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MANAGING COMPLEXITY:
ECONOMIC POLICY COOPERATION AFTER THE CRISIS

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PROCEEDINGS

MR. DERVIŞ: Welcome, everyone, and thank you for being with us, and I must say that I'm super happy because we have a great book to talk about. One of the authors, of course, is here, but we also really have a fantastic panel. So thanks to all the participants, but also in particular those of you on the panel that came to join us.

It's about the book, here it is. I don't know how many of you have -- Time will also do some propaganda for it, but I did read a good part of it this weekend, being contentious about it, and it's really an excellent book. And it's about cooperation, particularly at times of crisis, although not necessarily economic policy cooperation and not necessarily only at times of crisis. And it really goes quite deeply into the conceptual issues and also some of the case studies or situations, histories, that we've lived through.

It's always easy to say that it's good to cooperate. Cooperation is almost by definition a good thing, but it's much more complex to fully understand what exactly cooperation achieves and what it doesn't achieve. And those of us who are either in international institutions or have worked in international institutions have always been very, very keen on promoting cooperation, but we were not always clear on why exactly we're doing it and what exactly the benefits are.

Of course, ultimately, it's an empirical question, not just a theoretical question because even if the theory can give us the directions, and whether they are pluses and minuses, but at the end of the day, it's empirical data that has to determine what it being achieved.

Let me just say one more thing. There is a chapter in the book on standards and the whole regulatory cooperation, but I think what's very interesting to stress is not just what is stressed in that chapter by David Green, which is basically regulatory harmonization and cooperation in the financial sector. But increasingly, trade negotiations are also all about regulation.

In the old days it was rounds of tariff reductions. What is at stake now increasingly -- not entirely, but increasingly -- is really regulatory cooperation. It's not gone in detail in that chapter, but I think the debate about cooperation has a lot to do also with trade policy, which I think is a very important point. We see it in the whole TTIP debate currently very strongly.

So we have the details about our panelists, of course, on the invitation and on the program, but let me first introduce Tamim Bayoumi, very briefly. He's now a senior visiting fellow at the Peterson Institute, on leave from the IMF where he was the deputy director of the Strategy, Policy, and Review Department. It changes its name once in a while, but it's the key global policy department, with research, of course. But this is a department focused more immediately on operations at the IMF.

And we also -- I'm going to introduce the IMF connection right away. We also have Vitor Gaspar, who is the head of the Fiscal Affairs Department, so we really have very strong representation. Vitor was, before he came to the IMF, he was with the Banco de Portugal. He was also minister of state and finance of Portugal and director of research at the European Central Bank, among other things. So a fantastic member of this panel, like all the members, really. I'm so glad.

There is with us Heidi Crebo-Rediker, who is the senior fellow at the Council on Foreign Relations, who was the first chief economist of the State Department. There was no such thing as the chief economist of the State Department, I understand. She was also the chief economist or advisor of the International Finance and Economics Committee for the Senate Committee on Foreign Relations, where you were the chief international financial economist, basically, right?

But before that she was an investment banker for quite a few years, both doing public financing for public institutions and for countries financing packages, as well as private. And comes to this whole field not only with a strong national policy background, but with a very strong private policy background.

And then we have Fred Bergsten. While Fred Bergsten is in Washington, on Massachusetts Avenue, obviously what can one say? I'm not going to say too much, but I'm going to say -- which I found out by reading your CV this time -- that at age 27 you were advising in the White House, Henry Kissinger, on international financial and economic issues. At age 27, so that is quite something.

You are the founding director of the Peterson Institute and I think there are few economists, few academics, who have written more on issues of financial and international economics than Fred. So thank you very much for being with us. I'm sure one of Fred's favorite topics, the Chinese exchange rate, will be part of the discussion. (Laughter)

All right, so with that we're going to not follow Brookings' traditions very much. I'm not saying it's a very good tradition, but in general we don't encourage too many PowerPoints, but this one deserves a short PowerPoint by Tam. So, Tam, you come to the thing first while the rest, we sit, and then we will all join. We will all sit down once Tam has given his presentation.

MR. BAYOUMI: Well, thank you very much, Kemal, and thank you very much everybody for coming. Obviously, this is the book launch of “Managing Complexity: Economic Policy Cooperation After the Crisis.” And to some extent, this itself involved quite a lot of international cooperation since I did it from Washington, meanwhile my two other co-editors, Steve Pickford and Paolo Subacchi, were in London, at Chatham House. And I’d like to thank both Chatham House and the International Monetary Fund for support for this.

I’d also like very much, obviously, to thank Brookings for both publishing this book and for organizing this launch. There’s actually quite a lot of international cooperation here, as well, in terms of that we’ve already given a launch in London and another one in Shenzhen, so we’re moving around the world.

So what’s this book about? Well, I like to think about it is that, obviously, it’s about the thaw in the issue of thinking about economic cooperation after the crisis and what the crisis taught us about it. And I like to think about it, slightly, as a Cubist approach to looking at this question.

So, as you can see here in this piece by Picasso, you look at the guitar in several different angles, and you also look at the apples in various different angles. And the point about this is, the idea of Cubism is that if you look at things from several points of view, you will get a single view of the whole thing itself rather than just a view.

So I think of this book quite a lot like that, and there are two elements. The first is that we chose authors that we thought had different perspectives. So some of them are academics, some of them are policymakers who are actually in the fray, and some of them are people sort of in the middle. Another way of thinking about it is that we have a range of perspectives about how the crisis affected our thinking about cooperation, and they’re in all four parts of the book.

So the first part is about the intellectual framework for cooperation and how that was affected by the realization of quite how interconnected the world had become, which was something that we’d missed earlier in the run-up to the crisis.

The second part of the book is about the international responses. And here we have successive chapters by people who looked at this and it's not really about how the center reacted, it's more about people from the edges looking at what they think about the international response.

Then the third part of the book is how do you think about adding all these new policy areas into the framework? So I had this framework which was mainly about macro, and then how do you put in macroprudential? How do you put in structural policies? How do you put in regulatory policies? How do all of these things fit into the way that we think about policy cooperation?

And then the final part is about the institutional setting for cooperation. So, very often, discussions of cooperation have this thing where it's assumed that if the game theory works, it will automatically happen. And it strikes me that that isn't actually the way the cooperation really works in the real world. So what we have is an entire section discussing how cooperation actually might work in the real world.

