Think Tank 20:

Macroeconomic Policy Interdependence and the G-20

Izak Atiyas
Agnès Bénassy-Quéré
Suman Bery
Colin Bradford
Kemal Derviş
Peter Drysdale
Badye Essid
Gustavo H.B. Franco
Thomas Fues
Paolo Guerrieri
Sergei Guriev
Paul Jenkins
E. Fuat Keyman
Homi Kharas
Miguel Kiguel
Wonhyuk Lim
Jacques Mistral
Guillermo Ortiz
Raden Pardede
Jean Pisani-Ferry
Aleh Tsyvinski
Peter Wolff
Qiao Yu
Yongding Yu

April 2011

Think Tank 20:

Macroeconomic Policy Interdependence and the G-20

Izak Atiyas
Agnès Bénassy-Quéré
Suman Bery
Colin Bradford
Kemal Derviş
Peter Drysdale
Badye Essid
Gustavo H.B. Franco
Thomas Fues
Paolo Guerrieri
Sergei Guriev
Paul Jenkins
E. Fuat Keyman
Homi Kharas
Miguel Kiguel
Wonhyuk Lim
Jacques Mistral
Guillermo Ortiz
Raden Pardede
Jean Pisani-Ferry
Aleh Tsyvinski
Peter Wolff
Qiao Yu
Yongding Yu

April 2010

CONTENTS

EUROPEAN UNION

FRANCE

GERMANY

INDIA

INDONESIA

ITALY

KOREA

MEXICO

RUSSIA

TURKEY

UNITED STATES

Macroeconomic Policy Interdependence and the G-20

Kemal Derviş
Vice President, Global Economy and Development, Brookings Institution; Former Executive Head of the United Nations Development Program; Former Secretary of Treasury and Economy Minister, The Republic of Turkey; Advisor, Istanbul Policy Center, Sabanci University

Homi Kharas
Senior Fellow and Deputy Director, Global Economy and Development, Brookings Institution; Former Chief Economist, East Asia, World Bank

Challenges of Interdependence

Global interdependence has increased in many domains, such as the spread of infectious disease, nuclear threats, climate change and the management of the global economy. In each area, there exist large spillover effects across national borders that have prompted efforts to come up with globally coordinated solutions. In the economic domain, some of these efforts have either been enshrined in legally binding treaties, as in the case of trade rules that the Word Trade Organization has been set up to provide and enforce, or conventions and norms for behavior as in the case of the Basel Committee guidelines for the banking sector or rules relating to health issues coordinated by the World Health Organization.

The great financial crisis of 2008 and the ensuing recession that hit large parts of the world economy highlighted the importance of macroeconomic and financial stability as global public goods. Financial problems are highly contagious in a world where financial institutions have become global and systemically important, where capital flows move back and forth in huge amounts across borders, and where derivatives of various sorts tie markets together in novel ways that always seem one step ahead of regulatory authorities. The recession also highlighted the importance of coordinated global demand management through fiscal and monetary responses to the global downturn and, more broadly, of the need to buttress global confidence in the system and avoid self-reinforcing downward spirals.

The International Monetary Fund has long attempted to encourage macroeconomic policy coordination through some form of multilateral surveillance, as well as global forecasts and research on global economic issues. At the IMF, there is also a long tradition of promoting the development of prudential standards for the financial sector or prescriptions for prudent fiscal policy. Until recently, however, member states have not given strong support to the multilateral dimension of these efforts.

The 2008 crisis pointed to the deficiencies in the institutional arrangements for dealing with financial crises and global macroeconomic interdependence. With regard to the financial sector, the Financial Stability Forum has been expanded and transformed into the Financial Stability Board (FSB), and working with the IMF and the Group of Twenty (G-20), it is to provide global rules for regulating the financial sector. While much still needs to be done, the framework for tackling the issues appears set in place. The same cannot be said for managing global macroeconomic interdependence, or what is often somewhat loosely called "global macroeconomic imbalances". Until 2009, the efforts by the IMF to strengthen its multilateral surveillance processes did not in the past receive the needed degree of support from shareholders. But the G-20 did decide at the Pittsburgh Summit in the fall of 2009 to deal with macroeconomic policy interdependence through a new Mutual Assessment Process involving member nations, with a facilitating role for the IMF. That, broadly, is the topic of the collection of short essays in this volume.

At the outset, it is important to set realistic expectations for what the G-20 can hope to achieve. The limited progress of consultations under IMF multilateral surveillance in the past[1] points to the difficulty of reaching agreement on the need for macroeconomic adjustment in any individual country, the magnitude of the international spillovers and the desirable course of action.

Some pundits have argued that the failure of the G-20 to come up with a global realignment of exchange rates or with specific current account targets at the last summit in Seoul shows that there is no global leadership on this issue. That is perhaps too pessimistic. Agreement to proceed with identifying a set of indicators on the basis of which to have a structured dialogue was an important step forward. Taking that to the next level will be the real test.

The G-20 is approaching the topic of imbalances and macroeconomic interdependence through a process of consultation and joint discussion. But unlike the IMF, where votes are weighted by quota and where there is a formal voting mechanism to reach a decision, even if it is rarely used, no member of the G-20 is formally more important than another—all are in that sense "equal". This puts a high premium on "consensus". What is more, no final decisions can actually be taken at the G-20. In almost all matters, leaders will have to submit any jointly agreed actions for the approval of parliaments and domestic oversight bodies. Their discussions at the G-20 can be protracted for that reason. No leader wants to have their credibility diminished by being unable to implement an agreed-upon action because of insurmountable domestic political hurdles.

Macroeconomic Spillovers

Attempts at global policy coordination to deal with the *spillover effects of macroeconomic policies* are at a very embryonic stage. It is generally recognized that fiscal, monetary and exchange rate policies pursued in one country, particularly if it is a large country, do affect other countries. But it is equally recognized that every country has the sovereign right to undertake policies in a way to achieve its own domestic goals of full employment, low inflation and external balance. Low interest rates in the U.S. or Europe, for example, encourage short-term capital flows to emerging markets but the latter are "free" to take offsetting measures through sterilization, fiscal tightening or even capital controls.

Or, to take another example, when an open economy tries to stimulate domestic demand through fiscal or monetary expansion, part of the stimulus will leak into import demand and thereby stimulate production and employment abroad, subtracting some of the stimulus from demand at home. That is why the key topic at the London meeting of the G-20 in April 2009, when most advanced countries and many emerging economies were still in a deep recession, was *coordinated* worldwide fiscal expansion. The incentive for any one country was to rely as much as possible on fiscal expansion elsewhere, thereby protecting its own fiscal space, while benefitting from increased exports to countries stimulating their demand. The G-20 helped overcome this "free rider" problem; its contribution was no doubt more in the process leading to the summit than in the form of any summit decision, but that is to be expected from most forms of summitry.

Concern for macroeconomic interdependencies led to the G-20 to commit to the Mutual Assessment Process (MAP) with each country agreeing at the September 2009 Pittsburgh Summit to spell out its future plans for macroeconomic policies, leading to a process of "peer review", facilitated by advice and analysis from the IMF, with emphasis on spillover effects and the overall consistency of the projected growth paths. A first benefit of this approach is that each country can make its own policy decisions with better information on what others are planning to do now and in the future. A further benefit could accrue if countries actually changed their policies as a result of a coordinated strategy. The IMF has estimated that there are substantial potential benefits for the global economy if more coordinated policies could be pursued.[2]

The MAP is clearly a work in progress. It has not yet led to any major concrete results and the process itself is still evolving. At the Seoul Summit in November 2010, the G-20 agreed to come up with a set of macroeconomic indicators complementing the MAP, an agreement that helped at least to delay a major confrontation between the United States and China on exchange rate policies.[3] But the issues are far from resolved. After much debate, G-20 finance ministers agreed at their February meeting in Paris on which indicators should be included in a preliminary list, but there is as yet no agreement on what exactly to do with that list or on the numerical values of these indicators that would trigger further and deeper analysis. The G-20 has agreed that macroeconomic policy interdependence is an issue. It has embarked on the MAP as well as on a list of indicators to deal with the issue, but where this will lead remains very much an open question.

A Two-Step Process

What has been agreed on is a two-step process. First, a relatively restricted set of indicators will be examined, including the fiscal deficit and public debt, private savings rate and private debt, as well as the trade balance and net investment income flows and transfers, taking into consideration exchange rate, fiscal, monetary and other policies. Second, if these indicators point to serious problems for particular countries or for the external sustainability and consistency of policies, a more in depth analysis would be undertaken focusing on a much more comprehensive set of variables, including structural variables, which remain to be defined.

It took many months for the G-20 to agree on the first set of indicators and on the two-step procedure to be followed. The current account and trade-related part of the indicators were from the start the most obvious one as trade balances tie countries together through the interdependence in the effective demand available for each country's output and current accounts mirror differences between aggregate savings and investment. The importance of this "demand interdependence" for macroeconomic policy is in practice a much debated point.[4] As summarized succinctly by Blanchard and Milesi-Ferretti, demand interdependence and the battle for export shares and trade surpluses become more important when economies are in a liquidity trap and cannot achieve full employment through further reductions in interest rates.

Domestic debt variables and savings rates would seem to be less immediately central to the global macroeconomic interdependence debate. But experience has shown that both sovereign debt worries as well as concerns relating to excessive leverage in the private sector can be contagious and spread across borders and that a key spillover from individual country policies is the impact on international capital flows. Moreover, private and public savings in relation to investment demand are of course the underlying determinants of current account balances, so it is natural to analyze these sets of variables together. Finally, all this has to be viewed with due consideration for exchange rate and reserve accumulation policies. Current account balances that evolve in a flexible exchange rate environment without reserve accumulation or reserve sales by the public authorities are clearly different in nature from imbalances accompanied by fixed exchange rates and large scale foreign reserve interventions by central banks. These issues and differences link the "indicators" discussion to the discussion of the international monetary system, including the role of the special drawing right (SDR) and the provision of precautionary finance by the IMF.

The first basic set of indicators chosen by the G-20 reflects these considerations. It is clear that a deeper analysis will have to look at other indicators relevant to labor markets and employment, as employment is after all one of the two or three key objectives of macroeconomic policy. Moreover, issues related to income distribution, social policies and the "quality" of government revenues and expenditures are also relevant because they drive spending pressures and affect the growth outlook. A temporary fiscal deficit, reflecting a strong effort by a government to build infrastructure at a time when it can borrow at very low interest rates, has different long-term consequences from a deficit due mainly to rapidly rising defense or public consumption expenditures. So when looking at fiscal policy or deficit reduction plans, it is really not sufficient to look at aggregates. The "quality" of adjustment may be as important or even more important than its aggregate value when it comes to evaluating long-term sustainability.

The additional indicators mentioned above are perhaps more relevant to domestic economic outcomes than to the balance of payments or the current account, so one may question why they should be the focus of international consultation. But they are crucially important for the effectiveness and consistency over time of all macroeconomic policies. It is generally accepted, for example, that better social protection policies in a country like China would be very helpful in reducing high savings rates and strengthening domestic demand, thereby reducing pressure to maintain an undervalued exchange rate to generate employment. It should also be understood that persistent high unemployment in the U.S. poses a huge political challenge to fiscal consolidation and indirectly to the reduction of what remains a very large current account deficit. In the U.S., an infrastructure focused public investment program accompanied by savings through better targeting of entitlements toward poorer households, and reform of the tax system with more incentives for savings and investment, will be compatible with better employment performance and have much more positive long-term consequences than an indiscriminate across the board spending cuts program with no tax reform.

Perspectives from G-20 Countries

The perspectives contributed in this collection of short essays broadly relate to this macroeconomic policy coordination challenge that the G-20 is grappling with. Beyond the specifics of the indicator list, it is important that the issues be debated widely and, if possible, better understood. Macroeconomic policy coordination will certainly not be achieved in one stroke. Progress will take years and require both analytical and political progress. It would be both naïve and unfair to pronounce the November 2011 G-20 Summit a failure because it does not lead to an agreement to target specific macroeconomic magnitudes and reach consensus on the policies to achieve them by the G-20 membership. But then, what can and should be expected in 2011 from the G-20 on these issues? How can public understanding of the issues be strengthened worldwide? How can more cooperative attitudes be fostered? How can the process be moved forward, expectations be managed and macroeconomic policies be improved in a global perspective?

The short essays in this collection provide valuable and varied unofficial academic and think-tank perspectives from G-20 countries. The approaches toward macroeconomic coordination taken by the authors fall into three broad categories. First, some emphasize the need for better information sharing to improve the quality of national economic management. A simple example is that when each individual country's export and trade balance forecasts are added up, they are globally inconsistent. More realism is needed in making forecasts. A more sophisticated commentary on these issues goes into the limitations of data and models in forming views of imbalances, especially at the more disaggregated level of bilateral flows. There, the huge discrepancies between gross export flows and the value-added of exports—something that is not yet formally and systematically collected across countries—are noteworthy for the different implications for policy that are entailed.

A second set of considerations is around coordination when more than one global equilibrium is possible. This can be cast in a prisoner's dilemma formulation, where everyone wins by choosing one of the equilibria, but more generally raises the prospect of the existence of equilibria where one country benefits at the expense of another. In the latter case, consensus is unlikely and global rules or understanding of "fair play" in international trade and finance may need to be enforced through sanctions or other more formal processes (akin to the WTO dispute resolution mechanisms).

A third type of coordination is around the production of global public goods, such as low and stable inflation, international liquidity lines in times of crisis and sustainable growth for all economies including non-G-20 countries. Here, the concerns are more with whether adequate crisis mitigating measures have been put in place and with whether adequate attention is being paid by the large advanced economies, when setting their own national policies, to the likelihood of triggering a new crisis elsewhere in the world with attendant global costs of contagion and general loss of confidence.

Some of the views expressed are quite controversial. They reflect the opinion of the authors and should not be read as necessarily representing some sort of "country view". Naturally each author or group of authors is influenced by the specific experiences of the country or countries they come from or have worked in. That makes for the richness of this collection. As an example, we are struck by the fact that most authors from emerging economies tend to emphasize imbalances in financial flows and the risks of surges, sudden stops and crises in their countries that have far less developed financial markets. On the other hand, authors from advanced economies tend to view imbalances in terms of the trade and current accounts, which are more directly related to their concerns about underemployment. So, even the key agenda items must be broadly cast to gain acceptance in a G-20 process.

We are deeply grateful to the distinguished contributors and hope the contributions in this collection can both stimulate global debate and be helpful in furthering international cooperation.

References

Blanchard, Olivier, and Gian Maria Milesi-Ferrett, 2011. "(Why) Should Current Account Balances Be Reduced?" IMF Staff Discussion Note.

Bradford, Colin and Wonhyuk Lim (eds), 2011. Global Leadership in Transition: The G-20 – Toward Greater Effectiveness and Legitimacy, Brookings Institution Press, Washington D.C., with the Korean Development Institute, Seoul.

Dadush, Uri, 2011. "Global Rebalancing: The Dangerous Obsession," Carnegie Endowment for International Peace, Policy Brief 90, February.

Dervis, Kemal, 2010. "The G-20 and Macroeconomic Policy Coordination at the Crossroads," in Brookings G-20 Summit Report No. 5, November.

G-20 Seoul Summit Leader's Declaration, November 11-12, 2010. Seoul, Republic of Korea. (http://media.seoulsummit.kr/contents/dlobo/E1._Seoul_Summit_Leaders_Declaration.pdf).

International Monetary Fund (IMF), 2010. "G-20 Mutual Assessment Process—Alternative Policy Scenarios," prepared for G-20 Summit of Leaders in Seoul, Republic of Korea.

Independent Evaluation Office (IEO), 2011. "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07," IMF, January.

Endnotes

[1] See IEO (2011) for an in-depth assessment of Fund surveillance activities in the lead up to the financial crisis.

[2] See IMF (2010).

[3] See the G-20 Seoul Summit Leader's Declaration as well as Bradford and Lim (2011).

[4] See Blanchard and Milesi-Ferretti (2011) and Dadush (2011) for two somewhat opposite views on the practical importance of "Global Imbalances". See also Dervis (2010).

World Inflation: A New Challenge for the G-20

Miguel Kiguel

Former Under Secretary of Finance and Chief Advisor to the Minister of the Economy, Argentina; Former President, Banco Hipotecario; Director, Econviews; Professor, Universidad Torcuato Di Tella

World inflation is on the rise again and it is creating new challenges for policymakers in emerging and developed countries. Should the world accept a little more inflation or should it take a tough stance and fight it? Is it possible to coordinate a policy response when some economies show signs of being overheated while others are still recovering from the crisis? This is an important dimension of the macroeconomic policy coordination that the G-20 is facing.

In most countries, the rise in inflation appears to be driven by higher commodity prices, namely food and energy. One key question though is whether the increase is only temporary reflecting changes in relative prices or if instead it could lead to a permanent increase in inflation, as was the case in the 1970s.

The biggest policy dilemmas are in the industrialized countries, which are still recovering from the 2008 financial crisis. Unemployment is still high in the U.S. and in many European countries while the real estate sector remains depressed and has not recovered from the recession.

Commodity Prices Are a Key Driver of Inflation

Commodity prices have been on the rise in the last decade largely because they have been pushed upward by the high rates of growth in China and India. These two countries, and especially China, are dominating the additional demand for raw materials and putting pressures on a supply that grows very slowly.

