The Quest for National and Global Economic Stability

Edited by
WIETZE EIZENGA, E. FRANS LIMBURG
AND JACQUES J. POLAK

In Honor of
HENDRIKUS JOHANNES WITTEVEEN

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Preface

Former students of Dr H. J. Witteveen and many of those who collaborated with him in the past decades have decided a while ago that his great scientific and social merits are ample reason for presenting him with a *Liber Amicorum*. The fortieth anniversary of his appointment as professor at the Netherlands School of Economics in Rotterdam in the Spring of 1988 seemed a suitable time for presentation.

For this purpose a committee was formed consisting of the members listed below. The last three of these also act as editorial committee of this anniversary volume.

The topic the editorial committee chose is 'The quest for national and global economic stability'; this topic has always attracted Dr Witteveen's special attention and is in fact the common theme of his publications and speeches.

In compiling this volume, the editorial committee tried to give expression to the three fields in which Dr Witteveen developed his main activities: university, politics and international economic organizations.

The committee is deeply grateful to the authors who promised and supplied their contributions with great enthusiasm. All contributions were completed before August 1, 1987.

A volume like the present cannot be produced without considerable financial help. The committee wishes to list the institutions whose financial assistance enabled it to produce this book:

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Peter de Jong, former Prime Minister of the Netherlands, Honorary Chairman
Wietze Eizenga, Professor of Economics and Statistics, Leyden University
E. Frans Limburg, Chief Economist, Amsterdam-Rotterdam Bank NV
Jacques J. Polak, Senior Adviser, Development Centre, OECD; Consultant, World Bank

Hendrikus Johannes Witteveen

Hendrikus Johannes Witteveen was born in Zeist on June 12, 1921. He studied economics at what then was the Netherlands School of Economics at Rotterdam and is now the Erasmus University. He received his Master's degree on February 28, 1946 and his doctorate of Economic Sciences cum laude shortly after that, on January 23, 1947. The title of his doctoral thesis was 'Wage Level and Employment', an essay at synthesis between theory and empirical research. His supervisor was Professor Dr Jan Tinbergen. During the academic years 1946 to 1948 he served as lecturer at the Netherlands School of Economics, later as full professor. The title of his inaugural lecture was 'Freedom and International Co-operation'.

As a professor, Dr Witteveen deservedly enjoyed great respect. His graduate seminars on problems of economic policy were highly regarded by students. He was a compelling and original teacher. His approach was characterized by a perennial effort to bridge the gap between theory and decision-making in economic policy. This applied not only to his lectures but also to his publications. Thus, his report to the Association for Political Economy on 'The problem of capital shortage in the Netherlands, in particular the shortage of risk capital' (1952) concerned itself fundamentally with the structural situation of the post-war era and its implications for economic policy.

In his well-known book *Economic Structure and the Business Cycle* he elaborates on this report. He thoroughly examines the relationship between structural and cyclical developments. This pioneering work may still be considered a standard treatise in this field.

Of the many other subjects in the national or international field which Dr Witteveen discussed in lectures or in print, 'Inflation and the Fight against it' certainly deserves mention. In this context the future managing director of the IMF argued in 1954 for a revaluation of the guilder to help curb inflation in the Netherlands, on the grounds that a fundamental disequilibrium existed. In the Bretton Woods era, such a proposition was by no means easily accepted, and it took seven years before it was implemented.

As a university teacher, Dr Witteveen was firmly convinced that economists should take part in economic and political debates. He was a gifted and serene speaker. He had the capacity to explain intricate matters clearly, and as a result he was frequently invited to introduce discussions of economic and political subjects.

In this context it should be kept in mind that in those years Dr Witteveen held firm convictions on economic policy which he was trying to propagate. It is hardly surprising, therefore, that in addition to his scientific work he concerned himself with practical politics for many years, both as a Member of Parliament and as Finance Minister.

Dr Witteveen's first term as Minister of Finance was from July 1963 until April 1965. It was terminated by the fall of the cabinet, the causes of which had nothing to do with matters of public finance.

His second term of office lasted longer, namely from April 1967 until July 1971, when he served as Deputy Prime Minister and Minister of Finance under Prime Minister Peter de Jong. Contacts between the Prime Minister and the Minister for Finance were very intensive in view of the usual inclination of spending ministers to oppose financial stringency.

Given this fact of political life, the Minister of Finance must be sure of commanding strong support from the Prime Minister, which in the period concerned was given whole-heartedly by the latter. In those years of political responsibility Dr Witteveen earned both respect and sympathy thanks to his balanced judgment and friendly ways. He applied his academic insights e.g. by developing a counter-cyclical tax instrument that could be implemented by the government without delay, if necessary, parliamentary endorsement being required only *ex post facto*.

In the 1970s, Dr Witteveen's engagement in political practice took on international dimensions. When it had become clear in September 1972 that there were strong political objections to a third five-year term for Pierre-Paul Schweitzer as Managing Director of the IMF and there was no agreement subsequently among the membership about a successor, Dr Witteveen was prevailed upon to make himself available as a consensus candidate for the job. He agreed, and was appointed on September 1, 1973, less than a month before the Fund/Bank Annual Meetings in Nairobi, Kenya.