So just to give you a flavor about each section, let's start with the first one about the intellectual framework. I think, look, before the crisis the overwhelming intellectual view was benign neglect. If you kept your own house in order that was fine and obviously the face that the crisis revealed so much interconnection meant that you had to move beyond that.

And, in particular, it also focused on the importance of financial stability as a new reason for countries to cooperate, but all three chapters in this section point out that it's actually tricky to get cooperation working. In some of the chapter it's because sometimes it's good to cooperate, but other times it's less valuable. Other times it's whether the parameters across countries work or don't work.

So another theme which comes out of this is that cooperation actually since the crisis has been quite affected by disagreements about not only the size of spillovers, but also sometimes even the sign of spillovers. So, for example, I think if you put Janet Yellen and Raghuram Rajan in the same room, you wouldn't find that they would agree about what the effects of QE have been on the rest of the world. And I do think that this is a very fundamental thing. Our models tend to assume that we know what the signs are and what the spillovers are. But, actually, that's been an area of real disagreement across countries.

Finally, I think the bottom line of this section is that cooperation may work smoothly, but only in certain circumstances. There are times when it will work and times when it won't work, but I think the really important thing about this is that you need to keep the structure up because when it matters, it's very important to have cooperation. And one of the things I think we learned from the crisis is because of the dominance of benign neglect; there actually wasn't a very good structure to include some of the people who mattered in the world. So that's the first part of the book.

The second part, what really comes out from the discussion of international responses is the distrust of the center. So all of the essays, really, find the U.S. and the core European policies -- you get this feeling of slight distrust of them and they're seen as somewhat self-centered, and that after asking for cooperation immediately after the crisis, there's the sort of feeling that the rest of the world was really asked to look after itself pretty much.

And there's some sort of regret that there wasn't more enlightened self-interest. Nobody thinks you should do thinks which aren't in your own interest, okay? That would be asking something too much, but the idea to think about how it affected other people and then how that would come back to you, there might have been more thought about that. And that caused trouble for other countries.

And the risk of this is self-insurance by countries and an increasingly splintered safety net. I think that we've made some progress on that more recently. There was a period during which it was really moving in that direction.

Then the third part of book, this is about the integration of policies. And the first point is obviously that policy assignments that we had, monetary policy, worrying about macro fiscal policy and worrying about debt. Those things got completely scrambled, both by the crisis and by the zero ban. And one of the things which comes out very strongly in this part of the book are the significant gains from cooperation on financial regulation. It's pretty clear that financial regulation is something on which you would really want to cooperate because inconsistencies can be very important.

Another sub-theme which comes out of this is that we seem to expect people to cooperate internationally despite the fact that, actually, the degree of domestic cooperation within countries isn't always that high because we have independent central banks and fiscal policies. And so I think there's a question there about how those operations should work. So one of the bottom lines from here is that more progress on technical than on political areas -- hardly surprising since technical decisions can be left to other people, but it's still I think an important insight.

And I think the really important thing is that probably, just as happened with trade after the 1930s, there was this sort of international agreement that trade then mattered. I think the financial stability has also been added to that rather short list of things on which it is probably fairly clear that you should cooperate.

Finally, the fourth part of the book, rather than putting up a summary, I'm going to show you this chart, which we called The Cross Chart. And on the vertical axis you have whether the issue is well defined or not, or weakly defined. And if it's well defined then you can have a rules-based system, much more. If it's weakly defined, then you need much more discretion.

Then on the horizontal axis you have all the participants. Homogeneous or are they heterogeneous? And if they're homogeneous you can probably do it through a single institution because there's an agreement about where things are going or how to think about things. Whereas, if the groups are heterogeneous, then you probably need to have a much more ad hoc setup. So I think that's a really useful way to think about, in the real world, how you actually organize cooperation.

So, four brief conclusions. The first is, look, I think people forget how impressive the original moves straight after the crisis were. And, in a sense, I think that looking at cooperation now, you always say, well, it wasn't as good as straight after the crisis. Well, that was because it was very good then.

Second is cooperation has clearly been made a lot messier by just having all these other policies, financial stability, macro-structural, et cetera.

So third point is that some frameworks have been more successful than others. So I think the Financial Stability Board has been a reasonable success in the financial area. On the other hand, the G-20 efforts to coordinate macro policies, the mutual assessment process, has probably been not nearly as successful.

Finally, I think that given that the important countries of the world have become much more diverse, any successful cooperation will have to have inclusiveness as a fundamental point to it. You can't, at this point, just have the G-7 deciding what the rest of the world needs to do. I don't think that's going to work anymore, given the importance of the emerging markets and the global economy.

So, there we are. Thank you very much. (Applause)

MR. DERVIŞ: Well, thank you very much, Tam, and also thank you for, as you promised, sticking to the time limit, which is not easy given the vast subject we're dealing with. But let me ask you a first question before we go to Fred and the others. When we read about the Great Depression, the history, one of the problems that had been highlighted, I think, already at that time was the harm done by attempts to competitively devalue. And indeed, the fix by the adjustable exchange rate system of Bretton Woods, in a sense, was an attempt to deal with that.

So I'm a little bit surprised that you started by saying, well, in a way we thought that if everybody did the right thing, then there wouldn't be so much need for cooperation. That may have been true for a while, but in the 20th century practically the whole Depression and the birth of the Bretton Woods system had a lot to do with the realization that there was need for cooperation.

And in the book, I think it's at least in one (inaudible) chapter, there is the discussion that particularly because of the lower bond, the quantitative easing has in a way become another way of trying to achieve competitive duration.

So I wonder whether we could start maybe with you saying a few words on that, and then I'll hand it over to the rest of the panel.

MR. BAYOUMI: Yes, well, I think as you say, Bretton Woods was set up in reaction to the 1930s and very much was focused on not letting people devalue in that kind of way, in a competitive way. I think that what happened was gradually over the 1970s and the 1980s, even more the 1990s, this idea that you had two targets, an internal target -- internal balance and external balance, started to go out of intellectual fashion. And instead, people decided that because of the floating exchange rates that adjustments were automatic and that, therefore, you didn't really need to worry about the external sector nearly as much.

And so that internal-external balance with ISLM became much more just monetary policy, looking for internal balance, and not worrying about policy mix. And I think that was an important part of the benign neglect view, which I think was the dominant intellectual fashion by the 2000s.

