.

Even before 1973, there was isolated evidence of a downward secular shift in the share of profits. But it was only after the first oil crisis that this shift became a fairly general phenomenon. And, slowly and unevenly, attention began shifting toward more classical economic theory, with its emphasis on the relationship between real rates of return and real interest rates, and on the role of relative factor prices in determining both the level of output and the amount of employment associated with a given level of output. By 1977, Malinvaud (1977; see also 1982) had provided a formal framework for the coexistence of Keynesian and classical unemployment, and there is now a substantial literature on this subject running from Giersch (1979) and Sachs (1979) to Artus (1984). Empirical evidence appears to support the "disequilibrium-real-wage hypothesis," although it is slightly disconcerting to note that the countries identified as suffering from this problem differ among the studies. There has also been a revival of interest in the role of real wages in the 1930s (see, e.g., Sachs, 1983, pp. 271-274). And such is the lagged but intimate connivance among events, ideas, and action that, by 1984, a British Chancellor of the Exchequer had introduced a budget which, by increasing taxes on capital (investment) and reducing them on labor, turned another piece of conventional postwar wisdom on its head.

Managing the World Economy

More examples could be given of the almost complete reversal over the past thirty years of the conventional wisdom about domestic macroeconomic policy. But let us turn now to international economic policy. Inevitably, the evolution of ideas has centered around the exchange-rate regime, as the most direct interface between sovereign economic policies. It is fascinating to reread the heated debate between advocates of fixed or flexible rates that runs through the first Princeton Essays in International Finance.

What emerges is that there is a lot of common ground on the issues of economic analysis involved. Graham (1943) could accept as an ideal solution fixed rates between countries that maintained monetary stability; he just did not think that this was very likely. On the other side, Nurske (1945) could accept that "the external balance of payments should not require an individual country to . . . undergo either . . . inflation . . . or . . . deflation. . . . It is the exchange rate that should be changed . . ." (p. 24). But he also argued: "Barring inflationary developments in individual countries such adjustments should not be necessary except at infrequent intervals (say, five, ten, or fifteen years)" (p. 22).

In retrospect, the decision to go for fixed rates was probably based less on economic doctrine than on a broader philosophical approach to international economic management. After the disasters of the 1930s, it seemed unwise to assume that national governments could be trusted to act consistently in the collective interest. An internationalist—but also elitist—approach was needed. We (the elite) would meet in international organizations created for the purpose to decide how the international economy should be managed. Thus, although it was widely accepted that exchange rates could not remain fixed forever, it seemed natural to give an important role to an international bureaucracy in decisions about when and by how much they should be changed.

Behind this approach there was often the hidden hope that some form of supranational political authority would gradually evolve to legitimize this transfer of economic sovereignty. As this did not happen, it is all the more surprising that fixed rates became such a widely and deeply entrenched dogma in official circles. To its credit, the academic profession never lost sight of the fact that, in Graham's (1949, p. 3) words, "Exchange rates are prices," and eventually it launched a successful counterattack.

Once the decision had been taken to go for fixed exchange rates, both the need for, and the nature of, international economic management followed logically from the conventional wisdom of the day about domestic economic management. The major countries had a collective responsibility to maintain the right level of demand in the world economy as a whole. If the sense of the meeting was that the risks were on the inflationary side, then some countries should take restrictive action, essentially of a fiscal nature. And conversely if the risks were on the deflationary side.

Moreover, since it was assumed that "we" were keeping exchange rates more or less where they should be, then, if the risks were on the inflationary side, it was the countries with balance-of-payments deficits that should take restrictive action. And if the risks were on the deflationary side, it was the countries in balance-of-payments surplus that should take expansionary

action. This was the logical thread running through the Bretton Woods agreements, echoes of which could still be heard in the 1970s, as in the so-called "McCracken Report" (OECD, 1977, p. 30):

> Policymakers should communicate and consult with one another as a matter of intelligent self-interest. They should regularly try to form a view as to the need to stimulate or restrain demand in the world economy as a whole. Countries which should take the lead in expanding demand are those with high unemployment, low inflation, favorable balances of payments, large reserves and good creditworthiness. The converse obtains if overall restraint is what is required.

(The McCracken Report, written by a group of economists with widely different backgrounds, is of considerable historical interest. It is clear, in retrospect, that they were trying to build bridges between the Keynesian consensus, which was by then well into its decline, and the monetarist/neoclassical consensus, which was very much on the rise. Sadly, but perhaps inevitably, the report was unpopular in both camps.)