The increase in prices has been across the board as it has included energy and fuels, metals and agricultural commodities, and it represents a turning after many years in which commodity prices were losing ground to industrial goods and services. After taking a pause during the 2008 financial crisis when the prices of some commodities fell by two-thirds, they have resumed the upward trend and they are still on the rise.

In real terms, the prices of most commodities today are at the highest levels since the 1970s. However, the rise this time has been more gradual compared to the previous episode. In addition, it was not triggered by a decision of a cartel of oil producers, the Organization of Oil Exporting Countries, to drastically increase prices but instead it has been driven by market forces.

Is This Time Different?

The oil shocks of the 1970s were accompanied by an overall commodity price boom that was short lived and led to the phenomenon that is now widely known as stagflation.

The rise in inflation in the mid-1970s was significant in many industrialized countries and raised a new and important policy dilemma: whether to accept and validate through accommodating monetary policy higher rates of inflation or to fight them and try to bring them down through a tightening in macroeconomic policies. The final answer is well known. Central banks accommodated the rise in prices and most industrialized countries ended up with double-digit rates of inflation. In addition, the rise in the prices of oil and of other raw materials created a "supply shock" that led many economies to enter into recession and the world faced for the first time the phenomenon known as stagflation.

The rise in commodity prices this time around has been less disruptive than in the 1970s. In part because it has been gradual and in part because the industrialized economies have become less dependent on oil as they have been taking energy efficiency measures for the last three decades.

While the effects of commodity prices on output have been small, as the world economy continues to move ahead propelled by the emerging market countries, the policy discussions are once again in the front page. In the industrialized countries, the main issue is whether to tighten macroeconomic policies at a time when most economies have not yet fully recovered from the financial crisis and still face high rates of unemployment. The focus is on Europe and the U.S., whether the nature of the problems is different and whether the policy response is also likely to differ.

In both cases, the inflationary effects have been limited, especially when they are compared to the 1970s since headline in January 2011 was 2.4 percent in the Eurozone and 1.6 percent in the U.S. The policy response has been different. The European Central Bank (ECB) has announced that it plans to tighten monetary policy and raise interest rates as inflation is now higher than the existing target—a decision that creates risks for the "peripheral" countries like Greece and Portugal, which are still facing deep recessions and where a tightening in policies will make the much needed recoveries very difficult. If the focus of policies is based on these countries, the tightening in policies will be a big mistake. They need a weaker euro and lower interest rates to grow. But the ECB is likely to adhere to its mandate, which is to maintain inflation within its target. This means that the problems in the peripheral European countries are likely to worsen.

The U.S. has adopted a looser monetary policy, which is a reasonable approach given that the U.S. still faces large rates of unemployment. The maintenance of very low interest rates and the adoption of the quantitative easing policy last year imply some risks in terms of inflation, but it seems that it is the right way to go. Even if these expansionary policies end up raising inflation to the 3-4 percent range, it should not be a problem, as it could be a way not only to reduce the rate of unemployment but to help the recovery in real estate prices that have remained depressed since the 2008 financial crisis.

The Policy Dilemmas for Latin American Countries

The rise in commodity prices is a mixed blessing for some Latin American countries—at least for the ones that are commodity exporters. The higher prices have helped the external accounts and increased real income, but they also favored higher rates of inflation and a strengthening of the domestic currencies. We are probably witnessing a remake of the 2007/08 economic scenario when the concern was agflation—inflation led by a rise in agricultural commodity prices.

This time, the policy options look easier because the underlying inflation rates are much lower than they were in the previous episode while there is room to tighten macroeconomic policies as most economies still have in place the expansionary macroeconomic policies that were implemented in 2008. Besides, growth has remained strong and there are indications that the economies are overheated as they have quickly recovered from the 2008 crisis.

In general, countries have responded to the inflation pressures by raising interest rates. Brazil probably has been one of the most aggressive countries in this area, as the policy interest rate (the SELIC) is only 25 basis points below the rates of 2008. In other countries, the policy tightening has been more gradual. Argentina is the exception, as it has maintained a very expansionary monetary stance and inflation is on the rise.

While the use of tighter monetary policy seems appropriate in these cases, it can have some undesired side effects, namely a real appreciation of the currency. In fact, this is precisely what has been happening in most Latin American countries, where there is a concern that currencies could be overvalued and affect the performance of non-traditional exports. While this phenomenon could well be unavoidable when there is a significant improvement in the terms of trade, it can be somewhat mitigated through fiscal policy.

In fact, one better response would be to change the policy mix to one that relies less on increases in interest rates and more on a tightening in fiscal policy. Less government expenditures in domestic non-tradable goods is a way to limit the extent of real appreciation of the currency. Brazil has announced measures along these lines when it decided to tighten fiscal policy, though monetary policy is still very tight.

At the world level, it is difficult to envision a coordinated policy response to the renewal of the inflationary pressures, especially because the overall policy objectives are dissimilar in Europe and the U.S. regarding the concern about inflation and unemployment. In addition, the nature of the problems are different because while the emerging countries have overheated economies, sound fiscal balances and manageable debt burdens, the developed countries are facing high rates of unemployment and weak fiscal and debt fundamentals. It is probably desirable for the developed countries to accept slightly higher rates of inflation and maintain the stimulus, but it seems that at least Europe is unlikely to move in that direction.

In the meantime, the world is likely to continue facing high commodity prices and the bulk of the policy effort to control the inflationary effects is likely to fall on the emerging countries.

Defining an Asian Agenda in the G-20

Peter Drysdale *Emeritus Professor of Economics, Australian National University; Head of the East Asian Bureau of Economic Research; Co-editor, East Asia Forum*

East Asia, as elsewhere in the world, continues to face risks—both economic and political—in recovering from the global financial crisis. These risks are a consequence of past failure in the architecture of international governance, including regional architecture, that frustrated a coherent international response to the big problems of the day in their global context.

The global financial crisis and the emergence of the G-20 has changed all this dramatically and gives Asia, of which Australia is an integral part, and the G-20's Asian members the platform from which to assume a new role and proper responsibility in managing the world economic order. Korea led the way by hosting the first G-20 summit in Asia in November 2010. As the G-20 turns now to deal with the vulnerabilities in global recovery and develop a framework that might secure more effectively against future financial and economic shocks, Asia's response will be critical to its success.

Asia's position in the world economy now puts it in the spotlight in terms of what is at stake in managing the global trading system and who needs to shoulder the responsibility. Not so long ago, Asia could afford to be a free-rider in trade and economic policy leadership. This is no longer the case. China is now the largest exporter and second largest economy in the world, largest destination for foreign direct investment and the sixth largest source of foreign direct investment. Asia is already the second largest center of world trade; by 2020, it will likely be the largest.

Asia now has a platform at the global level to deliver on its growing international responsibilities, in the form of a G-20 process that includes China, Japan, Korea, India, Indonesia and Australia.

The immediate goal is to build on the process of, and give substance to, strengthening international macroeconomic policy coordination, which the G-20 has begun. How can Asia contribute best to this goal?

The G-20 finance ministers' meeting in Paris clinched an agreement on which economic indicators should be used to evaluate and tackle the economic imbalances at the heart of managing global recovery. Importantly, China signed on to the deal, which will see trade balance and investment flows monitored and take due consideration of exchange rate, fiscal, monetary and other policies. As China has always insisted in response to Western pressure on its exchange rate, exchange rates will only be considered in a wider policy context.

This accord marks an important first step toward dealing with the imbalance problem and putting the global economy on track toward more viable growth and prosperity. But this is only the first step. The Mutual Assessment Process (MAP), which involves review of G-20 members' national policy strategies with the assistance of the International Monetary Fund, will appeal to these indicators in the first stage of a two-stage process. That will assist in identifying weaknesses and inconsistencies in national policy strategies that are a consequence of deeper structural problems. Success in the process will depend much on how G-20 and other states approach it and how the process helps in shaping domestic policy strategies to achieve global macroeconomic outcomes that are viable in the longer term.

Many countries are trying to get out of the global economic trough by pushing exports. The United States' huge current account deficit requires it to lift exports, lift savings and spend within in its international means. China's current account surpluses persist and are the focus of U.S. Congressional angst and draft legislation that seeks to impose penalties for "undervaluation" of the Chinese currency. While the debt-burdened European economies, from Ireland to Greece, are constrained by commitments to the euro, all are striving to get growth through exports. And Germany, in holding back on domestic demand expansion, has become more and more competitive within the EU; and its increasingly competitive position is lifting its export surplus both within Europe and with the rest of the world.

Something has to give to resolve these inconsistent macroeconomic policy strategies. Not all countries can have export-led growth, if that is defined to mean a faster growth of exports over imports in all major economies. This is what has made the focus on the need for currency re-alignment —and pressure on China to lift its exchange rate — so intense. After the 2008 crisis and the collapse of the U.S. and European economies, an urgent priority is to restore industrial country growth and absorb the unemployment it created. Before the crisis, real exchange rates (set in East Asia) and real interest rates (set in New York) underpinned strong growth both in East Asia and the industrial world. But this arrangement also gave rise to global imbalances. It created the financial fragility, and the vulnerability to financial crisis, that was the context in which crisis occurred.

The U.S. can lift growth in the short run if it continues to over-spend relative to its long-run capacity. There are signs that this strategy is having some success. But this growth trajectory will only be sustained if global imbalances worsen again—if the current account surpluses in China (and Germany) expand and the U.S. current account deteriorates further. In this trajectory, there are large risks, at some point in the medium term, of a collapse of the U.S. dollar and risk of a dollar crisis.

These policy strategies over time will collectively push the world toward another low-interest-rate bubble. That will be bad for China, and for Asia generally, for which the current level of interest rates is clearly too low and quantitative easing presents problems. Further, international regulation is not yet strong enough to protect against the potential fall-out from that.

These are the policy dilemmas that the G-20 faces this year. They were put on the table in Seoul last November and the G-20 has begun to confront them by putting the MAP in place, with an aim of ensuring that national policy strategies are more closely integrated and sensitive to the global outcomes they might deliver. Although it is still a work in progress, it is one that has moved forward in Paris. More importantly is commitment by national leaders to define how they will re-jig policy strategies so as to take the pressure out of the strains in the international economy.

The Chinese leadership openly accepts that change is required in the exchange rate regime but argues, with justification, that shifting nominal exchange rate change alone will not prevent the re-emergence of the imbalance problem. China is therefore committed to putting in place structural reforms that are essential to delivering a domestic demand-led model of growth. There are complementary commitments in America and Europe that will also take time to deliver.

The MAP offers opportunity for China and Asia to define a constructive agenda of structural reform that will help break the impasse in medium-term macroeconomic policy coordination. The G-20 model is one that is familiar and valued in Asia from its experience in APEC of bringing national reform strategies forward for collective consideration, retaining independent national commitment in carrying them forward. It is a model that offers respect for national initiative and encourages responsibility for collective interests.

Behind the push for rebalancing regional and global growth is the recognition that continuation of "growth as usual" will no longer deliver on these objectives. The old open trade, open investment strategy is not enough. Global markets will find it very hard to absorb the pressures of Asia's growth because of how large China and India already are and how much strong growth potential they have. The pressure of current account imbalances is only one dimension of this and a symptom of the problem, but it is not the most important dimension that needs to be dealt with in achieving a better balance in regional and global growth.

The imbalances that have emerged in our economies, at their core, are a product of the whole range of structural and institutional impediments to efficiently mobilize resources for production and investment and deliver output so that the benefits of growth are spread widely across our communities; they are not the product of savings imbalances or exchange rate misalignments but they underlie them. On these issues—how best to make progress in opening markets through regulatory and institutional reform—Asia, from Japan to China and India to Australia, has a constructive agenda to set out and will be expected to display it.

The G-20 has opened the space for a cooperative process that can deliver the global policy coordination we now so desperately need. If it works, the process will institutionalize, globally, a new shared responsibility for managing the global macro-economy.

Inconvenient Asymmetries

Gustavo H.B. Franco

Chairman and Chief Strategist, Rio Bravo Investimentos; Professor of Economics, Catholic University of Rio de Janeiro; Former Deputy Secretary of Economic Policy, Brazilian Finance Ministry; Former Governor, Central Bank of Brazil

The recent events in the Middle East provide a challenging background to the discussion of economic asymmetries by G-20 leaders in the context of a framework for macroeconomic policy coordination. At the very core of recent debates on global imbalances—in addition to the usual discussion of the "exorbitant privilege" enjoyed by the U.S. and the global impact of quantitative easing —lies China.

China and its combination of demographics and democratic deficit have very concrete implications for its macroeconomic policy and in particular its exchange rate. This note is about the somewhat inconvenient thesis that the lack of democracy may enhance economic performance through an overly competitive exchange rate and cheap labor costs, which may be one obstacle in the global effort to coordinate macroeconomic policy.

A common and superficial view of the chronic weakness of the Chinese currency is that it is caused and maintained over the years by continued intervention or "manipulation" performed by monetary authorities—a claim that goes somewhat against practical experience in foreign exchange controls in developing economies and also against the skepticism of mainstream economists about the effectiveness of continued intervention and of targeting real exchange rates. There are indeed no signs of segmented markets and other indications of artificiality in the exchange rate formation despite some heavy regulation. Somehow in China, the undervalued exchange rate (in the sense of a major and sustained deviation from purchasing power parity rates) appears to be an "equilibrium" outcome, which is key to explaining how China keeps accumulating reserves without limitations and noticeable monetary impacts and inflation. The notion of "equilibrium" here requires caution; it can be interpreted as meaning that currency undervaluation *results* from a given "development model" rather than being an independent choice of strategy exercised by the authorities.

The exact nature of this blend of factors is being actively sought in many countries not only because of the flamboyant rates of growth in China which all the "peripheral" countries want to replicate, but also because many countries are experiencing undesired currency appreciation and/or inflation as a consequence of balance of payments surpluses. Developing countries with an extensive record of balance of payments deficit problems— like those in Latin America—are puzzled by the fact that "too much of a good thing", or foreign exchange abundance, can also have considerable costs and policy dilemmas. A formula to accumulate reserves indefinitely would offer a shield against external shocks without much fiscal costs and monetary consequences. This would be almost like a free lunch and even more so if it comes with high growth.

There is no doubt that the China development model is very appealing to other developing countries and there are many questions as to China's "uniqueness". Related discussions on an evolving "Beijing Consensus" are opening up debates on capital controls, intervention technologies and even tampering with inflation measurements. Yet, China appears to be the only unqualified success in dealing with chronic undervaluation and continued surpluses, challenging the notion that imbalances in international payments should produce self-equilibrating mechanisms. Indeed, China's ability to sustain surpluses through the years appears to be robust and one key ingredient behind it, beyond its demographics, is China's democratic deficit.[1]

There is no shortage of suggestive indicators in analyzing the economic consequences of authoritarian rule, a theme that is hardly novel in Latin America; the table below offers an unusual approach to the problem by sampling well-known country rankings produced by prestigious organizations focused on some key structural country attributes.

	WEF	IMD	IEF	EDB	TI-CPI	ATK-FDI	Rating
Brazil	58	38	113	127	69	4	Baa3
Russia	63	51	143	123	154	18	Baa1
India	51	31	124	134	87	3	Baa3
China	27	18	140	79	78	1	Aa3
TOTAL	**139**	**58**	**179**	**183**	**178**	**25**	

Acronyms and sources: *WEF, World Economic Forum, Competitiveness Index, 2010-11; IMD, Global Competitiveness Index 2010; IEF, Index of Economic Freedom, Heritage Foundation, WSJ, 2010. EDB, Ease of Doing Business Index, IFC & The World Bank, 2011; TI-CPI, Transparency International, Corruption Perception Index, 2010; ATK-FDI, AT Kearney Foreign Direct Investment Confidence Index, 2010; and sovereign ratings, long term debt, Moodys.*

The first two rankings refer to "competitiveness" and the other rankings in sequence refer to "economic freedom", business climate, perceived corruption, confidence to undertake foreign direct investment and sovereign ratings (the usual indicator for capacity and willingness to pay and also macroeconomic soundness). In all but the ratings column, the numbers refer to the country's position in a pool of many, as indicated in the last line. All these indexes are available in variety of decompositions, thus opening a vast world of possibilities as to the determinants of each country's position. The table does not report a "democratic governance index", a surprisingly difficult indicator to find.[2] However, one could argue that democratic values are embedded in attributes as diverse as enforcing contracts, property rights, rule of law, paying taxes, freedom from corruption and the like.

An explicit democratic governance index might not be that necessary to prevent anyone from seeing that more "business freedom" or "ease of doing business" may occur quite paradoxically in countries ranked very low in the broadly defined field of democratic practice. This is a challenging yet unsurprising finding that should not be seen as a shortcoming of any of the indexes listed in the table. If competitiveness or a good business atmosphere happens to be observable in dictatorships, one is simply forced to come to terms with the uncomfortable theory that authoritarian rule may enhance economic performance.[3]

If one closely examines the sources of competitiveness, it is clear that the factors reducing competitiveness in Brazil are mostly related to labor costs, labor laws and unions, and the limitations in increasing maximum working hours and in reducing safety standards and minimum wages—all of which adversely affect productivity. Indeed, a "social democratic" approach to labor market institutions may reduce competitiveness. In fact, the political and social institutions framing labor markets "can move wage levels up or down in any country by 40 percent or more" as put by a globalization non-enthusiast.[4]

The labor market in Brazil has many "European" features, especially when it comes to its connection to social safety nets, which makes labor more expensive or uncompetitive with respect to China, Indonesia and Guatemala. There are certainly other factors, such as demographics and infrastructure, to distinguish China as an off-shoring platform when compared to other countries with cheap labor. However, an unlimited supply of labor combined with well-crafted, export-led growth policies do make a winning combination within which competitive exchange rates reflect relative labor costs and continued balance of payments surpluses mirror a continued supply of new labor preventing wages from increasing.