MR. DERVIŞ: Okay, sorry. I mean, the way you're saying that, with the move towards flexible exchange rates really changed the system and, in a way, freed domestic policy, right? That was the view.

MR. BAYOUMI: Yes, and as I say, I think this idea that -- there was sort of a rejection of the idea that you should have external stability goals and that the exchange rate was what it was and the current account is what happened. I think at least amongst the leading advanced countries that was definitely the view, in a sense. And, of course, what happened was you had these models in which the spillovers across countries that are very small.

So it was both an intellectual view and it was supported by these large models which showed that if you had a shock in one country, it didn't spill over to the other countries very much. Because the financial system was not actually modeled in a very subtle way and that, therefore, all you had was trade, which is not going to be a very large spillover outside of some cases.

MR. DERVIŞ: Okay, thank you very much. I think that's a very key answer and with that I'll turn to Fred and ask him for his comments. I think this issue, which we just touched on -- the core of the spillovers -- hopefully, will be part of our discussion.

MR. BERGSTEN: Kemal, thanks for the invitation, thanks for the introduction. Since you mentioned my having been Henry Kissinger's economic deputy at a tender age, I can't resist noting that when some people introduce me with that in my background, they go on to note that that's a little like being military advisor to the Pope. (Laughter)

I made that comment on a panel with Kissinger not so long ago and he said, "That is correct. And Fred went on to have a distinguished career in the Carter administration, something quite difficult to have achieved." (Laughter) So, as usual, he gets the last word.

There's a lot to like in this book. It emphasizes, for example, that the benefits of cooperation are much greater in tough times. That crises force cooperation, and that's when you get most of it. And those two points together indicate why it's so important to keep the coordinating institutions afloat. G-20, even still to some extent G-7, even if they don't do much in calm times and even if they don't seem like being very important in most of their meetings, it is crucial to keep them out there and in existence because when times get tough and when crises hit, you need something like that to turn to. We saw that crucially in 2007, 2008, 2009, and I think that's a very important lesson that the book gives us.

There are some important conclusions in the final chapter of the book by a team from the

IMF, led by Raman, which I would commend to you. One says big is beautiful. It doesn't use those words, but what it says is that being able to bring a number of different issues together for purposes of international coordination improves the chances of cooperation by permitting trade-off across different issue areas. And it quite rightly -- he knows his ancient history -- cites the Bonn Summit in 1978 as the prototype of doing that.

People forget, the Bonn Summit in 1978 is what enabled the United States to decontrol its energy prices and start the global correction of the energy shocks of the 1970s. So big is beautiful in terms of issue coverage is a very important lesson.

The chapter also points out that you have to also see international coordination as happening at a number of different levels among countries. I like the idea of congruent circles. You have your narrowest circle, which to me needs to be a G-2 between the United States and China, because if the United States and China don't agree, not much happens these days. So that needs to be your narrowest group.

Very informal, you don't even admit it exists, but you need to have it. Then you radiate out to the next tier, the G-7, the G-20, the Europeans as a group, and then finally to the broadest grouping, the IMF, the WTO, the big international multilateral institutions. So think of it in terms of congruent circles of ever-expanding tiers of decision making in order to get things done in the real world.

The chapter by Raman, et al., makes a big error when it says that the Plaza Louvre process "failed after a short period." We just published a book about a month ago on the Plaza process and it achieved its goals perfectly. It wanted to bring the dollar down a lot, it wanted to correct the current account imbalances of the day -- which were at record levels for the day -- and, therefore, it wanted to head off protectionism in the United States, which was at a fever pitch and threatened to undermine the whole international trading system.

Plaza worked perfectly in all of those regards and, therefore, should be viewed as a model of international economic cooperation. In fact, one of these days we may need a Plaza II, and, therefore, it's particularly important to keep it in mind.

I have two main criticisms of the book, mainly for omissions, or at least not enough emphasis, on a couple of key issues. The book, naturally and rightly, focuses a lot on spillover effects from some countries to other countries. But it mainly -- I won't say solely -- focuses on spillovers from what they still call "the advanced economies," high-income countries, to the emerging markets.

And that, I think, is a little behind the times because the spillovers in the other direction are, if not quite as important, very important and certainly have to be taken frontally on board in any kind of serious effort to deal with spillovers and, therefore, international cooperation. We know that the emerging markets and developing countries as a group, who use PPP exchange rates, now exceed half the world economy, growing three times as fast as the rest of the world, have a counter for three-quarters of world growth over the last decade or so. So you have to look at that group not just as a receiver of spillovers, but as a perpetrator of spillovers.

Two obvious examples of that, Tam rightly said that the book extolled the virtue of the cooperative response to the Great Recession crisis, when it broke in 2008, but one should note that it was China which moved fastest, moved biggest in helping the world respond. We know, in retrospect, the U.S. response much extolled at the time was too timid. It should have been much bigger and it's one reason why we don't have faster world growth at this point in time. But China took the lead.

Now, on the negative side, and so as not to disappoint Kemal, I would point to China's massive currency manipulation during the period of the Great Recession when it was literally exporting huge amounts of unemployment to the rest of the world. China was intervening in currency markets to the tune of $1 billion to $2 billion per day, building $4 trillion of reserves, driving its current account surplus to 10 percent of its GDP; its currency undervalued by as much as 40 percent at its peak in 2007, 2008. In short, replicating exactly what our earlier speaker said was done in the 1930s and the whole international monetary system was created to avoid. The same thing.

It was competitive non-appreciation of a currency rather than explicit competitive devaluation, but the same effect. And in a period of high world unemployment it had massively negative effects on the rest of the world, all its trading partners. There were other countries in addition to China which did it -- roughly double the impact of China's own actions -- but it was a huge failure. In my mind, the biggest single failure of the international monetary system in the post-war period.

Also, in this case, underlining how you have to take into account spillovers from emerging markets, notably China, through the rich countries. The example also points to what I think was the other big lacuna in the book, which is that it does not say enough about the domestic politics of international economic cooperation. We tend to think of the imbalances, and this is most of the economics literature, we think of the imbalances in countries external positions as becoming unsustainable when financing is no longer available for the deficit countries.