For quite a time, in the 1950s and 1960s, this approach seemed to be working rather well, even though there was considerable slippage between theory and practice. But we did not, of course, succeed in keeping real exchange rates where they should have been. "Dilemma cases" emerged, most notably the United States in the 1960s, "where demand pressures are not inappropriate, but where the current balance is nevertheless out of line . . . because of imperfectly adjusted competitive positions"—a nice euphemism! (OECD, 1966, par. 46). We nevertheless soldiered on, and in so doing provided Mundell (1962) with the opportunity to develop an analytical framework in which monetary policy could be assigned to external objectives and fiscal policy to internal objectives. As Working Party 3 of the OECD (1966, par. 47) put it:

> A country in surplus because of large capital receipts should normally adopt an easier monetary policy than might otherwise have been appropriate. . . . Assuming that the general demand-supply situation is roughly in balance, the adoption of an easier monetary policy would usually call for some tightening of fiscal policy. . . . A country in deficit because of substantial capital outflows should normally adopt a tighter monetary policy than might otherwise be appropriate . . . and this may involve complementary changes in fiscal policy.

It is also worth noting that with an increasing number of observations we were gradually able to develop empirical tools that tracked quite well how the fixed-rate system was working. This was true not only for the price and income elasticities affecting trade and current balances, but also for capital flows, where we were able to draw on the work by Branson (1971) and others on portfolio-balance theory. Indeed, I still remember with some pride papers we produced in the late 1960s that gave forecasts running all

the way from GNP, through prices and interest rates, to trade balances and capital flows, ending up with changes in official-settlements balances and likely claims on the U.S. gold stock.[3]

It would be hard to exaggerate how completely this conventional wisdom about international macroeconomic management had been overturned by the early 1980s—although this is still often obscured by ritual references to the virtues of economic cooperation.

The intellectual origins of this sea change are fairly easy to trace. Working from floating exchange rates, it is possible to develop essentially static general-equilibrium models in which, with instantaneous adjustment in all markets, the impact on other countries of changes in prices or demand in one country is fully neutralized. In such models, economic relations between nations are left to be determined—as they should be—solely by real structural parameters, such as propensities to save and invest, the real rate of return on capital, and the supply curve of labor. Friedman (1953) and Johnson (1969) made major contributions to the revival of this approach to international economics, arguing that, under floating exchange rates, countries would and should recover their monetary autonomy. And once again, with a lag, the implications began to show up as conventional wisdom in official and governmental thinking. The slogan thus became: "If each country gets its fundamentals right, the world will look after itself." Indeed, this philosophy was partly incorporated into the Second Amendment to the Articles of the International Monetary Fund.

This change in the conceptual approach to international cooperation was part of a wider change in attitude toward the management of free-market economies, which is well captured in the aphorism: "Governments do not solve problems, they are the problem." At the international level, moreover, the case for the kind of elitist approach described earlier was to some extent undermined by its own apparently brilliant success. As a quarter of a century rolled by with almost uninterrupted growth, expanding trade, and no major breakdowns, memories of the horrors of the 1930s faded. Problems of national economic management gradually reoccupied center stage, especially in the 1970s, when the perplexities of stagflation became a central element in the intellectual and political debate.

It is no doubt natural that in this changed climate there should be a resurgence of the philosophical approach to international economic rela-

[3] Fairly detailed forecasts of capital flows and official financing were contained in confidential documents produced for Working Party 3 of the OECD, particularly in the period 1969-71. These forecasts were described and discussed in qualitative terms in contemporary issues of the *OECD Economic Outlook* (see, in particular, No. 5, pp. 33-59; No. 6, pp. 32-54; No. 9, pp. 25-39; and No. 11, pp. 29-40).

tions so evident in Graham's writings. Believing passionately in the virtues of maximum freedom for individuals within the national economy, this school has always tended to argue that the same should apply to sovereign states in the world economy. And, indeed, models can be produced in which world welfare is maximized when each country independently pursues its perceived interests, so long as it is fully informed about the intentions of others and how they will react to any course of action it takes. This school thus tends to argue that this informational role furnishes the only justification for the existence of international organizations.

As a matter of fact, even this qualification was challenged by Harry Johnson and others who, while extolling the virtues of private markets, argued, probably rightly, that meetings of national officials and governments can be subject to bandwagon effects, leading to collective misinformation and overenthusiastic crusades against the currently perceived enemy, be it unemployment, inflation, OPEC, or poverty. Some, like Vaubel (1983, p. 18) see international organizations in an even darker light:

> It is well known . . . that, to some extent, rational politicians and bureaucrats have an incentive and the power . . . to act against . . . the welfare of society at large. What is only gradually coming to be known is that international collusion strengthens this power.