The model is only reinforced when it comes to government spending and the tax system. Brazil has a large government compared to other BRIC countries and size goes along with complexity and bureaucracy. It is easy to exaggerate the negative impact of large government on growth, but in democracies there is no way out of certain social "obligations". Brazil has social safety nets that are intertwined with labor market institutions, which has large implications for public expenditure and taxation; China has no such obligations. Whereas one could say Brazil is ahead in regards to social overhead and security, China is unquestionably behind. Again, an asymmetry is associated with politics and its profound impact on competitiveness, exchange rates and economic performance.

In summary, the theory outlined here is that the competitive advantage of China has little to do with the exchange rate as such or with intervention in foreign exchange markets, but with relative wages or asymmetric labor market workings and demographics. And to the extent that labor markets are indeed tightly controlled in authoritarian regimes, we are back to the theory that authoritarian regimes do better than democracies in competitiveness and economic growth. The fact that the lack of democracy diminishes government responsibilities to provide social security, public health and education, only reinforces the theory because public resources are instead funneled into capital formation and infrastructure projects. In these conditions, growth comes along with increased inequality, which was indeed the case in much of Latin America when it was ruled by the military.

The relation between inequality and growth, as expressed by the "Kuznets Curve", was heavily debated in the 1970s in Brazil when the country was under authoritarian rule and living the so-called "economic miracle"; Brazil during this period was experiencing rates of economic growth similar to the rates of growth that China has experienced in recent years, though with rising inequality and tensions slowly translating into higher inflation. Albert Hirschman wrote about the incredible tolerance of dictatorship, inequality and inflation as long as growth remained high. Many such insights fit the recent Chinese experience quite well. Like Brazil at that particular moment, there were other examples of alleged "efficient" dictatorships in Latin America prone to some types of reforms and with good growth records. Each of these examples helps support the utilitarian argument that democracy might be a luxury good in the process of economic development.

Even more provocative, if we investigate a little further the comparison between Brazil in the 1970s and China today, is the way Brazil's authoritarian regime was phased out both for its perceived association with decreases in economic performance, supply shocks and inflation, and for the populist prone behavior following the years of authoritarian rule. The oil shocks in the 1970s produced stagflation, debt accumulation, balance of payments problems, high inflation and eventually the collapse of dictatorships in Latin America. Each country had its own trajectory, but let us take Brazil as example and avoid extending its lessons to others without serious qualifications. It is fair to say that Brazil's transfer of power to civilian rule was done in an orderly way since there was no revolution or political dislocation. Yet, the most impressive consequence of the political transition was the fiscal chaos that rapidly took form during the first civilian government starting in 1985. In five years, inflation reached 83 percent per month in March 1989 from levels slightly over 100 percent per year by the time President Jose Sarney took office. The derailing of fiscal accounts had everything to do with social demands of all types, turning Brazil's budget into complete disarray and leading to a rare case of hyperinflation during peacetime.[5] It is not difficult to see how much of a challenge this ended up becoming for Brazilian democracy. As social demands that were repressed during authoritarian rule exploded into economic chaos years later, a reversal toward strong regimes might look very feasible since "weak" governments that were paralyzed by a lack of consensus or authority were unable to respond to runaway inflation.[6]

All these Latin American stories and recollections may appear distant yet disturbing when connected to the social tensions created by inflation around the world, especially where democratic rule is lacking and most especially when combined with shock waves from the Jasmine Revolution in the Middle East. The lack of democracy is a theme with surprisingly little objective quantification and almost always absent from the discussion of economic asymmetries between countries. This note argued that the economic consequences of the lack of democracy might be very important in explaining the economic asymmetries at the very core of global imbalances. It will be hard for the G-20 process to address these issues explicitly, but it will be interesting to see whether the G-20 is able to raise awareness on the economic effects of democratic deficits.

References

Franco, Gustavo H. B., 1993. "The Political Economy of the Brazilian Hyperinflation" in Maria D'Alva G. Kinzo (ed.) Brazil: Challenges for the 1990s, Institute of Latin American Studies and British Academic Press, London.

Franco, Gustavo H. B. and Fausto Vieira, 2011 forthcoming. "Turning towards China? The 2008 Crisis and Its Influence on Brazil's Development Model," in Managing Openness: Outward-Oriented Growth Strategies After the Crisis, World Bank, Washington, D.C. (also available at: http://www.econ.puc-rio.br/gfranco/WB_Essay_6%5B1%5D.pdf)

Helliwell, John, 1994. "Empirical Linkages Between Democracy and Economic Growth," British Journal of Political Science, Vol. 24, No. 2, pp. 225-248.

Hirschman, Albert O., 1995. Propensity to Self Subversion, Harvard University Press, Cambridge.

Rodrik, Dani, 1999. "Democracies Pay Higher Wages," Quarterly Journal of Economics, Vol. 114, No. 3, pp. 707-738.

Rodrik, Dani, 2011 forthcoming. The Globalization Paradox: Democracy and the Future of the World Economy, W. W. Norton, New York and London.

Tavares, Jose and Romain Wacziarg, 2001. "How Democracy Affects Growth," European Economic Review, Vol. 45, No. 8, pp. 1341-1378.

United Nations Development Programme (UNDP), Sources for Democratic Governance Indicators, Oslo Governance Centre. (http://www.undp.org/oslocentre/docs04/Indicator%20Sources.pdf).

Endnotes

[1] Under the assumption of "unlimited supply of labor", balance of payment surpluses can last as long as it is possible to draw more labor to the countryside to prevent wages from rising. An extended discussion of the Chinese development model and its replication in other countries, and in Brazil more specifically, can be found in Franco and Vieira (2011).

[2] To judge from the survey found at UNDP, Sources for Democratic Governance Indicators.

[3] Tavares and Wacziarg (2001) and Helliwell (1994) are examples of studies that fail to establish a positive association between democracy and growth, and also define conditions under which the opposite conclusion would hold.

[4] Dani Rodrik (2011, p. 192). The original conclusion is in Rodrik (1999).

[5] For a full description of this process see Franco (1993).

[6] For a vivid description see Chapter 15 in Hirschman (1995).

Understanding Global Interdependencies: The Contribution of Economic Models

Badye Essid *Economist, Centre for International Governance Innovation*

Paul Jenkins *Distinguished Fellow, Centre for International Governance Innovation*

Introduction

The global financial crisis and the great recession dramatically illustrated how integrated the world economy is and how economic interdependencies have become more complex than previously understood or recognized. The crisis also made clear that these interdependencies and associated spillover effects demand ever greater attention to the design of domestic policy with international implications in mind. Indeed, one of the pressing global governance issues is the need to further develop a consensus on the nature of global interdependencies.

Without a clear understanding of the nature and scale of economic interdependencies, policymakers will not posses sufficient evidence of the benefits of international policy cooperation. While the global economy is no longer on the verge of collapse, it is critical that nations cooperate on adjustment policies to address global imbalances, put the recovery on a robust and sustainable path, and strengthen the international monetary and financial systems. One of the most demanding tasks facing the G-20 is this challenge of multilateral policy cooperation.

International policy cooperation is more likely to happen when there is agreement among nations about the economic outlook, the nature of the challenges they are facing individually and collectively, and the effectiveness of policies to be undertaken. Cooperation therefore needs to be underpinned by an analytic framework where objectives, an understanding of interdependencies, and policies are deemed consistent with desired outcomes. This essay argues for the need for the G-20 to devote more resources to enhance its analytic capabilities, especially through the development of economic models, to better understand the gains from cooperation.

The Mutual Assessment Process and Interdependencies

Surveillance and peer review have been used extensively to help identify objectives within an international context and to monitor progress against agreed objectives. However, these processes have been severly hampered by credibility and accountability issues. To overcome these problems, G-20 leaders at the Pittsburgh Summit in 2009 initiated the Mutual Assessment Process (MAP).

The MAP represents an important step in policy collaboration. It is owned by its members and is designed to ensure that members' national policies collectively fit together to achieve stated G-20 objectives. Three elements make up the MAP: aggregating G-20 members' policy and macroeconomic frameworks; assessing whether members' policies are the ones needed to meet G-20 objectives; and evaluating alternative policy scenarios.

The MAP thus draws on elements of both surveillance and the peer review processes, but it is also an attempt to overcome the credibility and accountability shortcomings of these earlier processes to monitor the progress on agreed objectives. The G-20, for example, faced internal disagreements about how quickly to unwind the exceptional fiscal and monetary stimulus measures taken during the crisis and there were real risks of a reversion to protectionism. The MAP has helped address and reduce those tensions. Likewise, the MAP is providing a basis for analysis of the issues surrounding the need to address global imbalances.

The MAP, however, is still in its beginning and it is too early to judge how successful it has been. In particular, it is still uncertain whether the process is capable of producing policy prescriptions and whether countries will put into action the commitments they have signed up to. The next round of MAP discussions will provide a clearer indication of how far countries are prepared to subordinate short-term national interests in favor of international cooperation and coordination of policies. Also, as the global economy becomes more diverse and multipolar but also more interdependent, it will show whether a system of country-led mutual peer review is more effective than current surveillance processes.

The step toward credibility that the MAP offers is the collective call from the G-20 for a "candid assessment," or greater openness, in how countries exchange data, scenarios and views on how their individual policies interact in support of the health of the global economy. Moreover, it is the effectiveness of this information sharing process that will be critical in engaging the leaders and subsequently domestic constituents in meeting objectives of the global economy. By providing a framework for identifying the benefits of cooperation, the MAP provides G-20 nations a promising opportunity to sustain greater levels of cooperation.

However, capitalizing on this opportunity will require additional resources to enhance the analytic capabilities of the G-20 in support of the MAP. One important avenue is through the further development of economic models that better capture the scope and complexities of global interdependencies. Economic models provide policymakers with a diagnosis and choices and trade-offs of different adjustment paths. A key challenge in the development of models is to come to an agreed characterization of the functioning of the global economy. In reality, what we should look for is a suite of models that over time will help us build a better understanding of what ties countries together.

Economic Models

Economic models can help analyze global economic interdependencies, quantifying the benefits of cooperation. However, the macroeconomic models in current use, while intellectually advanced, tend to be limited in their geographical or sectoral coverage. Moreover, there is a general perception that economic models failed to predict and even replicate ex-post the financial crisis scenario.[2] There is also a lack of agreement in terms of their ability to demonstrate the benefits of international cooperation, certainly for all G-20 countries.

A high degree of uncertainty surrounds the characterization of economic relationships employed for modeling. This includes data uncertainty—a factor exacerbated by problems of small data samples. Furthermore, developing accurate statistics becomes a more complex process when involving developing economies as well as advanced economies. Capacity building to improve data quality is therefore vital. Alongside developing consistent statistical standards, the data that is disseminated must be reliable—it must be trusted by the countries' international partners. The dangers of the misreporting of statistics are starkly illustrated by the 2010 Eurozone debt crisis, sparked by Greece unveiling drastic revisions to its debt and deficit figures. Not only did the Greek statistical revisions destroy the credibility of its data, but it also occurred within the Maastricht Treaty—purportedly one of the most internationally rule-bound constraints on fiscal policy.

In addition, there is uncertainty about key parameters in models, such as the response of aggregate demand to interest rates and changes in fiscal policy. Also, there is uncertainty as to whether shocks that hit the economy are short-lived, relatively long lasting or permanent. As the International Monetary Fund notes of its own Global Integrated Monetary and Fiscal (GIMF) model, "as with any modeling framework, the analysis of policies and their effects is stylized and indicative. The simulation results are subject to uncertainty."[3]

While current economic models are sophisticated, they work at a low level of disaggregation. For example, the IMF's GIMF model uses only five stylized regions—the United States, the Eurozone (split between Germany and the rest), Japan, developing Asia and the rest of world. GIMF is utilized by the G-20's MAP to collate the policies of G-20 countries and to demonstrate the benefits of cooperation through scenario analysis. Without the finesse to consider the G-20 economies as stand-alone components, it seems unlikely that this process can convincingly replicate all the macroeconomic facts to promote lasting cooperation. For these reasons alone, the G-20 needs to look to support the development of a suite of models that over time will deepen its analytic capabilities for measuring the benefits of cooperative, collective outcomes.

In addition, model structures typically used to assess the international transmission of business cycles only consider trade flows as the major link among economies. However, the growing literature on the channels of transmission shows that international financial integration amplifies the business cycle co-movement and that financial linkages were more important than trade flows (certainly among advanced economies) in explaining the severity of the global downturn. Devereux and Yetman demonstrate that when financial linkages are incorporated in the international business cycle models, the shocks are powerfully transmitted across countries.[4] The scale of the transmission of the shock depends, in turn, on the level of financial integration and the degree of portfolio diversification. The financial crises revealed the existence of liquidity spirals that amplified the crisis caused by high leverage ratios and maturity mismatches, and highlighted the necessity of incorporating banks as well as the interplay between leverage and asset prices into models.[5] Work to incorporate these types of channels into macroeconomic models would need to build on earlier theories that recognized the failure, in the context of asymmetric information and moral hazard[6], of classical theorems stipulating the irrelevance of the financial structure.

There are many reasons why economic models may be found to be lacking for the purpose of quantifying the nature of interdependences across economies. Still, it is important to understand the evolutionary nature of model development. No one model can answer all questions. What is critical at any point in time is to know what questions need to be asked and to then develop the right models to gain insight and understanding to assist authorities to make informed policy decisions. If the G-20 is to successfully play the role as the premier forum for international cooperation, it will only be able to do that if supported by an analytic framework that increasingly moves us closer to a consensus on global economic interdependencies—what ties us together. Put differently, we now realize that we live in an exceptionally tightly correlated world economy with the potential for highly correlated fluctuations in economic activity. To better understand the nature and channels of these international linkages and more generally to assess the need for economic policy cooperation and coordination, we need to further invest in the development of economic models.

References

Bernanke, Ben and Marc Gertler, 1989. "Agency Costs, Net Worth, and Business Fluctuations," American Economic Review, Vol. 79, No. 1, pp. 14-31.

Devereux, Michael B. and James Yetman, 2010. "Leverage Constraints and the International Transmission of Shocks," Journal of Money, Credit and Banking, Vol. 42, pp.71-105.

Dib, Ali, 2010. "Banks, Credit Market Frictions, and Business Cycles," Bank of Canada Working Paper No. 2010-24.

International Monetary Fund (IMF), 2010. "G-20 Mutual Assessment Process—Alternative Policy Scenarios," prepared for G-20 Summit of Leaders in Seoul, Republic of Korea.

Kiyotaki, Nobuhiro and John Moore, 1997. "Credit Cycles," Journal of Political Economy, Vol. 105, No. 2, pp. 211–248.

Kumhof, Michael et al., 2010. "The Global Integrated Monetary and Fiscal Model (GIMF) – Theoretical Structure," IMF Working Paper 10/34, February.

Meh, Cesaire and Kevin Moran, 2010. "The Role of Bank Capital in the Propagation of Shocks," Journal of Economic Dynamics and Control, Vol. 34, pp.555-76.

Tovar, Camilo, 2008. "DSGE Models and Central Banks," Bank of International Settlements, Working Paper No. 258, September.

Endnotes

[1] This essay draws on a forthcoming report on international policy cooperation produced jointly by the Centre for International Governance Innovation and Chatham House.

[2] For example, the commonly used dynamic stochastic general equilibrium models do not model financial markets. See Tovar (2008).

[3] IMF (2010).

[4] Devereux and Yetman (2010).

[5] The IMF is currently undertaking work on addressing and incorporating these issues in the GIMF model. See Kumhof et al. (2010), Dib (2010) and Meh and Moran (2010).

[6] Bernanke and Gertler (1989) and Kiyotaki and Moore (1997).

How to Formulate Guidelines for the Macroeconomic Indicators

Qiao Yu *Professor of Economics, School of Public Policy and Management, Tsinghua University, Beijing*

After the February 2011 meeting of the G-20 finance ministers and central bank governors in Paris, the finance ministers announced a communiqué that agreed on a set of indicators to be examined through a two-step process so as to allow them to focus on persistent large imbalances for coordinated policy actions. This is a big stride toward addressing the issue of macroeconomic policy interdependence against the backdrop of global imbalances. The progress has been achieved through mutual endeavors and multilateral compromises between G-20 countries committed to the Mutual Assessment Process (MAP) of the 2009 Pittsburgh G-20 Summit.

According to the communiqué, the preliminary set of indicators include: "(1) public debt and fiscal deficits; and private savings rate and private debt; and (2) the external imbalance composed of the trade balance and net investment income flows and transfers, taking into consideration exchange rate, fiscal, monetary and other policies." In order to make the indicators applicable, G-20 finance ministers also intend to reach agreement at their April meeting on indicative guidelines prepared by a special G-20 framework group, against which the indicators can be assessed for the goal of macroeconomic policy coordination (MPC).