But, in truth, that has not been the major problem for the United States and some other high-income countries. The Plaza agreement which I just talked about very positively was not caused because foreign financing for the U.S. current account deficit dried up. To the contrary, the U.S. deficit was being over-financed and the dollar exchange rate was being driven up. What threatened to collapse was the domestic politics of trade policy within the United States. Because the dollar became heavily overvalued, because our current account deficit was soaring by the standards of the day, Congress -- the House -- had already passed three pieces of major protections legislation which, if they had ever become law, would have severely undermined the global trading system.

And that's why the rest of the G-5 of the day was willing to cooperate with the U.S. to bring the dollar down, correct the imbalances, head off the protectionist threat. So the issue was not the external financial unsustainability of U.S. position, it was the internal political unsustainability that caused the problem. And I emphasize that because we are seeing a somewhat similar situation today.

Those of you who followed the trade debate in the Congress last year over trade promotion authority know that it was a very close call. It could have been defeated and the biggest single issue that threatened to defeat it was currency manipulation and the need to do something about that to avoid trade liberalization being undermined by untoward action on the currency front. Right now, with the Trans-Pacific Partnership outcome in the Congress, in the politics of the United States, very much at question.

One big issue again is -- Hillary Clinton cites it, not just Donald Trump, Hillary Clinton, every other candidate cites it as question number 1 about TPP, and indeed globalization more broadly -- currency manipulation. The lack of a systemic framework to deal effectively, credibly, convincingly in domestic political terms in the U.S., but other countries, as well, to avoid the build-up of imbalances of that type which can shift production, jobs, economic advantage from one country to another.

So to me, that is the big failing of the international economic system, particularly the IMF, and international monetary system, at this point in time. The book can't deal with every question thoroughly, but I think as we go forward and try to shore up the weaknesses in our international economic cooperative network, it is those issues, the spillovers from emerging markets to rich, the domestic politics of the issues that have to be given full attention.

MR. DERVIŞ: Fred, let me just follow up on one point here, before turning to Heidi. On the imbalances and the exchange rate manipulation front, in terms of the actual surplus -- what I call the Northern European surplus -- when you add to the German surplus, some of the Northern European eurozone countries, and then add Switzerland, which is in many ways part of that group, you get am overall surplus that is of the order of magnitude, in terms of the share of the global economy, than China was. China is now smaller, right now.

Now, I know the exchange rate arrangements are different, but it would be interesting to just very briefly -- we can come to it and later maybe Heidi will want to talk about capital flows and how that fits the Chinese picture these days. But how do you compare in terms of global management of the structure of global demand the Northern European surplus to the old Chinese surplus?

MR. BERGSTEN: Right. Analytically you're right, they're very simple. Germany was to Spain, in the run-up to the euro crisis, as China was to the United States. Huge flows of capital, the other side of the current account imbalances, inflating the money supplies in the recipient countries creating monetary conditions that underlay the bubble. Steve Pickford in this book has a very interesting analysis which supports that view. He says that it was because China manipulated the exchange rate, forcing the U.S. into big external deficit, the U.S. had to achieve full employment by maintaining very low interest rates, which in turn provided the monetary conditions for the bubble -- the breaking of the housing bubble.

Now, the Chinese didn't force the U.S. banks to make stupid subprime loans, but their behavior helped create the monetary conditions that permitted that kind of macro imbalance to occur. And I would say Germany to Spain very much the same.

In the one interesting case you mentioned of a Northern European country not in the eurozone -- Switzerland -- Switzerland became the world's biggest currency manipulator in 2012, building up a massive amount of reserves in order to counter the flows of hot money that came into it as a result of the euro crisis. But also running a huge, huge current account surplus and, again, shifting economic output from its main market, the eurozone, and particularly the peripheral countries in the eurozone, who were under such pressure, to its own small but not-so-insignificant economy. So I see very parallel situations.

The German case, of course, complicated by being in the eurozone. The Europeans have supposedly an imbalance procedure that's supposed to deal with intra-eurozone adjustment. It hasn't done it any better than the global system has done for the international picture. And, again, a huge, huge shortcoming in our current arrangements.

MR. DERVIŞ: Thank you, Fred. Heidi, your perspective?

MS. CREBO-REDIKER: Hi. So I would recommend this book to everybody here. I'm pleased that I had the opportunity to read it. And I guess the underlying message is, in a complex world, more coordination's better than the alternative, which is no coordination. So at the end of the day, warts and all, the story is well told in this book.

But I'd like to focus on a couple of things that are really from my personal perspective. And the first you might miss if you read through the chapters in this, that I think is incredibly important, and that is that there is a great deal of attention paid to looking through the prism of capital flows. And when I first started reading this book I thought that this was not going to be the case. But I think that one of the big differences that we have learned from this crisis, and I'm speaking from a background of someone who was in finance and moved to policy, so my whole world was looking through the prism of capital flows before I moved into this world, and it's important.

When I first moved to Washington, I had I think in the first week a conversation with a very esteemed economist at the IMF about the U.S. Treasury market and the 10-year bond. And I said, well, from a trading floor perspective it really comes down to what's safe, i.e., the foreign asset manager of People's Bank of China was buying that day, and whatever the mortgage hedgers were doing in the mortgage market. And those were the big capital flows that were driving the 10-year. And the gentleman from the IMF said, that's impossible, it's not in my model. (Laughter) And I said, well, that is a pre-crisis story that I think really shows that capital flows are incredibly important, from developed markets to developing, and vice versa. And it also, and unintentionally, underscores the point that Fred was making, in terms of how large the drivers were from China, and particularly from SAFE, on the one hand.

And then on the other, we can talk about this later, but one of the core drivers of the crisis being the mortgage market which became incredibly big. It became so big that the hedgers ran out of instruments to hedge against, so the 10-year swaps, all of those things, were indications of a crisis that was looming.

But again, I would suggest that you look for all of the mentions of capital flows and looking through that prism because I don't think the economics profession prior to the crisis really did a good enough job of taking them into account.

The second is the chapter on the eurozone crisis by former Finance Minister Saccomanni. He did a very good job for all of those who have not been paying attention to the tick-tock over the past several years of the eurozone crisis. It is one of the best chapters that I've read that really can bring you through the crisis and, I think, give a good sense of not only what has been done, what some of those challenges were in the policy cooperation within eurozone members. But also I think he rightly shows how much has actually been accomplished. So although painfully slow for those of us looking from the outside, institution by institution, ECB policy by ECB policy, looking at what has been done through the crisis because it is quite substantial, and I think it was a reminder to me of just that.