Thus, in a remarkably short space of time the international economic organizations have gone from being regarded as one of the brightest of man's creations, paving the way toward an evolutionary absorption of national economic sovereignty into a wider collectivity of interests, to being regarded, at best, as clearinghouses for the exchange of information or, at worst, as having a negative influence on world economic welfare.[4]

This statement may seem much exaggerated at a time when the International Monetary Fund is playing such an important and valuable role in dealing with the debt crisis. But that role is essentially an exercise in crisis management and bears little resemblance to what was understood by economic cooperation in earlier years. What is striking is that, while the Fund's influence on the policies of third-world debtor countries has greatly increased, its influence—and that of the wider network of international institutions—on the policies of the major industrial countries has virtually vanished. Today, it is commonly said that there never was such an influence—another example of rewriting history. Both France and the United Kingdom had to

[4] This Essay is focused on the management of the world economy at the macroeconomic level. At the microeconomic level, conventional economic wisdom has stood up much better to the test of time. There has not been the same *conceptual* erosion of the role assigned to international organizations to promote and police the maximum freedom for international trade and payments. Indeed, this assignment has held up surprisingly well to the intense political pressures generated by poor macroeconomic performance since 1973.

make conditional drawings from the Fund and, for at least twenty-five years after World War II, German and Japanese policies were strongly influenced by their desire to be "accepted" by the international community. The influence on American policies was, on the whole, less, but by no means negligible (see Solomon, 1977).

The change in attitude toward the international organizations has perhaps been most marked in the United States. But it is increasingly shared by the other members of the Group of Five, or "Versailles Group," with the exception of France, even if the language they use to express it pays more lip service to earlier conventional wisdom.

It is, of course, hard for those of us who have worked most of our lives in international organizations to realize that it was all a mistake. And we have been slow to respond to—or even fully grasp—the case now made against us. To give a constructive answer it is essential to distinguish the philosophical from the conceptual and factual basis of the new consensus. Reasonable people are always likely to differ about the proper role and function of government, and the consensus will no doubt continue to evolve in hard-to-predict ways over the decades to come. But the case for greatly restricting the role previously assigned to the international organizations with respect to macroeconomic policy also rests on the empirical validity of the general-equilibrium models in which floating exchange rates neutralize external shocks. I will return to this question later.

How Did It Happen?

I hope enough has been said to justify my two initial propositions: that conventional economic wisdom has proved very fickle over the last thirty years, and that there has been a striking parallelism between accepted doctrines regarding the management of market economies at the national and international levels.

The picture is obviously overdrawn, however. The prevailing consensus was never unanimous, and the dramatic changes did not occur in a vacuum. At each point in the story, there was a respectable body of minority opinion—monetarists during the Keynesian era, Keynesians during the monetarist era. Furthermore, conventional wisdom was colored in each country by its own history and intellectual traditions. Even at the height of the Keynesian consensus, German economic thought and policymaking continued to give more emphasis to monetary discipline. Even at the height of the flexible-rate consensus, French thinking remained strongly attached to the idea that the State, rather than private citizens, should determine a country's exchange rate.

More important has been the fascinating interplay among ideas, policies,

and events. Looking back, it is easy to see how ideas, with a lag, influenced policies; how policies, with a lag, influenced events; and how events, with a lag, changed ideas. It would take too long to trace this out in detail. It is most obvious in the shift in concern from unemployment to inflation. In 1942, Graham wrote, "Men are genuinely afraid that peace may . . . break out" (1942, p. 246). Four years later, he wrote, "if we . . . are so inept as to permit wide-scale unemployment, we shall suffer, and will deserve, the totalitarian fate we fought to avoid" (1946, p. 59). He was convinced, with many others, that "it is . . . within the government's power to set the level of total expenditures . . . wherever it will. It follows . . . that the government can set it at that optimum level which will provide full employment with a stable price level" (1946, pp. 40-41). Nobody can say what he would have written forty years later, but, given the concern about price stability that runs through his work, it seems probable that the emphasis would have been very different.

Take another example. During my time at the OECD, the ratio of public expenditure to GNP in the OECD area rose from 25 to 42 per cent. And with rising welfare benefits and falling tax thresholds, marginal tax/benefit ratios [5] rose to phenomenal levels. It is hardly surprising, therefore, that attention shifted sharply from the supposed positive externalities of the welfare state to its supposed negative impact on incentives to work, save, and invest.

Again, at the international level, it is clear that we badly mismanaged the adjustable-peg exchange-rate system built into the Bretton Woods agreements. It is equally clear that this is one of several factors that contributed to the ratcheting up of inflation that brought the golden era of the 1950s and 1960s to an end. And it was these events that swung the consensus toward flexible rates.

Many more examples could be given of the way in which the course of events appears to justify the change in conventional wisdom. But the question still remains as to whether, as members of the economics profession, we can really justify such radical 180-degree changes as have occurred.

The Verdict of History

The noneconomist historian, reviewing this period, might well be tempted to draw rather unflattering conclusions about our profession. Using our own terminology, he might unkindly suggest that the elasticity of conventional economic wisdom with respect to events appears, after a lag, to have been

[5] I.e., the ratio of increases in pre- to post-tax incomes after allowing for the loss of means-tested and other discretionary social benefits.