It has taken quite long time for G-20 countries to agree on these two groups of the indicators as politically feasible instruments designated to provide guidance for possible policy coordination. Yet, many important problems remain unsettled, such as how boundaries of the indicators are defined and what are the critical benchmarks of the indicators. In fact, there still may be wide discrepancies in formulating the agreed guidelines for the indicators that should be used to assess global imbalances. Apart from domestic political factors in "deficit countries" and "surplus countries", a lack of in-depth research and accurate information poses serious challenges for future steps. In addition, ambiguous definitions, flawed methodology and misleading statistics widen disagreements, which may result in general failure of achieving MPC goals.

Direct Measure of Global Imbalances

A trade balance is the foremost variable to reflect the scope of global imbalances in terms of merchandise transactions. Rodrigo de Rato argues that "the constellation of large (trade) deficits in one country, with counterpart (trade) surpluses being concentrated in a few others, is what we mean when we speak of global imbalances."[1] This variable greatly impacts the possibility of macroeconomic policy coordination between G-20 countries to cope with imbalanced commodity transactions since foreign trade closely links different countries together and trade imbalances mainly consist of external imbalances for a particular country.

A significant bilateral trade imbalance will be taken as a signal that "sometimes a productivity gain (from free trade) in one country can benefit that country alone, while permanently hurting the other country by reducing the gains from trade that are possible between the two countries."[2] Hence, a country's trade status is always a focal issue in domestic policy debates and a persistent trade deficit is more likely to trigger protectionist measures against its counterparties, especially when it is purged by economic hardship coupled with high unemployment. An example of this is the Japan-U.S. trading friction in the 1980s and the Sino-U.S. trade inequality of today.

The current trade imbalance between China and the United States is at the core of global macroeconomic imbalances. Needless to say, the huge Sino-U.S. trade disparity is neither sustainable for bilateral relations nor helpful for easing global tensions. This problem must be jointly addressed by the immediate involved parties and China must adjust certain commercialist trade policies to narrow down the trade gap. Similarly, serious bilateral trade situations in other countries should also be solved appropriately. The key issue here is to utilize an unbiased and reliable indicator to reflect actual trade positions of each country. Unfortunately, the prevailing method to calculate a particular country's overall trade balance is simply to aggregate customs export and import statistics with those of their respective trading partners. Likewise, the country's bilateral balance against a specific trading country is also calculated in the same way. Thanks to the complexity of global labor division and the sophistication of the global logistics structure, a country's trade balance image that is depicted by the conventional method may be considerably distorted in reality.

This deviation occurs most in sophisticated high-tech or brand-granting original equipment manufacturing sectors, where multinational companies have different networks of invention, production, marketing and services all over the world. In this respect, the conventional sum-up method is too simple and obsolete to precisely define a country's actual bilateral and overall trade status, which is considerably shaped by cross-border value creating networks of multinational companies. In this context, a big gap between "a home assembled product" and "a home value-added product" makes significant differences in the global trade landscape.

Apple, for example, sets up a global iPhone production network with nine companies located in China, South Korea, Japan, Taiwan, Germany and the United States. While all iPhone components are produced by these companies, they are all shipped to Foxconn, a Taiwan company located in China, for final assembly and then exported to the U.S. and the rest of the world. According to the conventional method, the iPhone trade in 2009 left a $1.9 billion deficit in the U.S. trade account. But the reality is that by actual value-added calculation, iPhone trade between China and U.S. ended up with $48 million of trade surplus with U.S.[3] In general, "the conventional trade statistics greatly inflate bilateral trade deficits between a country used as export-platform by multinational firms and its destination countries."[4]

Accordingly, World Trade Organization Director-General Pascal Lamy points out that "the statistical bias created by attributing the full commercial value to the last country of origin can pervert the political debate on the origin of the imbalance and lead to misguided, and hence counter-productive, decisions. Reverting to the symbolic case of the bilateral deficit between China and the United States, a series of estimates based on true domestic content cuts the deficit by half, if not more."[5] If trade statistics were aligned in line with the actual value contributed to a product from different countries, the artificially distorted portion of bilateral trade imbalances would be phased out and so would the misperception of the conventional sum-up method. Otherwise, flawed bilateral and overall trade figures will lead to spurious conclusions, escalating political quarrels in both domestic and global domains and quashing possible joint actions for the involved countries.

A comprehensive value-contributing approach should be developed and used to align trade statistics obtained from traditional customs channels. Although this adjustment procedure may be time-consuming and involve a huge technical challenge of collecting relevant information, it will reduce systemic errors from the simple sum-up method and create a solid foundation for all parties to gauge their respective actual trade imbalances in both overall and bilateral levels.

Investment income flow is a secondary indicator in assessing global imbalances. While this variable consists of an important part of external imbalances for a country, it has special meaning for developed countries that suffer from trade deficits but have income flow surpluses. That is, net inflows of investment income partially offset trade deficits in a particular country. This is especially true for the U.S. and U.K. over the past decade. If the value-contributing approach were adopted to obtain trade statistics, the accommodating effect of investment income flows on the current accounts of these two trade deficit countries would be much more visible.[6]

Based on accurate trade statistics, specific guidelines, including critical values for benchmarks used for assessing policy actions, can be formulated for all parties to discuss. This procedure would help G-20 leaders achieve a common ground for pursuing the goals of macroeconomic policy coordination.

Public Debt and Global Imbalances

The vast and growing U.S. public debt is another key indicator for assessing global imbalances. The U.S. public debt results partially from the long-lasting regular federal government budget deficits over the past decade, and partially from recent large fiscal stimulus for the crisis-torn economy.[7] The huge public debt nurtures extravagant mass expenditure far exceeding private revenue inflow, which in turn significantly deteriorates the U.S. trade position. Otherwise, expenditure would be subject to household income constraints and so the huge trade deficit would be at least partially checked. This linkage is also observed in many other developed countries.

Besides this demand side nexus, accumulating the massive public debt of the reserve currency issuer has strong but less visible implications on global imbalances in terms of debt-serving asymmetry. The U.S. dollar is the prevailing currency in the international monetary system. It is the sole transaction currency for the bulk of commodity contracts, a dominating carrier of foreign-exchange trading, and a major currency of debt securities and foreign reserves. Since there is no real alternative to replace the dollar in a foreseeable future, the dollar's status quo will last for a quite long time. But the trillions of dollars of U.S. public debt directly affects the stability of the dollar.

It is obvious that the persistent U.S. balance of payments deficit (mainly due to the trade deficit) is necessary to supply liquidity for the rest of the world. Similarly, the enduring U.S. budget deficit is also required to deliver debt securities that recycle the dollar. On the other hand, issuing money without binding restrictions implies that the *de facto* world central banker is free to abuse its double-deficits' privilege by issuing not "just enough" but "too much" greenback to reallocate global wealth. No sooner than when the Federal Reserve carries out an unprecedented quantitative easing policy do global imbalances move in favor of debtors largely through the unique way of U.S. sovereign obligation service. The rest of the world undoubtedly sees the U.S. as shouldering its debt by inflating them away, similar to what the Nixon administration did to dodge gold obligations in the early 1970s.

At least partially due to this trend, the prices of bulk commodities have notably surged in recent months, igniting inflationary pressures in many emerging economies. Interest rate differentials between developed and emerging countries have considerably widened, resulting in huge inflows of speculative funds toward the latter. It is quite ironic that when global wealth redistribution occurs, the debtors are unloaded at the expense of the creditors and the poor fill up the coffers of the rich while the latter takes a macro hedge against the former.

In this regard, public debt is a crucial indicator in guiding the G-20's coordinated action to restrain the major reserve-currency supplier to align the all-U.S. centric egoist monetary policy to assure the dollar's accountability and the international monetary system's stability, which are vital preconditions for adjusting global imbalances. Likewise, this variable has a similar but less crucial role for other developed and developing countries to enforce fiscal discipline in order to facilitate reductions in severe macroeconomic imbalances between and within specific regions.

The question is how to calibrate public debt in a way that all relevant parties will agree with. Of course sovereign debt is in the basket, but other quasi-government obligations should also be taken into consideration. For example, central or federal governments not only have explicit (or implicit) rights for solvency of lower-level governments, but they also bear legal and moral responsibilities for government-related contingent liabilities as well. The stakeholders may consider defining "core public debt" to contain sovereign liabilities and "supplementary public debt" to include other obligations. The stakeholders might also consider setting up a clear critical value for assessing policy actions.

Both private savings rates and private debt are informative but less obvious gauges. Many attribute global imbalances to domestic factors, such as over-consumption in the U.S. and over-saving in China. This may provide some justification for monitoring private savings rates and private debt in the involved countries. Unlike public debt and budget deficits which are exogenous variables, these two factors are basically endogenously determined.[8] In addition, it would not be possible in the short run to see a sharp decline in the United States' high propensity to consume coupled with a dramatic dropping of China's high propensity to save. Compared to public debt, private savings rates and private debt are regarded as suggestive and secondary indicators.

Conclusion

Indeed, there are no such things as "global balanced merchandise trade" or "global macroeconomic balances" in the entire history of the contemporary world. On the contrary, the world economy always moves forward in a variety of imbalanced ways. Nonetheless, extreme out-of-balanced growth will sooner or later lead to serious political and social backlashes that hinder the global economy. Therefore, it is an important task for the international community to cooperate in order to align undue global imbalances and manage it to a tolerable level.

To serve this end, trade balances and public debt are two key indicators logically appropriate and politically acceptable to the involved stakeholders. As global imbalances vaguely refers to the situation of one particular country's huge deficit against the surpluses of its major counterparties, trade balances can be used as an immediate and direct rule-of-thumb measurement of global imbalances in terms of skewed merchandise transactions. Public debt, on the other hand, can be taken as an intricate marker of highlighting another facet of global imbalances with respect to asymmetric wealth flows between reserve-currency issuers and takers.

The other variables raised in the Paris Communiqué, though informative, are secondary ones. Besides, it is confusing and impossible for G-20 countries to pursue multiple goals specified by a diverse set of indicators. The simpler the goals of macroeconomic policy coordination are, the easier they can be executed.

The International Monetary Fund could play an important role in the MPC process. To make the guidelines for key indicators agreeable and executable, the IMF could develop a new method of revising trade balance statistics and define new categories of containing different layers of public obligations. Moreover, the IMF should identify "outliers" of both key variables for setting up possible critical values to guide joint actions. Together with the other supportive indicators, the modified key variables may be the first try-out instrument for the G-20 countries, via the IMF venue, to implement cross-country macroeconomic policy coordination.

References

Boskin, Michael, 2011. "Debate on Fiscal Policy," China Development Forum, March 20-21, Beijing.

De Rato, Rodrigo, 2005, "Correcting Global Imbalances—Avoiding the Blame Game," Speech in the Foreign Policy Association Financial Services Dinner, New York City, February 23. (http://www.imf.org/external/np/speeches/2005/022305a.htm).

G-20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009. Pittsburgh, U.S.A. (http://www.pittsburghsummit.gov/mediacenter/129639.htm).

G- 20 Meeting of Finance Ministers and Central Bank Governors, Paris, 18-19 February 2011. (http://www.g20.org/Documents2011/02/COMMUNIQUE-G20_MGM%20_18-19_February_2011.pdf)

Hughes, Neil. 2010. "Piper: 15.8M US iPhone sales in 2010, even without Verizon." AppleInsider. January 6. (http://www.appleinsider.com/articles/10/01/06/piper_15_8m_us_iphone_sales_in_2010_even_without_verizon.html).

Lamy, Pascal, 2010. "Globalization of the Industrial Production Chains and Measuring International Trade in Value," World Trade Organization, October 15. (http://www.wto.org/english/news_e/sppl_e/sppl174_e.htm)

Rassweiler, Andrew. 2009. "iPhone 3G S Carries $178.96 BOM and Manufacturing Cost, iSuppli Teardown Reveals." iSuppli, June 24. (http://www.isuppli.com/Teardowns-Manufacturing-and-Pricing/News/Pages/iPhone-3G-S-Carries-178-96-BOM-and-Manufacturing-Cost-iSuppli-Teardown-Reveals.aspx).

Samuelson, Paul A., 2004, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization," The Journal of Economic Perspectives, Vol. 18, No. 3, pp. 135-146.

Xing, Yuqing, and Neal Detert, 2010. "How the iPhone Widens the United States Trade Deficit with the People's Republic of China." Asian Development Bank Institute Working Paper 257, Tokyo.

Endnotes

[1] De Rato (2005)

[2] See Samuelson (2004).

[3] In Apple's total $1.9 billion of iphone value, China only contributed 3.6 percent in manufacturing costs. The rest were values of components contributed by Japan (34 percent), South Korea (13 percent), and Germany (17 percent), the U.S. (6 percent) and others (27 percent). See Rassweiler (2009). Also see Hughes (2010).

[4] Xing and Detert (2010).

[5] See Lamy (2010).

[6] This variable may contain certain suggestive information about portfolio capital flows, but it is not timely and accurate measure.

[7] It is estimated that the US budget deficit will be $1.6 trillion in 2012, about twice of the total budget deficits aggregated from the other G7 countries plus Greece and Portugal. See Boskin (2011)

[8] These variables are profoundly influenced by a country's institutional settings such as social security nets, depth of financial market, cultural heritage and others. Hence, it is inappropriate to simply adopt them for joint policy purpose.

Concrete Steps toward Realistic Reforms of the International Monetary System

Agnès Bénassy-Quéré *Director, Centre d'Etudes Prospectives et d'Informations Internationales*

Jean Pisani-Ferry *Director, Bruegel; Member, French Prime Minister's Council of Economic Analysis; Member, European Commission's Consultative Group of Policy Analysis; Professor, Université de Paris-Dauphine*

Yongding Yu *Director-General, Institute of World Economics and Politics of the Chinese Academy of Social Sciences*

Governor of the People's Bank of China Zhou Xiaochuan's famous 2009 paper awakened the debate on the international monetary system from a three-decade long state of apathy. In the run-up to the 2011 French presidency of the G-20, many ideas have been floated about reforming the international monetary system, through reports, papers and conferences. These contributions have especially pointed out the deficiencies of the present system: dependence on a key reserve currency, which in turn leads to asymmetries in the process of adjustment; inability to provide incentives for surplus countries to adjust; disregard for spillovers effects of national monetary policies and as a result the possible inadequacy of the global monetary stance; the developing and emerging countries' costly reliance on self-insurance through reserve accumulation; inability to channel net capital flows from low-return, advanced economies to high-return, emerging countries; and large real exchange-rate misalignments, sometimes leading to "currency wars". Old policy dilemmas, such as that of Triffin, have been revisited and old ideas such as the expanding the role of the special drawing right (SDR) have been intensively discussed.

The need for a change in the international monetary system—what Keynes famously called the "rules of the game"—is accentuated by tectonic shifts in the balance of international power. These shifts were already visible in the last decade, but they have been accelerated by the financial crisis and its asymmetric effects on advanced and emerging countries. By 2020, the balance of economic power within the global economy will be more equal than at any time over the last two centuries. Therefore, there is a strong case for moving toward a multipolar monetary system whose main planks are likely to be the U.S. dollar, the euro and the renminbi.

In the short term however, there is no hope to rebuild the international monetary system according to any of the grand designs on offer. The weaknesses of the euro and the renminbi are too apparent for these currencies to constitute alternatives to the U.S. dollar. To reform the rules of the game is an ambitious enough endeavor. To rewrite them entirely, as some proposals suggest, is not on the agenda. We are not in 1944.

It is therefore time to focus the debate on the possible deliverables. Already, official working groups have been tasked with providing concrete proposals for the G-20 to discuss at the finance ministers' meetings in view of decisions to be taken at the heads of state and government G-20 summit in Cannes in November.

So what could concrete steps be? What reforms would help address fundamental deficiencies and command a sufficient degree of consensus? We suggest three avenues:

- First, to create consensus on policies toward capital inflows and provide a framework for international surveillance of national capital controls, reserves and exchange rate policies. This would help tackle the risk of "currency wars";

- Second, to draw on results from the Korean presidency in 2010 and strengthen financial safety nets so that countries do not have to self-insure through accumulating reserves or to rely on possible bilateral swap lines to access liquidity when confronted with sudden stops;

- Third, to prepare and plan for a change in the composition of the SDR that would strengthen the multilateral framework while favoring evolution toward a more multipolar system.

Exchange Rates, Capital Flows and Reserves

The first topic seems highly controversial at first sight because it touches upon the sensitive issue of exchange rate policies. It does not need to be so. To start with, it is increasingly apparent that the global crisis has had highly asymmetric effects, which call for a real exchange rate realignment between the advanced and the emerging world. This realignment is going to take place one way or another, either through nominal exchange-rate changes or through divergent inflationary developments. Higher pressure on consumer prices will lessen the willingness of governments and central banks in emerging countries to oppose exchange-rate appreciations through reserve accumulation and/or capital controls.

By the same token, the controversy about capital controls is abating. The International Monetary Fund is less reluctant than in the past to make room for such controls in the policymakers' toolbox. At the same time, it is increasingly recognized by policymakers in emerging countries that capital controls are only one instrument among several. They are part of a broad range of macroeconomic and macro-prudential tools that may be used to limit the detrimental impact of large, volatile capital inflows.