And then the last thing I would leave -- and it's not a criticism of the book because I think that this book lays the groundwork for another book I hope Tam is going to write, and that is using some imagination about thinking about what this policy coordination means for any potential future crises. Because we all know that there's been a great deal of work in making banks safer, in actually plugging a lot of the holes and a lot of the challenges that we were facing in 2009, 2010.

At the same time, there are multiple canaries in the coal mine that you can hear when you talk to market participants about risks that are out there, risks that have shifted. And I would give a huge amount -- and this is an IMF-sponsored publication -- the GFSR has become a true source of flagging for those crises that could threaten the financial stability, which is now a global common good, which I think you pointed out rightly. It's informed by what I hear from people in the markets about what they truly think are the next risks that are out there.

And I think absent any kind of a formal linkage between what very complicated financial participants can and will do in markets, and the regulators and the supervisors and the surveillance mechanisms, I think they do as good a job as any of actually trying to flag some of those big macro-financial stability risks. So I think that the book does do a good job of that. We all need to use a great deal of imagination and to look forward to what crises are out there in the future. But I think this book is a good shot at laying the groundwork for that.

MR. DERVIŞ: Heidi, let me do one follow-up question in terms of capital flows and linking it to the debate on global imbalances. There may be different views on this, but at the times when Fred was stressing that problem of the Chinese surplus, if anything, the Chinese were trying not to let their exchange rate appreciate, right? But now, with the kind of worries there is the danger of significant capital outflows from China, which would actually depreciate their exchange rate and the opposite would happen, and, in a sense, in terms of the G-2 that Fred was referring to, in terms of international cooperation more broadly, I mean, how do you see the interaction, and particularly from the U.S. point of view, of potentially massive capital flows affecting China and the exchange rate?

MS. CREBO-REDIKER: So I guess I'll take this from a 30,000-foot and leading off of what I think I would put on the plate for the GFSR next edition, and that is that we have both the risk of large capital outflows from the likes of a China. We also have large capital outflows coming from commodity producers who over time have built up reserves and insurance for when times are bad. And those times are bad right now.

So you're seeing not only the pressures on one with capital outflows, but you're seeing the likes of Saudi, for example, and SAMA, see capital outflows. And I think that their big question to what happens not only to exchange rates, but also to assets because this is not a question of a sovereign wealth fund or a central bank holding currency, they actually invest in assets.

So treasuries, European sovereign bonds, if there are sovereign wealth funds and equities, what is it going to mean if you see this kind of movement, for two totally different reasons, but from large reserve and asset managers from the official sector, what does that mean for asset prices? What does that mean for financial stability? So I think that's one of those questions that we need to be thinking about and I would imagine that Jose Viñals is probably doing just that.

MR. DERVIŞ: Thank you very much. Vitor, can you please give us your perspective now, and then we'll try to have a few little interactive points before we turn to the audience. Thanks again very much for being here, Vitor.

MR. GASPAR: Thank you, it is a pleasure. I liked the book a lot. I like this idea of managing complexity. I think that applies to international cooperation, but it applies more broadly to macro. Macro has proven much more complex, much more -- or I would even dare say confused than many of us thought, even just a few years ago.

And the way Tam put it in his presentation, managing complexity, a Cubist approach to cooperation; I think that was really nice. I think that a Cubist approach captures this quite nicely. Let me start with a theme which is strong in the book, which is this idea that financial stability gives a very strong ground for international cooperation at this point in time, exactly as trade did after the rebuild of the global economy after the Second World War.

Now, I think this is a very good point. I would have emphasized financial aspects beyond stability. That is, if you look at the rebuilding of the global economy after the Second World War it was not about trade stability, it was about trade integration. And so what we are now facing is, the key question to me is, what are the cooperation prerequisites for successful global financial integration? That includes financial stability, but it goes beyond financial stability, and the issue of the importance of capital flows in macro clearly testifies to that. There is more to capital flows and the importance of capital flows in macro than financial stability.

Now, a chapter that I also liked very much in the book was the chapter on the euro area by Fabrizio Saccomanni. We were actually colleagues more than once. We were colleagues at the central banks, and I did attend some of the meetings that Fabrizio chaired in the Monetary Policy Subcommittee in the pre-euro area days. And we were colleagues as ministers in the Eurogroup and the ECOFIN during the crisis. And I think that Fabrizio very much captures the challenges that policymakers faced during the period, the ones that were successfully tackled and ones that were not successfully tackled. And I think it’s a very revealing chapter.

As for me, what I remember is that when the global financial crisis started, I was actually working in Brussels for the European Commission and we were preparing a volume on the 10th anniversary of the euro area, and one of the topics that we were covering in the various chapters of the book was spillovers. And people were very skeptical before the crisis about spillovers. Then the crisis came and one could actually touch spillovers and, even on occasion, be run over by a spillover. So those things became very, very clear, very evident, and the impact of that statement on the intellectual framework for cooperation is very clear in the book.

Now, going forward, as both Fred and Heidi have already said, the book provides a framework set of tools that can be used to think about cooperation going forward. And two aspects, and I'm finished, that I think are very important come from Tam's own chapter where he looks at the need for cooperation across policies in a given country. When you have a situation where monetary policy is constrained because interest rates are at or near zero, the monetary transmission mechanism becomes more challenging and ends the ability of monetary policy to deliver inflation at target, and output at potential in a timely manner becomes more difficult, more challenging, and ends the case for coordination, the need for coordination with fiscal, and structural becomes stronger. And that's something that Tam discusses with some detail.

In that contest, Fred's point about the importance of domestic politics is crucial. In today's world of international cooperation, domestic national politics will always be dominant. Tam also makes that point when he was talking about the importance of the incentive compatibility.

Incentive compatibility in international cooperation is compatible with national politics. And so I see Tam's position and Fred's position as very close. Now, looking forward, if one would have a situation where in advanced economies downside risks to inflation, downside risks to economic activity would materialize in a situation where at this point in time the industrial production index has grown less since the peak of the previous business cycle, has grown less this time when compared with the similar period of the Great Depression, and that applies to the U.S., to the euro area, it applies to Japan, if downside risks materialize under this condition, the case for international cooperation will be overwhelming.

And at that point in time, you will have the greatest level of complexity that one can imagine, which is the need for monetary fiscal structural cooperation, not to forget the financial side of it, macroprudential and regulatory. And then, in order to be able to tackle the challenge at the global level, one needs also international cooperation on top of that. If that scenario would materialize, Tam would have a great book to write.