This was the hectic beginning of his single five-year term at the Fund (he actually left the Fund in June 1978 to give his successor a slightly more comfortable start), during which crises and emergencies were continuously demanding his attention. The wide movements of exchange rates, the oil price increase of late 1973, the (up-to-then) most severe postwar recession of 1973—75 were among the most disconcerting developments in the world economy that he had to face. At the same time, the international monetary system passed through a phase of deep uncertainty. The par value system had been blown away by the events of 1971—73; by the time Dr Witteveen arrived on the scene, reform of the international monetary system was being discussed by the Committee of Twenty in great seriousness but without any indication that agreement was in sight. Indeed, in 1974 the effort was abandoned and an amendment to the Articles of Agreement that acknowledged this situation was prepared for adoption at the Jamaica meeting in January 1976.

During this period of turmoil Dr Witteveen was an energetic Managing Director who took many initiatives and spoke out freely on many of the crucial issues of the day. He was particularly active on the financial side of the Fund. Within a month after the 1973 oil shock he proposed an Oil Facility in the Fund (patterned in large measure on the existing Compensatory Financing Facility) and persuaded the Committee of Twenty to speak out against deflationary, beggar-my-neighbor responses, to that shock. He marshalled additional resources for the Fund through quota increases and a new borrowing facility that came to be widely known as the 'Witteveen Facility'. He sponsored a subsidy facility to lighten the interest cost of the Oil Facility for the Fund's poorer members. And he pushed hard for the sale of part of the Fund's gold for the benefit of low-income countries; he proposed that the profits on all the 50 million ounces of gold sold (one-third of the Fund's holdings) should go to these countries, but in the end had to accept the compromise under which half of the profits landed in the coffers of the governments of *all* Fund members.

Dr Witteveen was deeply interested in international monetary matters on which he often spoke out. He argued for a far more central, controlling, role of the SDR; he expressed concern about the Euro-dollar markets; and he worked continuously for more stable exchange rates, an objective that he tried to serve by a greater use of the Fund's consultative procedures.

All in all, his term in the Fund was packed with activity — an activity that served as a healthy tonic to the institution in a period when its role was seen by many as being on the decline.

After leaving the IMF, Dr Witteveen was asked by the Amsterdam-Rotterdam Bank to join the bank as an international adviser. At that time, AMRO was seeking opportunities for expanding overseas. Dr Witteveen played a leading role in remolding the bank's country risk assessment procedure into a full-fledged exposure control system. This helped a great deal in containing AMRO's exposure, the size of which proved well manageable after the outbreak of the debt crisis.

As part of his assignment, Dr Witteveen frequently presents his view on the world economy to several decision-making and advisory groups within AMRO, as well as in the bank's annual report. Stability (or the lack of it) is a recurring theme of his argument. This theme is also predominant in his addresses to the annual meeting of Ambassadors to the Netherlands, held at AMRO's Head Office after Budget Day. His thorough unravelling of budgetary intricacies and his well-targeted comments make these events most enjoyable for all who have the privilege to attend.

On top of all this, Dr Witteveen's extensive network of international relations has proved an invaluable asset in many cases. He combines his internationalism and his continuing interest in matters of education by sitting on the supervisory board of the 'Witteveen Dekker Indonesian Scholarship Foundation'. This was established following an initiative taken by Amro and Philips, the Dutch electronics company, with the purpose of enabling Indonesian students to attend lectures at the Erasmus University of Rotterdam.

The Committee

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Strengthening international economic cooperation: the role of indicators in multilateral surveillance

ANDREW CROCKETT[1]

Following a distinguished career in academic and public life in the Netherlands, Dr Johannes Witteveen took up his position as Managing Director of the International Monetary Fund on September 1, 1973. I was privileged to serve as his Personal Assistant during his first year in office, having previously held the same position during the last year of the tenure of his predecessor, Pierre-Paul Schweitzer. Almost exactly a month after Dr Witteveen took office, he and I were flying back from the Fund's annual meetings in Nairobi when our pilot announced we would take a detour from our planned route. We shortly learned of the outbreak of hostilities between Egypt and Israel.

It was in a way a symbolic beginning to his term of office. For the 1973 Middle East war was a prelude to (though not by any means the primary cause of) the oil price increases of 1973—74. Adjusting to scarce energy was to become the dominant economic theme of the remainder of the 1970s and the early 1980s. Dr Witteveen played a central role in harnessing the forces of international cooperation to smooth this adjustment, beginning with the oil facility of 1974, and continuing with the effort to find new and more flexible monetary arrangements to meet the needs of a changing international economic system.

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. In the remainder of this chapter, I will attempt 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.

Wietze Eizenga et al. (eds.), The Quest for National and Global Economic Stability

I. 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.[2] In the absence of a 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 US dollar and the absorption of real and financial resources from the rest of the world. In itself, the emergence of the US 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 US 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 US 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.