Policy consensus may therefore be within reach. What will be more difficult is to agree on institutional arrangements. To start with, the emerging international consensus should be written down in some sort of soft law such as a code of conduct. Second, the joint monitoring of capital controls and exchange-rate policies, with the aim to sort out macroeconomic and financial stability motives from mercantilist motives, would need to be allocated to an international body. This body should provide assessments and policy suggestions, as well as technical assistance when required. A natural candidate for this task would be the International Monetary Fund. However, this would require amending the Fund's statutes since the IMF presently has no legitimacy to review financial-account policies. Hence, a formal approval by 85 percent of the IMF's board of governors would be needed. While this is not impossible, it is demanding in view of the lack of trust in the institution in significant parts of the emerging world.

Financial Safety Nets

To build financial safety nets, two different routes may be taken: a strengthening of bilateral central bank swap lines and an extension of multilateral schemes. During the crisis, swap lines generously extended by the U.S. Federal Reserve and to a lesser extent other key central banks proved instrumental in providing U.S. dollar liquidity to national central banks. However, these were unilateral, discretionary initiatives and the benefits of which were reserved to some partners and whose repetition may not be taken for granted should another crisis hit.

One idea would be to institutionalize the network of swap lines under the supervision of the IMF. There would be a risk of losing in the process the flexibility demonstrated in the crisis. Understandably also and perhaps more importantly this project encounters vigorous opposition by central banks, whose independence is already questioned by their role in keeping ailing banks (or, in the European case, states) afloat, the threat of a return of fiscal dominance, and the extension of their mandate to macro-prudential surveillance. Formal commitments from central banks to extend swap lines to countries designated by an international institution are in these circumstances unlikely.

The institutionalization of bilateral swap lines would also amount to creating a two-tier system whereby countries would explicitly depend on the support of regional partners. Such schemes may be attractive to some countries where cooperation around a regional hub has developed, but it can hardly provide a global solution.

This leads to envisaging multilateral schemes. It is necessary here to distinguish three different variants:

(1) The pooling of central banks' foreign-exchange reserves, possibly with a transformation of part of them into SDR reserves;
(2) The creation of new IMF facilities;
(3) A more active policy of SDR allocations through more frequent and possibly counter-cyclical and/or targeted allocations by the IMF.

The pooling of official reserves has already been practiced at a regional level and it could conceivably be extended to a multilateral level. While this is efficiency-enhancing, it raises difficult questions in regards to the sharing of the exchange-rate risk and the use of the reserves. Reserve pooling would require rules on how each member could use these reserves, which would be difficult to do ex-ante. Furthermore, access rules would make reserve pooling inferior to unconditional self-insurance through reserve accumulation.

International Monetary Fund facilities are a way to channel reserves to countries hit by capital outflows. The recent evolution has been toward the creation of no-conditionality (the Flexible Credit Line – FCL) or low-conditionality (the Precautionary Credit Line – PCL) facilities that aim at crisis prevention rather than crisis management. Further proposals have been put forward such as the IMF's Global Stabilization Mechanism (GSM)—a new mechanism that would activate the provision of liquidity to systemic and vulnerable countries in case of systemic shock. The problem with such facilities is that potential beneficiaries may remain unsure of getting access to them in time of need, which makes them partial substitutes to reserves only.

New SDR allocations would not have this shortcoming. They would provide countries with SDR reserves that they could exchange for reserves denominated in the currency of their choice. If provided in limited quantity and in response to increases in the demand for reserves only, such allocations would be unlikely to have far-reaching consequences for global liquidity while providing a welcome buffer to vulnerable countries. But to make them a recurring feature of the provision of liquidity, a revision of IMF statutes would be needed since currently an 85 percent majority within the IMF board is needed to decide an SDR allocation. This avenue cannot be considered closed but it presents serious hurdles.

A New Special Drawing Right

Several SDR-based proposals are on offer. One aims at addressing a different shortcoming of the international monetary system, namely the lack of safe assets at a global level. The idea is to create a new investment vehicle by allowing international financial institutions, including the IMF, to issue debt securities denominated in SDRs. The liquidity of the SDR market could be enhanced by developing the private use of the SDR through commodity invoicing and subsequent demand for SDR-denominated bonds.

This is certainly not the only way to enlarge the range of safe and liquid assets that are needed at the global level. Another way, which should be encouraged, would be the development of national-currency bond markets.

Although consistent with the initial purpose of the SDR in 1969, the promotion of SDR-denominated securities through IMF borrowing is likely to encounter a number of obstacles. Aside from technical problems related to the initial liquidity premium (estimated 80-100 bp by the IMF staff) and the needs for market infrastructures for SDRs, IMF members are probably reluctant to renounce oversight of IMF resources that they currently enjoy.

Rather than trying to create an SDR market from scratch, we suggest adapting the existing SDR to the new global environment through more frequent allocations and through planning the inclusion of the renminbi in the SDR basket—which presently only includes the U.S. dollar, the euro, the yen and the British pound—in the context of an opening up of China's financial account and a move to a flexible exchange rate regime in China. Such reforms would be consistent with the fast shift of the global economy in favor of China. It would put the largest reserve holder at the center of the SDR liquidity-provision system and would create a natural venue for monetary policy dialogue and possibly coordination between the five countries involved in the SDR—a G-5 circle.

Interestingly, the renminbi need not be immediately included in the SDR and China need not immediately open up its financial account in order to play a part in financial safety nets. The People's Bank of China has already started extending swap lines to a number of foreign central banks in renminbi, aside from the Chiang Mai Initiative. It could also provide liquidity in dollars in exchange of a number of listed currencies—say the currencies of the G-20 and provide SDR-denominated loans. Without waiting for China to move to free convertibility and to integrate into the multilateral liquidity provision scheme, this would be a way for it to diversify its reserves smoothly while providing international liquidity in times of stress.

Conclusion

In brief, the most workable deliverables today seem to be: (1) guidelines and surveillance on capital controls, (2) a new regime for deciding on SDR allocations that would facilitate a less infrequent use of this instrument, and (3) the inclusion, after some delay and against financial opening up, of the renminbi into the SDR basket.

Would these three reforms be conducive to addressing the shortcomings of the international monetary system? Probably only partially. But they would represent concrete steps toward change and pave the way for longer-term evolutions.

Multilateral Surveillance and Macroeconomic Policy Coordination: Designing an Appropriate Framework

Jacques Mistral

Professor of Economics; Head of Economic Studies, Institut Français des Relations Internationals; Former Advisor to the Directeur Général du Trésor et de la Politique économique, Ministère des finances - Paris; Member of the French Prime Minister's Council of Economic Analysis

As the global crisis moved away from an immediate emergency phase, world leaders at the G-20 summits turned to long-term issues. The basic idea launched in Pittsburgh was that international collective action could put the international economy on a stronger, more balanced and sustainable growth path. They trumpeted the creation of a new framework based on a Mutual Assessment Process. This article emphasizes the need of international coordination of economic policies, argues that too little has been achieved in this regard, explains that insufficient attention has been paid to the institutional base of the Mutual Assessment Process and offers proposals for a more efficient framework.

The Risks of Inadequate Macroeconomic Policy Coordination

International economic policy coordination is a challenging and frequently disappointing task. This is possibly one of the reasons explaining why many macroeconomists are comfortable with the idea of uncoordinated economic policies, in particular when economies are in genuinely different situations; if growth potential, unemployment, balance sheets and/or other parameters are materially different, it is not only comprehensible but desirable for macroeconomic policies to differ. It is thus a frequent argument that each government doing what it thinks is best for its own economy (the U.S. fighting excessive unemployment, Europe cleaning its own problems, China "reorienting" growth) is the most appropriate contribution to the common good. This argument can provide some comfort to international inaction. Unfortunately, in a deep crisis, things are more complex and inaction should not be an option.

Global interdependencies on the products and capital markets have proved strong and these interdependencies generate spillover effects likely to produce undesirable outcomes if unproperly managed. Tightening governments, for example, expect to gain on net exports by relatively constraining costs, income, indebtedness and demand in comparison to their trading partners. Monetary divergences as well have counter-productive consequences. Capital flows might amplify the consequences of asymmetric policy moves. Above all, global imbalances remain a Damocles' sword hanging on the future of the global recovery.

The fear of the great recession turning into Japan's lost decade or worse into a new great depression has until now been averted but the risks facing the world economy are not eliminated. Current policy discussions within the G-20 framework probably underestimate the relevance of these parallels for understandable reasons. In short, euro-area policymakers could, under German inspiration and influence, exaggerate the benefits of a principled austerity; following decades of benign neglect regarding debt, American policymakers could underestimate the coming limits of global investors' willingness to finance U.S. tax and monetary profligacy; and China could wrongly assess the permanence of open export markets in face of its continuously increasing surpluses. "Macroeconomic policy wars" cannot unfortunately be considered as things of the past. This paper argues that academics should properly assess these risks and policymakers should act and try harder to definitely avoid them.

Informal Coordination Not Sufficient for Growth Management

The creation of the G-20 has undoubtedly been an appropriate answer to the financial crisis and it proved a useful framework to design urgent measures. Following a successful but fragile recovery, the challenge for the G-20 is to shift from a crisis management status to sort of a global steering committee. The G-20 probably has the potential to exercise this sort of leadership. But the challenges are many; there are the questions of legitimacy, the articulation with other international fora and the issue of effectiveness, among many others. Since the G-20 has rightly been characterized as the "premier world economic forum", many of these questions will be cut according to its success in attaining its proclaimed goal of a "strong, balanced and sustainable growth". However, recent summits have been disappointing in this regard.

There is an understandable agreement to avoid contentious and unproductive debates within the G-20. But when using pragmatism leads to eliminating imbalances and exchange rates from the agenda even at the level of the finance ministers, and when communiqués barely mention the issue, one can argue that the process is not up to its task. In the new science of "summitry", it is interesting to observe what a difference this situation makes with the beginning of the G-7 meetings, whose primarily role was precisely to organize a conversation on the same sort of issues. There is little doubt that the successful role of the G-7 regarding financial and monetary issues proved a very important starting point which at that time gave its legitimacy to this restricted group. Bluntly speaking, the Toronto or Seoul summits did not pass the same test. Concerns over the conflict between short- and long-term objectives dominated the debate on fiscal consolidation. In place of a disciplined and informed conversation on international monetary affairs, we have witnessed a theatrical scene starting a new "currency war". Rhetoric and saber-rattling are no contribution to a stronger and more balanced growth.

The Indicators and Their Processing: A Bigger Role for the IMF

In the fall of 2010, U.S. Secretary of the Treasury Timothy Geithner suggested adopting a common view on what was a desirable range for current account surpluses and deficits. The proposal was badly received and considered as aggressive by surplus countries. The Seoul Summit nonetheless ended with an agreement to have the G-20 framework group produce a set of indicators that would help in evaluating what is an unsustainable current account. Despite its apparent modesty, this goal proved difficult to attain. The selection of this set of indicators has been narrowly and unenthusiastically fixed at the meeting of G-20 finance ministers in Paris in February 2011. One can say "it's a first step"; the reality is that the progress is extremely modest. After all, these indicators are well known and publicly available. What is needed is the indicators gaining more voice! Whatever their choice, and subsequently the models that will serve for analytical purposes which by experience will constantly be a work in progress, emphasis should be put not on the surface but on the substance of policy coordination.

Global imbalances today are supersized when compared with previous ones and could potentially pose greater threats to financial stability than in the past. Their correction will require long lasting efforts which will weigh on both sides of the economic equation, a reallocation of global savings and demand, and the implementation of important structural reforms. There is a need not only to agree on a one-shot correction of macroeconomic policies but on the definition of a new trajectory. This requires a common understanding of the economic outlook and a convergence in the manipulation of policy tools. Multilateral surveillance as embedded in the Mutual Assessment Process is not enough; informal coordination of macroeconomic policies, as embedded in the framework, is not enough. If they are really willing to deliver more sustainable growth, leaders should be willing to reach analytical agreement and policy conclusions.

The preparation of the summits should be put within a more formal and demanding process. What follows is a suggestion to act in this direction.

The core of such a formal process of economic policy coordination is the International Monetary Fund. Its proper role has been debated for years; before the economic crisis, the IMF was even dismissed as a "firefighter without fire". The IMF's legitimacy has been contested and there was a clear need to put its shareholders' structure and governing bodies more in line with the realities of the 21st century. Now, things have changed. Backed by its recognized technical competencies, the IMF is a significant contributor to the work of the G-20, in particular with the early warning exercise and G-20 surveillance notes. But the world could and should make more productive use of the International Monetary Fund. This is the place where the three steps—indicators, surveillance and coordination—should mix into a real policy decision process. This requires a reflection on its mandate and governance.

Political Will Should Be Expressed in a Stronger IMF Mandate

Every international institution works according to the agreement of its participating nations enshrined in its mandate. But make no mistake, this seemingly clear expression is misleading. One should distinguish a political mandate, which is expressed in broad, ambitious sentences, and the legal content, whose restricted terms are the basis of the institution and the only real definition of its powers. For example, the IMF has articles of agreement that read as very broad goals in relation with the above discussion. Article 1.6 reads as follows: "the purpose of the IMF (is)… to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members". This was and remains a perfect political goal except that the IMF in the present circumstances has no tool to make it happen. For example, the former managing director of the IMF, Rodrigo de Rato, launched a multilateral surveillance exercise pursuing this goal, but never got any traction. Politically speaking, the mandate is clear and appropriate. However legally speaking, member-nations have very few obligations to reach the common goals they have subscribed to and this is what has to be changed.

An important and preliminary question is whether it is necessary to change the IMF's articles. A careful legal investigation of the issue by the IMF's general counsel concluded that much could be done within the existing articles; that's fine because any attempt to change the articles would probably be a recipe for failure. There is a possibility for the IMF board to adopt an "organic decision" which would for example give a sharper expression to the present article 4.3a: "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations". Following the financial crisis, the Fund organized a vast series of consultations in order to improve its ability to monitor the international financial interdependencies, going far into the direction of scrutinizing major financial institutions. The suggestion here is rather that the IMF should focus its ambitions on its core business, current accounts and exchange rates. An effective multilateral surveillance process will not work until an agreement is reached to give more expertise, voice and power to the IMF, which means translating this goal into legal obligations for its members.

Embedding International Economic Policy Cooperation

The G-20 summits are prepared by finance ministers' meetings. This creates sort of a duality with the International Monetary and Financial Committee (IMFC), the finance ministers' gathering as tutors of the IMF. This duality needs to be clarified. The governance of the IMF has been extensively discussed according to the question of shares and chairs. This is an extremely important issue and hopefully significant progress has been made even if more remains to be done. But the reality is that these changes, as desirable as they are, will not make the solution of global financial problems easier. A new step forward is needed to more effectively exercise multilateral surveillance at the top of the International Monetary Fund. This is why an effective policy coordination process requires the transformation, as expressed in the statutes of the IMF, of the feeble existing IMFC into a politically responsible council.

The Manuel Report recently revived this old suggestion which has always attracted criticisms from different quarters. Joseph Stiglitz, for example, recently complained that the proposal did not go sufficiently far in the redistribution of power in favor of developing countries. On the other side, Barry Eichengreen mocked the idea of changing the name from IMF Committee to IMF Council, both being in his views synonymous with ineffectiveness. Both criticisms are debatable but fall short of measuring the issue at stake. Remember that one of the origins of the G-7 in the context of an already troubled financial world in the 1970s was precisely the ineffectiveness of the committee and the need to have a meeting of officials at the ministerial level, more able than the executive directors of the IMF, to make decisions and seal agreements. This was why the G-7 finance ministers' meeting has taken place for years the day before the formal IMF Committee. This settlement today is anachronistic. It would be unwise to duplicate the G-20 or 24 finance ministers acting at the head of the IMF with a G-20 finance ministers group working for the leaders. The same reasons, which made the creation of the G-20 leaders meeting necessary, require the empowerment of the previous G-20 finance ministers group. This is why the solution to reconcile legitimacy and effectiveness is to reform the governance of the IMF and to create a politically accountable council.

The new council would have explicit powers regarding the strategy of economic policy coordination and its first task would precisely be multilateral surveillance. The skeptics will immediately ask why this arrangement should be more efficient than the existing ones. No doubt, there is here an element of betting which can be expressed in the following way. The fact that surveillance did not work in the past does not necessarily mean that nations reject collective discipline. The example of the World Trade Organization and its Dispute Settlement Body is proof of the contrary. This example rather suggests that informality is enemy to effective policy coordination. The political economy of international relations can easily support the view that nations will reluctantly adhere to informal policy coordination mechanisms; the benefits raised from a flexible framework are more than offset by the costs of an unpredictable course of events. This is why this proposal relies on a more explicit definition of the obligations of IMF members and gives more powers to the council to exercise surveillance.

The council naturally supervises the activity of the IMF and makes strategic decisions regarding the major programs and the launch of new initiatives; without starting here a discussion on the special drawing rights, the council would clearly have big responsibilities should any progress on this issue be the fruit of an improved international economic cooperation. The creation of the council would change the architecture of powers at the head of the IMF. The executive board would be transformed into a permanent representation of the ministers and would lose its responsibilities in the day-to-day management. Conversely, the managing director would enjoy greater independence. In a figurative sense, the managing director could be the voice of the indicators; he would be the guardian of the principles to which the governments have subscribed, he would pressure his council to act cooperatively and he would to report to the G-20 summit so that better international economic policy coordination could really happen.