MR. DERVIŞ: Another book, Tam. Let me follow up on one thing in terms of this -- actually the stress also on the chapter on the dogs that didn't bark, right? The need for cooperation within a country.

First, I would think that at a crisis time, that cooperation, at least in the emerging country economies, did always exist. Just to give the example from when we were managing the crisis in Turkey, we had an all-stars, to use Tam's -- not every six months, but every Monday morning. Clearly the Central Bank governor was there and that did not prevent us at the time to pass the law that gave the Central Bank independence, and nobody was giving him orders. But the fact that in a crisis situation people sit together is, in many countries, I think is actually the case.

Now, there are two interesting questions here. One is, what happens in Europe? How do you have an all-star meeting in Spain or in Germany when the Central Bank -- well, the Central Bank is in Frankfort, but not in Berlin. Is that a special problem? Because you don't have the all-stars in -- either you have to create the eurozone finance minister, then that finance minister can have a meeting with the Central Bank governor, with Draghi, or what do you do? So that's one question.

And the second question may be for Tam when he comes back. When you say coordinating monetary fiscal and structural, what do we all think of -- and it's a big debate, that you can have a set of structural policies which would work in the political economy sense, given a certain dose of fiscal expansion, or not. In other words, what you can achieve in terms of labor market reform, for example, depends whether at the same time your macro polices are pushing the unemployment rate up or down. So obviously this is an issue.

So it would be interesting to get the view, whether the lack of that kind of coordination -- in other words, some people saying you need this fiscal framework, without thinking what impact it has on structural policies, particularly in Europe, is one of the examples that one can deal with. But first, maybe, the issue of -- you were a Central Bank governor --

MR. BERGSTEN: No. I was a modest head of research.

MR. GASPAR: Head of research, okay. All right, but you were in the Central Bank. What does one do in Europe if you can't have an all-star meeting in a country?

MR. BERGSTEN: So let me try to address your two questions telegraphically. To my mind, the key issue about monetary policy and the moment when monetary policy starts having to be coordinated with other policies is indeed when monetary policy faces constraint, when interest rates are at or near zero, and, therefore, there is this additional uncertainty about the transmission mechanism and the ability of monetary policy to deliver price stability and output at potential, so inflation is very good and output at potential, in a timely manner.

When that happens the case for coordination with both fiscal and structural becomes very strong. The ability of monetary policy to provide the correct environment for structural reforming, particularly labor market structural reform to take place is weakened and, therefore, there are a number of specific challenges that materialize in that case. In terms of monetary fiscal interaction, on the one hand, fiscal can support monetary policy in delivering inflation at target and output, potentially, in a timely manner under those circumstances. On the other hand, if downside risks materialize, one of the things that does happen is that nominal GDP growth falls and ends the leveraging, in general, and the control over the public debt path becomes particularly challenging.

So the interaction is two ways. Fiscal can support monetary, but what happens in terms of the inflation target and nominal GDP growth is crucial for fiscal. So the case for coordination is very strong. Now, once you factor in uncertainty about potential output growth, and in particular the recent revisions down of potential output, you realize immediately that fiscal is a key tool for structural policies. So the interaction between structural fiscal and structural policies stripped to essentials is very, very strong. And so it’s, again, one very good example of the complexity that Tam is talking about.

The interaction between monetary and fiscal is two-way, and the same applies between fiscal and structural. And I’m emphasizing fiscal very much because, of course, I’m from the Fiscal Affairs Department which, by the way, never changed its name. (Laughter)

MR. DERVIŞ: That’s very good because, actually, one doesn’t forget how to define it. Anyway, thanks a lot. Tam, just a few -- don’t try to react to everything now because we’ll open the floor, but some key points that you want to react to?

MR. BAYOUMI: I thought Fred’s mention of spillbacks, the IMF talked about this, the spillbacks, so you have effects from advanced countries to emerging markets and they have spillbacks back. I think that’s right, I think that’s something which we will have to look at. The Fund has obviously been doing in its spillover reports, but I think it's a really important thing.

I think financial areas which Heidi talked about, this canary in the coal mine, it's always complicated because in a sense, the way I look at the world is that we have this nice macro thing which is kind of like relativity in physics, you move one thing and another thing moves nice and accurately and you can predict it, reasonably closely. Meanwhile, financial markets are quantum mechanics. They're either zero or they're one. They're either working or they're not. And I don't know whether you know, but in physics it's taken a hundred years and they still haven't put quantum mechanics and relativity together. And I have a feeling that we're going to have to accept that there's simply two ways of looking at the world, one of which is kind of macro and one of which is kind of financial, and that we need to worry about both of them equally.

On Vitor's point, yeah, look, I think we had this nice idea before the crisis that we could put everything into these little boxes and this is exactly what this did, and this was exactly what that did and I think, in a sense, what's happened is we've now got low growth, is that really structural? Where does macro fit in? Is it really demand? Is it structural? Is it supply?

In a sense, we've just thrown everything back into the same hopper and they're trying to work out what to do. And I think that's part of the managing complexity sub-theme.

MR. DERVIŞ: All right, we'll turn to -- well, maybe just one last word from me. In terms of the interaction between structural and macro, both fiscal and monetary, in Europe there are two very strong views, and I'm not saying one is right the other is wrong. Maybe both are right in some sense, but I simplified. The German view is that if you don't push on the austerity fiscal side and the debt restriction side and the toughness of macro policy, the political economy will be such that the structural measures won't be taken because the danger isn't there. The crisis is getting better and you're kind of giving the patient aspirin and the fever goes down and the patient thinks she's better.

The opposite view is that when the macro conditions are so tough, when the unemployment rate is rising, from a political economy point of view you cannot do some of the labor market reforms or product market reforms or other structural reforms that you know you should do because the social system will revolt, will break down. So which one is the case?

I think it's an example of both complexity and interdependence that, at the end of the day, I think the only answer one can give is it depends on the country and it depends on the particular situation. I wouldn't say that one was always right and the other one is always wrong. But just as an example, and any comment later, particularly from Vitor, would be appreciated.

But, anyway, let's go to the audience now. And we'll take two or three questions together and then come back to the panel. Yes? You were very fast in raising your hand. (Laughter)

MR. FREITAY: Thank you very much, Alex Freitay with the European Institute. Because it's a follow-up to what you were saying. And I wouldn't argue against coordination, I wouldn't argue against interdependence, but I would like to raise the question of the euro area context, for instance, given the facts that monetary policy should be independent from fiscal authorities and from politics therefore.