Conclusion

The G-20 has been a quick and efficient answer to the immediate risks involved by the eruption of the financial crisis. The challenge now for this summit is take on its responsibilities as the "premier world economic forum". Its defining challenge is to design a credible path toward “strong, balanced and sustainable growth”. The Toronto and Seoul summits proved rather disappointing in this regard. The Mutual Assessment Process and the introduction of a series of “indicators” definitely appear as insufficiently sharp. This paper argues that the world needs a formal framework for developing a more efficient economic policy coordination, that this process should be centered on the IMF, and that a few conditions can transform multilateral surveillance into a better policy decision-making process. These proposals can be received with skepticism because the obstacles to international collective action are well known by experts and government officials. A more positive view can nonetheless be backed by the spirit of international cooperation, by the fact that this political will is deeply rooted in huge interconnected economic interests and by the fact that the perils of a Japanese style lost decade or of a new great depression cannot assuredly be considered as past. This is why it is useful to build on previous stages and to recommend to “give more voice to the indicators”.

Macroeconomic Policy Interdependence and Developing Countries: Is Mutual Assessment for Members Only?

Thomas Fues *Head of Training Department and Senior Fellow, German Development Institute*

Peter Wolff *Head of World Economy and Development Financing and Senior Fellow, German Development Institute*

The decision at the G-20 Pittsburgh Summit in the fall of 2009 to install a Mutual Assessment Process (MAP) as an analytical underpinning of a more rational debate on economic policies was clearly a remarkable step toward a more cooperative way of economic policymaking in the major economies. Particularly noteworthy is the role of the International Monetary Fund as a facilitator in this process. In the past, IMF surveillance had to be taken seriously only by indebted developing countries. They had to fear the consequences of misbehavior, in terms of strict conditions on the use of financial support from the Fund. For the other countries, IMF surveillance as a routine exercise prescribed for all IMF members in its Articles of Agreement has become less and less relevant since the Fund does not have any influence on the economic policies of non-borrowing members. And when in 2006 a new process of multilateral surveillance was installed by the IMF in order to tame the conflict between the U.S. and China on the perceived overvaluation of the Chinese renminbi, it ended up as a dialogue of the deaf without any tangible results.

To be precise, the MAP is not about surveillance. The role of the IMF—with input by other multilateral organizations, particularly the World Bank—is that of an independent technical advisor to the G-20. The IMF was asked to provide a thorough analysis of the submissions of policy frameworks by all G-20 members that would entail "(1) identifying the inconsistencies and incoherence of national assumptions in G-20 submissions; (2) analyzing the multilateral compatibility of country submissions; (3) analyzing the aggregate impact of national policies on global economic prospects; and (4) identifying what additional policy commitments might be needed to reach the G-20 members' objectives".[1] The overall objective of the G-20 has been to provide a resilient recovery from the great recession that would lead to strong, sustainable and balanced global growth.

In its assessment, the Fund has confronted the G-20 with a clear message:[2] the aggregate policies of the G-20 members as stated in their submissions will not lead to the desired outcome. Global growth will most probably be lower than expected and global imbalances are expected to resume widening through 2014. World GDP would be higher by around 2 percent by 2014, if G-20 members would pursue more collaborative policies in terms of joint action on three fronts: structural reforms and exchange rate flexibility, fiscal consolidation, and product and labor market reforms. Insufficient internal rebalancing and the absent external rebalancing were identified as serious risks to the sustainability of global growth.

In accordance with its assignment by the G-20, the Fund is concentrating its analysis on the G-20 economies and their aggregate effects on the global economy. Although the G-20 members cover around 90 percent of global gross national product and thus clearly dominate the pace of the global economy, the absence of the rest of the world from the analysis is striking.

A supporting document by the World Bank opens the perspective for the global economy as a whole and makes it clear that the contribution of developing countries to global growth is not limited to the emerging markets represented in the G-20.[3] Low-income countries (LICs) are increasingly interlinked with emerging markets and contribute significantly to global growth. Rebalancing of the global economy is not confined to the G-20 members as a zero-sum game but has to include the developing countries where significant contributions to alleviate the "global demand deficit"[4] can be expected.

In this context, it is again striking that the policy recommendations of the IMF for internal rebalancing in emerging surplus economies are confined to G-20 members only: "(1) a gradual increase of government investment of 2 percent of GDP, starting in 2011 and implemented over 3 years in the *emerging Asia* region of the model; (2) targeted transfers to the poor to strengthen safety nets—amounting to around 2 percent of GDP".[5]

Of course, the underlying assumption of the IMF approach is that emerging surplus countries do have fiscal space that allows them to finance additional expenditure through higher fiscal deficits. Most low-income countries do not have this option, since their fiscal position is rather weak after the crisis, as the IMF has stated in an earlier analysis.[6] However, if the G-20 really endeavors to take responsibility for the global economy as a whole, it is necessary that investment, social safety and growth in the about 90 low-income and lower-middle income countries, and not only in emerging countries, have to be taken into consideration.

Here, the G-20 Development Agenda comes into the picture as laid down in the Seoul Consensus for Shared Growth with the commitment "…to work in partnership with other developing countries, LICs in particular, to help them build the capacity to achieve and maintain their maximum economic growth potential".[7] The main features of the Seoul Development Consensus are nine thematic areas ("pillars") that are seen as critical for accelerated growth in developing countries (infrastructure, human resource development, trade, private investment and job creation, food security, growth with resilience, financial inclusion, domestic resource mobilization). A Multi-year Action Plan on Development is supposed to support the actual implementation. Thus, it addresses the need for a growth strategy for developing countries that have been absent from the analyses of the IMF so far, the implicit consideration being that less developed countries benefit from global growth, but they do not contribute to it.[8] With a more forward looking perspective, the Seoul Consensus gives the reason why a growth strategy for developing countries is warranted also for global rebalancing: "... because the rest of the global economy, in its quest for diversifying the sources of global demand and destinations for investing surpluses, needs developing countries and LICs to become new poles of global growth—just as fast growing emerging markets have become in the recent past".[9]

Obviously, there are good reasons why growth and development in the rest of the world should not be dealt with separately from the process of macroeconomic policy coordination among the G-20 member countries. This refers also to the macroeconomic and structural indicators which are to be developed for G-20 members throughout 2011. Notwithstanding the difficult political process of reaching an agreement about a common set of indicators, the question remains why there should not also be a discussion on a set of monitorable indicators for investment rates in developing countries and related sources of finance.

Going beyond national policies and their mutual assessment within the G-20, macroeconomic policy coordination must also address the global policy framework and global economic regimes, particularly in the areas of international finance, trade, commodities, knowledge and climate change.[10] Global economic governance reform needs to systemically integrate the overarching objectives of poverty elimination and inclusive growth. The G-20 has to embed its policy coordination process in this framework (also captured by operational indicators) otherwise its legitimacy and effectiveness will be severely constrained due to outside criticism and popular rejection. Findings and policy recommendations flowing from the G-20 Working Group on Development should be linked to the policy coordination mechanism to provide for overall policy coherence of individual states and the group as a whole.

As welcome and necessary as such innovative efforts on macroeconomic policy coordination are, they are not sufficient for planetary stability and global development. The G-20 needs to go beyond balancing the world economy and accept its responsibilities for global welfare and the special requirements of low-income countries. The MAP and macroeconomic policy coordination must, therefore, be systematically linked to the Seoul Development Consensus, thus clearing the way for a global social contract which guarantees human security, inclusive growth and sustainable prosperity for every individual and society.

With regard to the developmental dimension of macroeconomic policy coordination, the following steps are of primary concern:

- provide conducive framework conditions in the global economy and promote coherence across global regimes in order to support the structural transformation of developing countries toward inclusive, sustainable and low-carbon growth;
- assist developing countries in managing excessive capital inflows as a result of the monetary expansion in the U.S. and Europe; including capital controls and enhanced mechanisms for financial supervision and regulation;
- increase the voice of all developing countries in the formulation of global financial regulation and expand their representation in regulatory standard-setting bodies such as the Financial Stability Board as well as the Bretton Woods institutions;
- contain excessive commodities market speculation in order to safeguard food security and price stability for all developing countries;
- address current and future debt crises of developing countries by designing a new framework for sovereign debt relief and, as a short-term measure, extend the HIPC initiative to include all low-income countries and vulnerable lower middle-income countries;
- stop "murky protectionism" of G-20 members by the introduction of comprehensive mechanisms for duty free/quota free market access for all low-income countries;
- support universal standards on corporate social responsibility which cover the whole extent of global value chains building on, harmonizing and integrating existing multi-stakeholder efforts in this field (as committed in the Seoul Action Plan);
- introduce national laws in all G-20 countries along the lines of the recently passed Dodd-Frank financial reform legislation in the U.S. in order to promote universal transparency in extractive industries;
- agree on a global standard against which transnational companies must report their activities in their annual accounts, on a country-by-country basis in order to combat tax evasion and avoidance and help developing countries to raise resources domestically;
- mobilize financial resources in support of inclusive growth in developing countries and for the provision of global public goods as a key development challenge for the G-20 through introduction of a financial transaction tax;
- formally link the G-20 process to deliberations and policymaking of U.N. bodies such as the General Assembly and ECOSOC; and
- institutionalize G-20 mechanisms for inclusion of and outreach to non-member states and non-state actors.

How can the developmental dimension be integrated in the MAP and the G-20 debates on policy coordination? We suggest that the submissions of the G-20 members on their policy frameworks should contain a chapter on the linkages between national economic policies and the Seoul Development Consensus for Shared Growth and its companion Multi-year Action Plan on Development. This procedure would contribute to enhancing policy coherence for development at the domestic level. In their assessments of the national submissions, the IMF and World Bank would also have to evaluate them in consideration of the impact of G-20 policies on low-income countries, with formal comments to the IMF/World Bank analysis by UNCTAD and UN-DESA. Such analysis would contribute to improving global framework conditions for developing countries.

In parallel to such incremental reform steps, the G-20 needs to deepen the shared normative framework of global governance along the lines of the leaders' statement of the G-20 Pittsburgh Summit in September 2009: "we have a responsibility to recognize that all economies, rich and poor, are partners in building a sustainable and balanced global economy in which the benefits of economic growth are broadly and equitably shared. We also have a responsibility to achieve the internationally agreed development goals."

References:

G-20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009. Pittsburgh, U.S.A. (http://www.pittsburghsummit.gov/mediacenter/129639.htm).

G-20 Seoul Summit Leader's Declaration, November 11-12, 2010. Seoul, Republic of Korea. (http://media.seoulsummit.kr/contents/dlobo/E1._Seoul_Summit_Leaders_Declaration.pdf).

International Monetary Fund (IMF), 2009. "The G-20 Mutual Assessment Process and the Role of the Fund," Prepared by the Strategy, Policy, and Review Department and the Legal Department, Washington, D.C.

IMF, 2010. Emerging from the Global Crisis: Macroeconomic Challenges Facing Low-Income Countries, Washington, D.C.

IMF, 2010a. "G-20 Mutual Assessment Process—Alternative Policy Scenarios," prepared for G-20 Summit of Leaders in Seoul, Republic of Korea.

United Nations Conference on Trade and Development (UNCTAD), 2010. The Least Developed Countries Report 2010.

Willem te Velde, Dirk (ed.), 2010. The G-20 Framework for Strong, Sustainable and Balanced Growth: What Role for Low-Income, Small and Vulnerable Countries? Overseas Development Institute, London.

World Bank, 2010. "Growth and Development in Emerging Markets and Other Developing Countries," G-20 Growth Framework and Mutual Assessment Process, Washington D.C.

Endnotes

[1] IMF (2009, p.3).

[2] IMF (2010a).

[3] World Bank (2010).

[4] IMF (2010a, p. 12).

[5] IMF (2010a, p. 17).

[6] IMF (2010).

[7] Seoul Summit Declaration.

[8] IMF (2010)

[9] Seoul Summit Declaration, Annex I.

[10] UNCTAD (2010).

Global Imbalances, Spillover Effects and External Monitoring: Some Indian Perspectives

Suman Bery *International Growth Centre, New Delhi and Member, Prime Minister's Economic Advisory Council*

Introduction

Jointly with Canada, India co-chairs the G-20 Framework Working Group. This working group was set up at the G-20 Pittsburgh Summit with the mandate to elaborate the leaders' agenda of returning the global economy to strong, sustained and balanced growth. At Seoul in November 2010, the leaders tasked this group to develop indicative guidelines with the technical support of the IMF for consideration by the G-20 Ministerial to take place in Washington in April 2011.

As co-chair of a critical and influential working group, India has been thrust into the heart of a complex and contentious global debate on how to measure, assess and correct the current imbalances and prevent future ones. In this article, I will not comment on India's position as co-chair of the working group, except to note that within India there has been remarkably little discussion on how the country's officials should exploit this prestigious platform. Rather, I examine these issues more broadly from the perspective of India's own growth strategy, its medium-term interest in deepening its own global integration while avoiding unreasonable risk, and its domestic political structures and constraints. It seems reasonable to assume that India's views of these medium-term interests will in turn affect the positions assumed by Indian officials and leaders in the global discussions. Given that the objective of this collection of articles is to encourage fresh thinking on these issues, this paper also tries to assimilate some of the more recent analysis emerging from the global recession to provide a personal assessment.

Analytical Considerations

From the perspective of the major emerging markets in the G-20, is anything really distinctive about the recent recession? Other than China, none of them are as yet systemically important for the global economy, although many of them now enjoy significant regional influence as growth poles and as potential sources of contagion. For at least the last 20 years, officials of these economies have voiced growing concerns on a range of issues in global finance. These concerns include the unpredictability and fickleness of capital flows, the volatility of cross-rates across major currencies, the reality and unfairness of contagion, and the steady reduction in the relative scale of official finance available as a safety net. There has also been considerable bitterness about the influence over major governments that international banks leveraged in order to ensure repayment of debt that had been incurred under questionable circumstances.

The "spillover effects" on emerging markets from policy decisions taken by advanced economies have been a source of concern for many years now. These concerns did not generate much policy traction because the influence was largely unidirectional from the advanced countries to the emerging markets without much impact in the opposite direction.

Seen in this light, it is not the policies of the advanced countries which are distinctive this time round. Rather, three other factors seem to be at play. First, collateral damage from such spillovers has been sustained by other advanced countries and not just by the poorer countries. Second, one important emerging market, namely China, is now important enough to affect global economic activity. Third, as pointed out by Blanchard and Miles-Ferreti,[1] the fiscal and monetary policy space is now sharply curtailed in many advanced countries.

These circumstances have compelled the advanced countries finally to pay attention to some of the concerns previously voiced by the emerging markets. This provides an opening for the latter group to press some of their earlier concerns. Yet there is also justified unease among these countries at putting in place a set of disciplines that might be unnecessarily intrusive, selectively applied and administered by the executive board and staff of the IMF—an institution whose own legitimacy and impartiality are currently under examination.

I next turn to the links between global imbalances, official financial flows and the recent crisis. As mentioned earlier, there has been sufficient intellectual and analytic consensus to prompt concerted action on failures of regulation and supervision, to identify perverse incentives in financial markets, and to address difficult issues of measuring and curbing systemic risk.

By contrast, there is little such consensus on global imbalances. An early formulation focused on the global savings glut, which resulted from the failure of investment to recover after the Asian crisis, with the U.S. current account adjusting passively to these autonomous flows. Seasoned observers are skeptical of this explanation, arguing that the crisis was not caused by "net flows across the Pacific but gross flows across the Atlantic"—a view that has received some endorsement in more recent work emerging from the Federal Reserve.[2]

Within the G-20, the focus of the discussion has shifted from the trade deficit to the current account and to reserves accumulation. Governments in countries besides the U.S. are irked that the central bank at the heart of the international monetary system, the U.S. Federal Reserve, sets policy completely disregarding international consequences, while the Federal Reserve argues that its best contribution to the world economy is by ensuring sustained noninflationary growth of the U.S. economy.

India's Situation

For India, distinguishing between various concepts of "imbalance" is relevant to ensuring that global rebalancing over the coming decade helps to support and sustain its own growth over the medium term and does not act to retard it. In turn, India's growth can make an important, though not decisive, contribution to sustaining recovery of the global economy. In his remarks, at the various G-20 meetings, Indian Prime Minister Manmohan Singh has been clear on the primacy that India gives to restoring growth in the advanced countries. This is because of the boost that this will give to India's own growth and because improved prospects for growth in the advanced countries is essential to sustain the commitment of those countries to an open world economy.

India's growth pattern has been qualitatively different from that of its peers in East Asia. India's rapid growth in the first decade of the 21st century has recently caused it to be considered an "honorary" member of this Asian fraternity. While there are some characteristics such as the role of the demographic transition which are similar, there are others which are distinctive and have an important bearing on India's stake in global rebalancing. This is true whether one considers: the earlier wave of successful industrializers, which include Japan and the "newly industrialized economies" of Korea, Taiwan, Hong Kong and Singapore; the more sophisticated ASEAN countries which followed, notably Malaysia and Thailand; or most recently China. All these countries have been characterized by fast growth in output and employment in manufacturing on the supply side and an important role for net exports as a source of demand.

By contrast, a striking aspect of the Indian experience is the relatively poor performance of manufacturing, particularly manufacturing in the so-called "formal" sector, and the corresponding specialization of the economy and trade in services. Equally on the demand side, net exports have been an insignificant source of final demand. Over the last two decades, India has also been plagued with a chronically weak fiscal position, leading to a relatively high debt stock—one that remains tolerable only because of relatively rapid growth.

These differences from other successful Asian emerging markets reflect themselves in the structure of India's balance of payments. In the decade since the Asian financial crisis, most East Asian countries have tended to run surpluses on their current accounts. In the case of the ASEAN countries, these surpluses reflect the fact that investment rates did not recover after the Asian crisis even as saving rates remained relatively strong. In the case of China, they famously reflect the fact that despite a towering and possibly inefficient investment rate, corporate and household savings are even higher, generating a large current account surplus.

With the exception of a couple of years in the middle of the last decade when it ran a small surplus, India has typically run a deficit on its current account of around 2 percent of GDP. This is financed by a net surplus on private capital flows, particularly portfolio flows and to a lesser extent net foreign direct investment. Yet this relatively tranquil overall picture masks a large and growing deficit on merchandise trade—now approaching 10 percent of GDP—offset by a surplus on invisibles account, including both services exports and large and relatively stable remittance flows. Given India's dependence on imported oil—about 70 percent of domestic consumption—the trade account is heavily affected by movements in the international oil price.

Similar to its Asian peers, India has accumulated significant stocks of international reserves despite this deficit on the current account primarily because of a fluctuating surplus on the net private capital account. It has done so for the same reasons that many other emerging markets accumulate large foreign exchange reserves. The reserves act as a financial safety-net in case of a "sudden stop" in capital flows and they help avoid disruptive nominal appreciation of the exchange rate, even while accommodating an increasingly wide degree of flexibility in the rupee-dollar exchange rate.

India is significantly poorer than most of its G-20 emerging market peers despite having sustained rapid growth for almost three decades. This is partly because India is much less urbanized. As its demographic transition is still incomplete, India faces sustained growth in its labor force over the next two decades.

If the focus is on the adjustment of current account balances, India has little "rebalancing" to do. It may nonetheless have considerable and legitimate concerns on the impact of global policies designed to reduce imbalances elsewhere. However, if the focus is more on imbalances in the trade account as seems to be the case, then India's interests are perhaps more closely aligned with those of the advanced countries, particularly the U.K. and the U.S., than with China. And if the focus of policy coordination is to reduce the accumulation of official reserves by emerging market countries, then India's interests lie with those concerned in strengthening so-called "safety-net" policies and any associated disciplines on capital movements and exchange rate regimes so to avoid becoming a victim of sudden stops in net foreign capital movements.

Indian policymakers have clearly signaled their view that India expects to be a net importer of private capital for the foreseeable future, but it believes that self-insurance remains the only credible mechanism of risk mitigation available at the present time. As an absorber of foreign savings, India has not contributed to global imbalances. However, as a significant accumulator of reserves, India does have an interest in the liquidity and maintenance of value of such reserves and in the orderly management of global liquidity. India has benefited enormously from its integration into the global economy, yet its growth strategy cannot really be called export-led, unlike other countries in East Asia. Accordingly, its primary motivation for reserves acquisition has been and will continue to be precautionary. Even so, these are likely to grow with the size of India's trade, the scale of its payments obligations, and the size and maturity of its financial system.

India's fundamental policy challenge is less one of external adjustment than of internal adjustment. As reflected in the current account, both the absolute levels and the relationship between aggregate saving and aggregate investment are broadly appropriate and do not require change. Equally, aggregate growth is at healthy levels and is likely to be sustained. What is needed is an improvement in the quality of this growth.

India would move to a better development trajectory if it could depreciate its real exchange rate such as to improve the competitiveness of its tradables-producing sector. Yet the paradox and challenge for domestic economic management are that India needs to do so while improving the supply of key non-tradables, including infrastructure provisions in the public and private sectors, as well as a broad range of human capital enhancing interventions, such as better public education and public health.

Thus, the appropriate policy shift for India is one that promotes expenditure switching without requiring expenditure reduction. Political economy considerations aside, the most appropriate policy mix for achieving the desired outcome is through a combination of fiscal consolidation, public expenditure reform and additional trade liberalization. Fiscal consolidation in turn could legitimately include both revenue and expenditure elements, along the lines of major reforms of the systems of direct and indirect taxation currently under consideration. More important is a fundamental restructuring of government subsidies on food and fuel, which has been endlessly talked about but keeps foundering on the shoals of vested interests and political timidity. Reduction or removal of fuel subsidies in particular should help reduce the oil import bill, releasing resources for domestic expenditure. Finally, unilateral trade liberalization, which has been of decisive importance in reducing anti-export bias in the last decade, has now ground to a halt partly because of the desire to retain bargaining chips for the stalled multilateral negotiations and partly out of fears about unfair competition from China.

The hypothesis underlying this policy prescription is that the real exchange rate is more durably influenced by policies, such as taxation, that affect the real economy. The issue nonetheless arises: what is the role of nominal policies, such as the nominal exchange rate, in bringing about the desired shift? In the case of China, it has been argued that a nominal appreciation would be important in shifting demand impulses away from external to domestic. Shouldn't the same argument apply in reverse to India? While the argument is superficially attractive, my own inclination is to be cautious. The Reserve Bank of India has gained valuable experience and credibility in managing an increasingly flexible exchange rate, which gives it all-important freedom in conducting monetary policy for domestic Indian conditions. One important by-product of this flexibility is the shifting of exchange risk assessment to private agents and the development of hedging instruments to allow them to do so.

To conclude, India's primordial interest as a member of the G-20 is the restoration of buoyant global economic activity since that will give India more space for the necessary domestic adjustments. India should resist being clubbed together with China in the debate on global rebalancing as India's interests are more fundamentally aligned with the deficit countries. The country's goal should be further trade deepening of its economy through multilateral trade liberalization; therefore, avoiding protection in the advanced countries is critical. But the fundamental economic challenges for India are domestic and this is where the bulk of its attention must remain directed.

I am grateful to Dr. Alok Sheel for helpful interactions and suggestions; however I am solely responsible for all judgments and any errors of facts or interpretation.

References

Bernanke, Ben et. al., 2011. "International Capital Flows and the Returns to Safe Assets in the United States, 2003-2007," International Finance Discussion Paper 1014, Board of Governors of the Federal Reserve System, Washington D.C.

Blanchard, Olivier, and Gian Maria Milesi-Ferrett, 2011. "(Why) Should Current Account Balances Be Reduced?" IMF Staff Discussion Note.

Endnotes

[1] Blanchard and Miles-Ferreti (2011)

[2] Bernanke et. al. (2011)

Emerging Market Economies, Macroeconomic Policy Coordination and the G-20

Raden Pardede *Co-Founder, Creco Research Institute, Jakarta*

Prior to 2008, the participation of emerging market economies (EMEs) in international economics discussions was mostly limited to a following role. From the 1970s to the 1990s, advanced countries dominated economic discussions and macroeconomic policy cooperation took place among the top developed industrialized countries.

After the 1997 Asian financial crisis, it was recognized that the financial markets of emerging market economies could have serious spillover effects on global financial markets, including the developed financial markets. Emerging market economies had gained greater influence and had become too important to ignore in discussions on economics and financial issues. As a result, the G-20, comprised of a more balanced membership taken from developed and emerging economies, held meetings in 1999 for the first time at the finance ministers' level.

However, it was only after the outbreak of the global financial crisis in 2008 that emerging market economies were invited as full participants in the international discussions and to participate in macroeconomic policy cooperation at the highest level. Emerging market economies have become too important to ignore given their greater economic contributions to global economic growth over the last decade. This development is very encouraging. Never before have leaders of the new emerging market economies shared the same table as the leaders of the advanced economies to find solutions to common global economic problems.

The Rationale for Macroeconomic Policy Coordination

There are two rationales for policy coordination. The first sees coordination as a means of supplying public goods that decentralized actions would be unlikely to produce. The second emphasizes economic spillovers between countries and the consequent relevance of coordination in assessing economic policy externalities.

A theoretical rationale for policy coordination is based on strategic game models. These models show that a Pareto optimal "Nash" equilibrium policy could be found that leaves some countries better off without others being worse off. The key message is that if all participants agree to coordinate their policies then they internalize the externalities which can lead to higher welfare for all.

With the global economy becoming more integrated in recent years, the issue of external effects and public goods has become more prominent since the size of the externalities and public goods depends critically on the extent of economic integration between economies. In this era of globalization, the recent global financial crisis and global financial regulations are two obvious examples of public goods and the presence externalities. Macroeconomic policy coordination through the G-20 clearly provides a good case on how a group of nations can try to solve global problems together.

The Progress of Macroeconomic Policy Coordination and the G-20

The concerted and decisive actions of the G-20 helped the world to deal effectively with the 2008 financial and economic crisis. Despite the difficult issues, the G-20 made real and steady progress on addressing global economic challenges. These meetings have already resulted in a number of significant and concrete outcomes:

- There was great progress in macroeconomic policy coordination among the G-20 members to achieve strong, sustainable and balanced growth to mitigate the adverse impact of the crisis. G-20 members agreed to coordinate global fiscal and monetary expansion at the onset of global financial and economic meltdown.

- The G-20 agreed to broaden the scope of financial regulation and to strengthen prudential regulation and supervision.

- There is now better global governance and greater consideration for the role and needs of emerging markets and developing countries, especially through the ambitious reforms of the governance of the international monetary system, the IMF and the World Bank.

- The reappointment of the IMF and the strengthening of its capability by providing additional funding to prevent future crises.

- Agreement to address global imbalances and currency tensions.

- Endorsement of the Basel III reform and continued work on systematically important financial institutions.

- The recent Seoul Summit also attempted to create new momentum to conclude the Doha Round and reiterated the G-20's commitment to fight protectionism.

Why Has Macroeconomic Policy Coordination through the G-20 Been Successful Thus Far?

With the progress of the G-20 forum to date, it is certainly valid to ask why its coordination of macroeconomic policy has been a success and how we can maintain good coordination to resolve global economic problems in the future. Several points are worth further discussion:

- In the game theory setting, this result is an easy Nash cooperative game equilibrium since all members of the G-20 share a very clear and common objective to avoid a global meltdown.

- The fear of contagion in the global financial system is valid in that spillover from the U.S. financial crisis could quickly spread to other countries. The potential of global depression is real and is on an unprecedented scale since the Great Depression of the 1930s. This is a strong reason why global leaders moved quickly to tackle the problem immediately.

- Initiators and leaders from "crisis" countries (advanced economies) have been willing to share the table with new emerging economies to formulate appropriate policy coordination.

- Information about the crisis is well distributed not only across global markets but also across communities within countries (both global constituents and local constituents). This helps leaders in a country to communicate with its local constituents.

- There are also less political constraints as most leaders can make decisions faster in times of crisis. The nature of decision-making is that it diverges in times of crisis from normal times.

In times of crisis, the executive has more power and flexibility in decision-making than during normal times. During the crisis, most countries have legal frameworks that enable leaders to make a significant and urgent decision to prevent the country from collapsing. The executive can take initiatives that are only later presented to other political leaders including parliament. This luxury disappears during normal times when the executive has to follow the political process, meaning the decision-making process may be drawn out.

Can We Emulate Previous Successful Coordination of the G-20 Forum?

The optimist's answer is "yes", but it is much more difficult to achieve a cooperative win-win "Nash" equilibrium when the scope of the objective is broadened and there is no longer a crisis. Cooperative equilibrium will only be achieved gradually. Nevertheless, the rationale of macroeconomic policy coordination is still valid as an investment for the continuation of coordination.

We have to avoid a blame game, as if one country is responsible for the mess. Each must take responsibility and avoid solutions tainted by political interests. The fact that the global recovery takes place in dual speeds makes the coordination difficult as members of the forum have their own objectives and therefore come up with different policy responses. In this kind of situation, there is a tendency for each country or group of countries to think of their own interests rather than a global solution. Moreover, some leaders believe in one false hope as if only one recipe is appropriate for every country.

We must have a clear focus and at the same time we should not confuse symptoms with illness. We should expect disagreements on the distribution of gains; all may gain but one may gain more than the others.

In spite of this, we should not be discouraged if on some occasions cooperation hits a wall. Macroeconomic policy coordination should continue since a win-win gain can only be realized after many trials and errors and with the relationship firmly grounded in strong commitment and patience.

The Global Imbalances: Symptoms or Illness?

Discussions of the global financial crisis are always followed by discussions on global imbalances. Many top U.S. policymakers believe that imbalances reflecting the global savings glut are one of the sources of the global financial crisis. The causes of the crisis lay not in the U.S. but in Asia. Hence, countries that have a current account or savings surplus should adjust their policies accordingly to increase their domestic demand—mainly consumption—to boost imports and thereby help the deficit countries like the U.S. to recover.
However, many economists like Dadush, Eidelman, Sachs and others reject this idea. This hypothesis clearly disregards another important factor—the presence of an under-pricing risk environment, in which the U.S. Federal Reserve plays a central role. The G-20 emerging economy countries also have their own answer. According to them, the crisis began from internal problems with U.S. over-borrowing; hence, the widening of the budget deficit is America's responsibility and not theirs. In short, the U.S. needs to restructure its economy and get its own house in order first.

Proponents of the argument that global imbalances cause global financial crises are clearly mixing up symptoms and illness. Global imbalances, as reflected in current account imbalances between most of the EMEs plus Germany and Japan, and advanced economies, are symptoms of domestic illness. Hence, each economy has to address its domestic structure problems in order to solve global imbalances. Putting the blame on others is the wrong approach that may result in temporary political gains but does not address the real problem.

The discussion above should not be misinterpreted to mean that global imbalances are not a problem. Current account imbalances need to be discussed and resolved. Nevertheless, it is somewhat excessive for them to be a central focus of macroeconomic policy coordination since not all countries have a strategy of export-led growth. All members of the G-20 recognize the imbalances problem and understand that this is not sustainable. G-20 leaders had agreed in November 2010 to find a way to tackle them. Such imbalances, as reflected in the current account balance, private and public savings, and debt and capital flows, could trigger or augment crises and destabilize the global economy.

However, the timing and approach to resolve the imbalances mostly rely on the seriousness of the world's political leaders to restructure their own economies. This is certainly not only the responsibility of the emerging market economy leaders. Ultimately, all leaders should address this problem and communicate with their constituents in order to obtain the necessary support for further domestic economic restructuring.

An Emerging Market Economies' Agenda on Macroeconomic Policy Coordination

In a multi-speed economic recovery environment, some emerging market economies are recovering rapidly while advanced economies are continuing to struggle, with some even in decline. As a result, many leaders in advanced countries are more concerned with accelerating their own economic recovery, as if the global financial markets problem has already been fully addressed. Some see export-led growth as a panacea for the problem of global imbalances. But while all advanced economies may share the same goals, the policy responses are different since they have different fiscal and monetary conditions.

By comparison, emerging market economies are focused on: the rise in food and energy prices; the potential asset bubble and overheating due to simultaneous fiscal and monetary policy; vulnerability to large-scale and volatile capital flows, exacerbated by low interest rates in most advanced countries; reliance on the U.S. dollar as the key reserve currency; and the need for regional and/or global financial safety nets to help insure against such capital flow volatility and dollar dependency.

In a recent interview to the U.K.'s *Daily Telegraph*, Mervin King voiced his concerns and warned us about the potential reemergence of financial crisis. "The problem is still there. The search for yield goes on. Imbalances are beginning to grow". This is relevant since potential problems from systematically important financial institutions have not been fully addressed. King said that "we allowed a banking system to build up which contains the seeds of its own destruction" and "we have not yet solved the 'too important to fail' problem".

Lessons learned from the recent financial crisis—the asymmetric policy power of advanced countries and the asymmetric impact of the financial crisis on emerging market economies—provide a strong reason for leaders of EMEs to continue to focus on the unfinished agenda of a comprehensive regional or global financial safety net.

The asymmetric policy power of the U.S. could significantly affect the emerging markets but not the other way around. For example, the U.S.'s zero interest rate policy will push capital flows to EMEs and may create volatility as opportunistic fund managers in the U.S. try to benefit from interest rate differentials. Conversely, if U.S. interest rates are hiked significantly, the EMEs might be adversely affected as the cost for raising funds for financing deficits or debt refinancing will rise significantly. Therefore, EME debt will potentially rise significantly.

One important aspect of the current international financial architecture not yet considered by the G-20 is the asymmetry of the international financial architecture with regard to capital flows. Currently, the burden of dealing with volatile capital flows falls entirely on the receiving country and not the originating country. Although many emerging economies have evolved effective frameworks for managing such inflows, this has frequently come after many painful experiences. In addition, such volatility still entails difficult trade-offs between currency instability, inflation and asset prices.

During the financial crisis, despite the fact that all countries agreed to provide fiscal stimulus, some emerging market economies were severely constrained in funding the stimulus. It is true the crisis started in the U.S., but the capital markets were punished in emerging market economies too, as reflected by the significant increases in the yield curve and the CDS rate in both the domestic and U.S. dollar currencies. Should the emerging market economies need funding from the market to finance fiscal stimulus in times of crisis, they have to pay a higher cost. Most advanced countries did not face this problem since they could easily issue debt at a lower cost in their own currency.