And you cited the case of Germany, for instance, if the Germans had had their way in the euro area context, of course they would have encouraged monetary policy and, therefore, the ECB to structure their monetary policy in a way that it would have put constraints on politicians and encouraged very strongly politicians to enact those very austerity policies or structural reform policies that you're advocating. That would have meant, though, that monetary policy and the ECB would have missed on its only mission, on its only goal, which is to ensure price stability at a level close, but below 2 percent.

So how do you resolve that conundrum that if you start coordinating too strongly or too much among these different actors, they might lose some of their independence and their ability to act. Do you see that danger?

MR. DERVIŞ: We will take two or three, so anybody else? Teresa?

SPEAKER: I want to ask a politically incorrect question. Coordination typically, all cooperation has to be led by the executive, but we are seeing here in this country a risk that -- or let's say a lot of calls for isolationism in the main candidates for the presidential elections. How do you think this can affect the scope for cooperation going forward?

MR. DERVIŞ: Wait, one more, maybe? Yes, in the back there?

SPEAKER: Is financial stability best pursued by a single set of global policies or rules, or is it best pursued through the coordination of different domestic policies and rules?

MR. DERVIŞ: Okay, let's go back to -- Vitor, why don't you start?

MR. GASPAR: That is fine, if you allow me, I will take the first two questions, so yours and the question on monetary policy. And I will pass on the last financial stability question. Also, Teresa's question on U.S. politics.

Now, on your question, which is a very good question about structural and macro, in general, the way we're thinking about it at the IMF is that one must go well beyond structural in general and discuss what kind of structural we're talking about. And one needs to be specific about that.

So, being specific about that, and using chapter 3 of the Spring World Economic Outlook, in that context, there is very good research I've found in which the authors show that for employment protection legislation and for unemployment benefits, the macroeconomic conditions prevailing matter a lot. And the impact of these structural reforms is very positive over the medium term and positive in the short term if there are strong economic conditions and, in particular, if monetary policy can react to structural reform. But they're negative in the short term and they may even be negative under the medium term if implemented under weak economic conditions.

Why am I making this point from the World Economic Outlook so emphatically? I'm doing it because the argument in the World Economic Outlook goes beyond your argument, which was political and about political conditions. It turns out that the economics also have something important to tell us.

Now, on monetary policy and the so-called German view, I would see it in a completely different way. The ECB statute, it's very clear, monetary policy aims at price stability, and price stability is defined as inflation at 2 percent. Close to, but below 2 percent, to be exact, and so the reason why the president of the European Central Bank has called for action on the fiscal and structural side and hinted at the importance of coordination with monetary policy because that would help monetary policy deliver on its statutory goal. And he's doing it in order to be able to reach the mandate. In my view, that is compatible with the very strong defense of Central Bank independence that has been the tradition in Germany for decades. And it's completely compatible with the independence of the Central Bank and the pursuit of its mandate.

MR. DERVIŞ: Fred?

MR. BERGSTEN: Yeah, I'd like to put just a slightly different spin on what Vitor was saying about Europe. Europe is a very peculiar animal in economic terms. It's an economic union with no government. And so by force of lack of alternatives, the European Central Bank has operated as the government of Europe. They don't like to put it in those terms, they like to talk about the independence of the Central Bank, but it was the European Central Bank that got rid of Berlusconi when he was threatening to drive Italy totally into the ditch.

It was the European Central Bank which took expansionary action when you could not get adequate fiscal or structural steps to bring Europe out of the depths of its crisis. And I think the European Central Bank was absolutely right to do that. But we all have to understand that when it does so, it is by dint of, again, the absence of alternatives of acting as the economic governor of the eurozone as a whole.

We ought to be thankful we have it, but we ought to be clear that that's what is happening and that's the way it will have to continue to operate until Europe gets its act together, gets a eurozone governance structure, gets a eurozone finance minister, and the like, so that the other parts of economic policy in Europe can be brought together.

The Germans, of course, are fundamentally inconsistent. On the one hand, they want the European Central Bank to deal only with monetary policy and to do so at a rigorous way. But, on the other hand, they block mutualization or creation of a European fiscal policy that would permit then some balance in the decision-making process so that the ECB did not have to do it all. As long as that tension continues to exist, the reality will be ECB runs the European economy.

MR. BAYOUMI: Can I --

MR. DERVIŞ: Well, sorry, yeah.

MR. BAYOUMI: So very briefly, I've been discussing with Fred for more than 20 years economic and monetary union. (Laughter) And I will not impose on you the tradition of that dialogue. (Laughter) But on the political side, I don't think that Fred is being accurate. And I think that the perception that Fred is indicating is actually quite dangerous for the independence of the Central Bank.

MR. DERVIŞ: Well, let me add something on that point. And I just spent 10 days in Germany. Fred, I don't think your summary -- and, of course, it's a summary -- quite reflects the reality. The reality is that Germany, and particularly Schäuble of all people, is actually in favor of fiscal coordination in Europe, provided it goes hand-in-hand with sharing of sovereignty, which, of course, would give German a big weight in the decision-making process. So the debate is really not should there be fiscal coordination or not, but if the fiscal coordination goes ahead, will the rules -- the weighted voting -- be such that Germany has a weight in it that reflects its population and its economy, or is the sovereignty part of the nation remains so strong that there is mutualization, but inability of Germany to legally and politically influence what kind of fiscal policy is conducted?

MR. BERGSTEN: Wow, wait a minute, Kemal, that chicken-and-egg stuff has been the center of the debate for 50 years longer than Vitor and I have been talking about this, and it's why nothing happens. Because the French say we've got to have political union, or Schäuble would say we have to have political union if we're going to have common fiscal policy. The way to get political union is to agree on common fiscal policy and that will, in turn, force the decision-making process that essentially integrates the politics of the eurozone. You can't wait to write a new constitution in order to set out the voting shares of the member in the new European political union before you do anything else or, as we have seen, nothing else will happen.

Do it the other way. Do it the functionally specific way, which they started when they created the monetary union on the assumption that economic union would follow. It did not, obviously, and so now you have to take explicit steps in that direction. If you wait for political union forever, no more will happen and Europe will be a continued crisis.

MR. DERVIŞ: We won't monopolize the debate. (Laughter) But politically, we don't have to go (inaudible) again, but somebody has to have fiscal rules by which fiscal policy is made. And if that's the disagreement, on the German part they want to have a weight which, to simplify it, for example, the French don't agree to. But, Heidi, why don't we give it to you so you either take it away from this topic or give your -- you haven't been in Europe in a long time, you might give your --

MS. CREBO-REDIKER: So far less contentious isolationism in financial stability. (Laughter) No, I think I do share the concern about a real sense of isolationism. And I think that that -- I understand where it comes from, but I also think that it's a danger because, on the one hand, we are -- part of the lesson from this book, part of the lesson from the crisis that we're all coming out of is the interconnectedness of markets, of trade, of capital. You can't be an isolated nation, particularly if you're going to lead, but if you're going to participate in the global economy, it's just by definition -- and our subject, too, the spillovers that come from the rest of the world.

So I think that we also have an opportunity because while we're not growing as fast as we should, we are in the United States in a much better position, relatively speaking, than many other developed countries in the world, and that gives us an opportunity to really reinvest in the international economic order that we created.

I am a firm believer that this is a time to really double down and make sure that we all understand the importance of having a robust IMF and multilateral development bank system; that we look at this as something that is a good that's been created with a strong set of values and it's an opportunity to actually reinvest in those structures that we created. So I think that the isolationism, while understandable, is something that's misplaced.

SPEAKER: I just would like to make clear that I don't agree with isolationists. I'm just worried about unifications of at least the platforms, so far, are being followed by some of the regional candidates here for the whole architecture of the international policy cooperation.

MR. BERGSTEN: Can I just say, Kemal, we all know that Trump would be a disaster, we know that. (Laughter) No need to be politically -- Trump would be a disaster. But, as I said in my remarks, we have to keep in mind the linkages between this kind of antiseptic international economic cooperation we talk about and the domestic politics. And I was glad Vitor strongly supported that, as did Kemal.

On a couple of occasions in the last 50 years or so, the United States has felt that the way the international system was working was violating its fundamental interests, and it had to break out. The most dramatic case was Nixon in '71 taking the U.S. off gold, putting on an import surcharge, and breaking all the rules of the day. I strongly criticized it at the time.

In retrospect, it was necessary because, remember, it was the U.S. breakout from the Bretton Woods system that moved the world to flexible exchange rates, which all would now agree was essential. And without the U.S. having done that, I doubt it would have happened, and if so, it would have been much delayed. Actually, when I was in government back in that period and Paul Volcker was undersecretary of Treasury, we tried to negotiate with the Europeans some move towards more flexible exchange rates and got absolutely nowhere. So it was probably necessary for the U.S. to break crockery in order to reform the system in a way that came out positively.

In the mid-'80s, when the dollar became massively overvalued, the domestic politics here was threatening to erupt, as I said earlier. Jim Baker had the wisdom to reverse totally the benign neglect of the first Reagan administration -- that was really benign neglect. But the dollar soared to huge overvalue, and, fortunately, the other key countries saw that he was right and did it in a cooperative way. But that, again, was breaking new ground, Plaza Agreement and all that, coordinated move on our exchange rates. Those two episodes indicate what's the real systemic risk, which is that the United States, the core country in the system, is driven by its domestic politics to break out of the system.

Now, no system is worth its weight in feathers, let alone gold, if it can only work or only achieve the kind of structural changes it needs when the center country breaks out of the rules and violates all of the conventions. But that's happened twice.

Now, crucial question that you raise: Is it about to happen a third time? I gave a lecture at my place about three years ago where I said -- I went back and rehearsed some of history and said, if we don't cooperatively manage constructive reforms of the way the system and its cooperation works, then we run a risk of getting another John Connally. Well, I didn't realize it would be so soon. (Laughter) I mean, Trump is Connally cubed. (laughter)

And, fortunately, I don't think any of that could happen, but it is symptomatic of the problems that I, at least, was talking about and that the book talks about in more intellectual ways. But the need to have the system deal much more effectively with underlying imbalances and unsustainabilities that could otherwise cause some real damage.

MR. DERVIŞ: Okay, we're running almost to the end, so we'll ask Tam to say the last few words before thanking him again and the panel.

MR. BAYOUMI: Three very quick things. One is that in coming back to the book, in my own chapter I argue that what you should have is an organized discussion across fiscal monetary structural reforms, where people come and say how they think it will affect not only their own area, but also everybody else's area. And I think that lack of organized discussion, which I think would also be helpful in the international sphere, is something which is quite striking.

So Fred has been talking about people breaking out, well, why didn't the Americans go and say this isn't working for us? How can we do things? So that's one thought.

MR. BERGSTEN: I'll tell you, I've tried.

MR. BAYOUMI: The second thought on -- I do actually think, in a way, I think that we're still waiting for new intellectual consensus. The oil crisis killed the mixed economy view of the '60s and early '70s. I think the current crisis has killed the Reagan-Thatcher "greed is good" sort of thesis. And I don't actually think we've got a new one coming. And I do actually think the next American President will be very important because the idea that you can get a new intellectual consensus without the American leading it seems to me sort of nuts. (Laughter) So it seems to me that whoever's leading the U.S. for the next four years will probably be quite important from that point of view.

The final point I'd like to make is, obviously, I would be remiss if I didn't mention that Brookings will be very happy to sell you copies of this book at the end of this. (Laughter) And I would be very happy to sign them in whatever way that you want. So please feel free, after having heard all of this interesting talk and all of this praise of the book, please feel free to feel that your wallets can be opened and provide largess.

MR. DERVIŞ: Well, thank you all. This is, after all, a book launch, so. (Laughter) But I think Tam took some risk by saying he would sign it in whatever way you wish. (Laughter) I'm not sure that's quite -- I mean, for example, if somebody asked him to sign it by endorsing one of the two U.S. presidential candidates, I'm not sure he can do that. But anyway, I do hope you will take advantage of his presence, and I do want to thank everybody, and particularly, of course, Heidi, Vitor, and Fred for joining us.

This kind of discussion could go on a long time. These issues are not yet solved, but I do believe we had an excellent discussion, with different viewpoints, but also some strong points of convergence. Thanks all of you for coming on such a beautiful day, and hopefully you will take advantage of the sun that's out there for a while. Thanks a lot. (Applause)

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