The most important instrument during financial crises is the availability of liquidity. The global financial crisis in 2008 led to market panic, which subsequently resulted in huge demand for U.S. dollar liquidity. Even countries like South Korea and Singapore are at the mercy of the U.S. Federal Reserve when facing difficulties in U.S. dollar liquidity in the peak of a liquidity crunch. This is no secret and even my country, Indonesia, tried very hard to search for liquidity facilities from one advanced economy when the Asian crisis broke out in 1997. Unfortunately, Indonesia returned empty handed.

Global financial safety nets are not really in place yet. Emerging market economies still rely on their own foreign reserves rather than institutional funding (for example, regional Chiang Mai and the IMF). If the EMEs are not convinced on this issue then they will continue to accumulate reserves as insurance against capital flows volatility.

Conclusion

We all recognize the importance of macroeconomic policy coordination in solving global economic problems, especially in a more integrated world. And it is in our own interests to have among other things macroeconomic policy coordination through the G-20. Based on the discussions above, let me briefly make several points:

- Recent policy behavior in many forums despite its repeated insistence on the need to coordinate policies highlights that in "good times" coordination becomes a less urgent priority. Conversely, policy coordination becomes more appealing during times of economic weakness.

- Start with a simple objective, a common denominator, and avoid too many objectives. Tackling systemic crisis together is the minimum target.

- Review and evaluate possible asymmetric responses in relation to the definition of systematically important countries and systematically important financial institution given the EME experience.

- A more ambitious target, such as global imbalances, or other future problems, will need strong commitment, good interpersonal relationships among leaders and close interaction among high-ranking officials, equal partnerships and a transparent agenda.

- Emerging economies are very fragile to financial crises and food and energy price volatility. Hence, it is understandable if emerging market economies would like to see a twin focus of macroeconomic policy coordination: the first is a significant improvement of global financial safety nets and the second is more stable prices of food and energy.

References

Dadush, Uri and Vera Eidelman, 2011. "Stop obsessing about global imbalances." VoxEU.org, March 6. (http://www.voxeu.org/index.php?q=node/6174)

McKinnon, Ronald I., 2010. "Why exchange rate changes will not correct global trade imbalances." East Asia Forum, June 5. (http://www.eastasiaforum.org/2010/06/05/why-exchange-rate-changes-will-not-correct-global-trade-imbalances/)

Sachs, Jeffrey, 2010. "The G-20's new thinking for the global economy." Project Syndicate, November 30. (http://www.project-syndicate.org/commentary/sachs172/English)

Vines, David, 2011. "The global imperative for macroeconomic policy coordination." East Asia Forum, February 20. (http://www.eastasiaforum.org/2011/02/20/global-imperative-of-macroeconomic-policy-coordination/)

Macroeconomic Policy Coordination and the Generation of World Effective Demand

Paolo Guerrieri *Professor of Economics, University of Rome Sapienza; Professor, College of Europe, Bruges*

"Oligopolistic Interdependence" in the New Multipolar Global Economy

The international economy is shifting to a new multipolarity. About half of global growth is now from emerging economies and this is transforming power relations. A key feature of the new multipolar economy is that no single country can on its own assure stability to the international economic system. The latter is centered on a small number of leading nations—the U.S., EU countries, China, Japan and etc.—which are able to exert a veto power over other decisions but that are not in a position to unilaterally impose their own solution to arising conflicts. The U.S. remains no doubt the world's top political and economic power but it is no longer able to exert single-handed management of the world economy, much less against the will of the other leading nations. Because of these great asymmetries in international power distribution, one is induced to view economic relations among major countries as a system dominated by an "oligopolistic interdependence".

In this new framework, leading nations' individual policies can determine multiple equilibrium solutions that are more or less efficient in respect of the whole system but all equally attainable. It is well known that decentralized and non-coordinated interaction among a few countries may not lead to optimal outcomes for the entire world. Independently and autonomously formulated national policies can also turn out just mutually incompatible.

In the present system, there are various incentives for national policies that are justified for individual countries but harmful for the world economy. A telling example is the very recent currency war as the Brazilian finance minister called it last September. Every country desires a weaker currency to sustain growth via net export improvement. But the total of the world net exports by definition equals zero. The trouble is that not all currencies can be weak. If one weakens, another must strengthen. Furthermore, not all economies can have a net export improvement. This zero-sum game in currencies and net exports means one country's gain is some other country's loss and a competitive devaluation war ensues. This is the well-known problem of the prisoner's dilemma or a collective action problem. Subsequently, ad hoc cooperative agreements are required to promote compatibility among national policies and to ensure international stability.

The strengthened interdependent oligopoly in international economic relations has thus increased the need for macroeconomic policy coordination and enhanced the potential benefits of cooperation. This enhanced cooperation in the multipolar game is important in many areas including international trade and finance, but it is particularly important in respect to the coordination of macroeconomic policies between major countries and the growth of the world economy.

Global Imbalances and World Effective Demand

The coordination of macroeconomic policies has a crucial role to play in ensuring a stable high rate of growth of world effective demand. It is well known that demand and supply are both important factors that contribute to the growth of countries around the world. However, while supply factors depend more closely on domestic structures and national policies autonomously formulated by individual countries, in the present highly interdependent oligopolistic system the growth of effective demand is more closely dependent on the international context as domestic macroeconomic policies are heavily influenced by balance of payments constraints. This is even more so the case since the expectation of effective demand that policymakers convey to market agents is so important for growth. Therefore, a stable growth environment at present depends both on the demand policies implemented by the larger countries and on the institutional environment which determines the diffusion and stability of effective demand expectations.

As agreed by the G-20, there must be a shift to a more balanced global pattern of demand to ensure that world recovery continues and future crises are avoided. To sustain effective demand at the world level, the key problem today is to remove macroeconomic imbalances. Macroeconomic imbalances were one of the key drivers of the recent global financial crisis since they led to excessive capital flows into the U.S. and other fast-growing developed economies, thus relaxing America's credit constraint and perpetuating low U.S. real interest rates that in turn favored borrowing and the housing bubble.

The global recession that followed did not remove these huge imbalances. After a temporary narrowing, the latest IMF and OECD projections suggest that world current account imbalances are likely to remain substantial until the middle of the present decade. Along with the large East Asian surpluses, the German and the other European countries' surpluses will probably increase the U.S. current account deficit.

The task of rebalancing is to drain demand from where it is in short supply to economies that tend to suffer from excess demand. The well-known recipe is for the United States to save and export more, while countries like China, Germany and Japan must move in the opposite direction. At the same time, greater flexibility in Chinese and other Asian currencies is an important ingredient of the adjustment.

The main difficulty in applying this therapy is related to the problem of asymmetric adjustment between surplus and deficit countries in the present international monetary system. Current account deficit countries eventually must adjust as they run out of foreign exchange reserves and as bond investors impose market discipline—a partial exception being the U.S. which benefits so far from the dollar's international role. On the other side, surplus countries feel little pressure to reduce their current account surpluses or to prevent their currencies from appreciating. Since deficit countries spend less and save more when they are forced to adjust while surplus countries cannot be forced to reduce their savings and increase consumption, more global effective demand can be lacking when imbalances persist for too long.

In the past, this deflationary bias was at least partially mitigated by the U.S. expansionary and current deficit policies. However under the present oligopolistic system, following the bursting of asset bubbles which forces deficit countries to deleverage, a deflationary bias can fully produce its effect at the global level and eventually lead to a global lack of aggregate demand and hence a lower growth rate over the medium term.

The G-20 and the Need for Macroeconomic Policy Coordination

In the new multipolar system, stable growth assumes the contours of a public good since macroeconomic cooperation in terms of coordination of national macroeconomic policies is not only desirable but also necessary for producing expansionary world demand and avoiding persistent imbalances.

The global crisis was first and foremost generated by international macroeconomic arrangements that permitted balance of payments explosions and the unsustainable accumulation of assets and liabilities. Therefore, we should try to restore an effective supra-national mechanism to promote stability-oriented macroeconomic policies at the national level, especially by oligopolistic countries.

No fully satisfactory solution to this problem may come from strengthening institutions and cooperation in related areas. Monetary agreements can impose indirect constraints on macroeconomic policies insofar as these must follow courses which are coherent with exchange rate agreements. However, a monetary system may be quite robust and still produce a deflationary bias on member economies.

Trade liberalization may promote growth by opening market opportunities and improving supply conditions, however expected growth is a precondition for liberalization rather than vice versa. It may also be added that while trade regimes influence the allocation of trade flows among countries, macroeconomic regimes determine the overall size of trade.

As far as financial relations are concerned it is well known that, in order for a debt-based system to perform satisfactorily, the rate of growth in indebted economies must be higher than the rate of interest on debt—at least in the long run. In addition, the propensity to cooperate among both borrowers and lenders increases with the expected rate of growth.

One major problem is that while international institutions that deal with trade and financial issues do exist, they do not for macroeconomic coordination. Clearly the G-20 is now the priority-setting and decision-making organization for this kind of challenge since the recent global crisis has shown that the G-7 could no longer perform this function. And the process of macroeconomic policy coordination to which the G-20 countries have agreed is a crucial component of the rebalancing program since it is where the pieces of a cooperative strategy for growth will be identified and assessed. In the macroeconomic coordination process, the IMF should perform the key function as the operational arm and effective secretariat of the G-20.

A Rules-Based System and a Global Surveillance of National Policies

A first job for coordinating macroeconomic policies is to enhance communications among the players involved by increasing available information, which will create linkages and improve the context of cooperation. In the present multipolar system, there is a lot of uncertainty in the Keynes sense with actors uncertain about the future behavior of other actors. Since the leading actors involved are few in number, uncertainty will easily lead to prisoner dilemma situations in which the best strategy is defection. If one considers the Amartya Sen "assurance principle", then individual behavior will be conditional on the expected behavior of others. Hence, macroeconomic policy coordination could reduce such uncertainty and favor collective actions.

Information certainly plays a crucial role in influencing national strategies but it should be viewed more as a precondition for cooperative policies. Cooperation could also mean a close coordination of national policies via reiterated shared decisions on the definition (even in quantitative terms) of objectives and/or instruments of economic policy. In this case, an agreement between national policymakers is required every time. This type of cooperation, though the most frequently advocated in official meetings, is also the most difficult to implement due to the serious constraints it imposes on national autonomies.

Cooperation should take on yet another meaning today as a set of norms and rules (regimes) which countries bind themselves to observing in the implementation of their economic policy strategies, even though they keep their autonomy in making their own policy decisions. The framework outlined should lead countries to take into account existing interdependencies when implementing their policies so to modify their behavior toward greater system stability. It is this last type of international agreement that we need today by restoring some shared rules of the game for international macroeconomic adjustment.

The key problem to its success is how to exert pressures on surplus countries, such as China and Germany, to participate in the adjustment process. By failing to adjust, surplus countries constrain world effective demand and threaten the stability of an international macroeconomic order.

Two types of interventions seem necessary. The first is related to identifying those persistently large imbalances which require the intervention of the IMF. In this regard, there are many options that were offered in recent debates and could be applied. The set of indicators agreed at the February Paris G-20 finance ministers' meeting and related to the domain of balance of payments, debt and capital flows may also be used for this purpose.

The second aspect is related to the kind of adjustment that should be implemented by countries. Countries should not be forced to adopt specific measures but instead should be free to pursue the adjustment policies they prefer. What is crucial is that they bear the consequences if the adjustment policies they pursue prove to be ineffective. In this regard, the IMF should have some kind of enforcement rule incentives and sanction mechanisms. Otherwise, we are going to repeat the previous negative experiences, where peer pressure did not produce significant results. The absence of such sanctions was a critical weakness of the so called Bretton Woods II system and it could become a central weakness of the new one.

Financial Globalization and Macroeconomic Policy Coordination

Wonhyuk Lim *Fellow, Korea Development Institute; Fellow, Korea National Strategy Institute*

Macroeconomic policy coordination is the heart and soul of the G-20's mission. The 2008 global financial crisis highlighted the interdependence of national economies and gave impetus to the creation of the G-20 at the leadership level. Through this forum, the leaders at the September 2009 Pittsburgh Summit established the Mutual Assessment Process (MAP) to ensure the collective consistency of their macroeconomic policies; and they agreed at the November 2010 Seoul Summit to develop a set of indicators to address global imbalances. After much debate, the G-20 finance ministers subsequently agreed in Paris in February 2011 on a two-step process: first, to examine a relatively restricted set of fiscal, financial and external indicators; and then, consider a much more comprehensive set of variables, including structural variables, if the initial indicators point to serious problems.

Although the progress made by the G-20 in promoting macroeconomic policy coordination is commendable, the substance of that progress is becoming problematic. In particular, under the current agreement, there is an increasing risk that the G-20 will drift toward a highly contentious debate on structural reforms at the national level instead of tackling the realities of financial globalization, which is at the core of macroeconomic interdependence these days. While "demand interdependence," affected by structural variables, is an important source of macroeconomic spillovers, "financial interdependence" should receive greater attention in the MAP if it is to lead to effective macroeconomic policy coordination and avoid what is likely to be counter-productive discussions on overhauling deeply ingrained institutional arrangements and practices by G-20 members.

Just as macroeconomics as a discipline is undergoing a wholesale re-examination in the wake of the 2008 global financial crisis, macroeconomic policy coordination by the G-20 should draw lessons from the crisis and focus on the implications of financial globalization. Against the backdrop of a fundamental asymmetry between reserve currency and non-reserve currency countries and uncertainty about the extent of implicit government guarantees for financial institutions, the liberalization of capital flows creates spillover effects that were not evident in the era of capital account control. The G-20 should focus on developing new debt sustainability indicators that cover the private sector as well as the public sector and reflect the realities of financial globalization. In this regard, it must be recalled that countries such as Ireland seemed to do well prior to the crisis, when assessed by traditional debt sustainability measures that focused on the fiscal health of the public sector. At the end of the day, what matters in the eye of the creditor is the ability of the debtor (with uncertainty about the extent of implicit guarantees by national or foreign governments) to pay back in both the short and long run, and new debt sustainability indicators should reflect this basic principle.

Macroeconomics Before and After the Global Financial Crisis

The G-20's thinking on macroeconomic policy coordination is bound to be affected by the evolution of macroeconomics as an academic discipline. To avoid a repeat of the global financial crisis and promote strong, sustainable and balanced growth through international economic cooperation, it is useful to examine why macroeconomics as a discipline had failed to detect and mitigate the risks that led to the crisis and how macroeconomists are rewriting their playbook in the wake of the crisis.[1]

In terms of relevant aggregate variables and policy instruments, macroeconomics is comprised of monetary, fiscal, financial and external dimensions. The essential goal of macroeconomic policy is stable inflation and stable output gap, preferably at a low level. The mapping between policy instruments and targets is complex. For example, fiscal, financial, and external policy instruments affect inflation and output gap.

Prior to 2008, however, macroeconomic policy was viewed largely as a monetary issue. The use of discretion in the application of non-monetary policy instruments was discouraged, and it was believed that the adoption of a single monetary policy instrument could achieve both stable inflation and stable output gap. That single monetary policy instrument was the interest rate rule that targeted a low and stable level of core inflation, or consumer price inflation net of volatile food and energy price movements, with little regard for asset prices. As Olivier Blanchard (2011) notes, it was thought that setting the key policy rate affected the term structure of interest rates and asset prices—and hence aggregate demand—in a predictable manner. In the pre-crisis period, mainstream macroeconomists also believed that fiscal policy, susceptible to political abuse and misuse, was basically unnecessary in the short run with the right use of monetary policy. To the extent that they cared about fiscal policy, they focused on maintaining mid- to long-term fiscal sustainability, with a rule of thumb such as keeping the government debt to GDP ratio below 60 percent. As for financial policy, most macroeconomists basically ignored the details of financial intermediation and regulation such as leverage and capital adequacy ratios. Finally, on external policy, macroeconomists thought that a country could either set an inflation target and float, or fix its exchange rate by adopting a hard currency peg or joining a common currency area. Looking back at the pre-crisis consensus, Blanchard (2011) observes that "in a world in which central banks followed inflation targeting, there was no particular reason to worry about the level of the exchange rate or the current account balance. Certainly, attempting to control exchange rates through capital controls was undesirable. And multilateral coordination was not required."

The global financial crisis shattered this consensus and forced macroeconomists to re-examine their beliefs. In the wake of the crisis, it was evident that macroeconomic policy was much more than a monetary issue. The adoption of a single monetary policy instrument, the interest rate rule, could not guarantee stable inflation and stable output gap. In fact, the *appearance* of stable inflation and stable output gap prior to the crisis had concealed deterioration in the balance sheets of households, firms and financial institutions, as measured by such indicators as debt-to-income ratios. The details of financial intermediation and regulation mattered a great deal because of balance sheet effects and counterparty risks. Fiscal policy came back with a vengeance when the interest rate reached the zero lower bound and the public sector had to step in to shore up aggregate demand to make up for the precipitous decline in spending by the private sector. As financial shocks propagated beyond national borders and governments adopted expansionary policies, macroeconomic policy coordination was needed to arrest contagion and overcome the free rider problem. External policy was clearly affected by "financial interdependence" and "demand interdependence."

Greece provides a case in point on macroeconomic interdependence in the age of financial globalization. Greece is a relatively small economy in Europe, but if it defaults, its international debt is large enough to affect the solvency of systemically important financial institutions in other parts of Europe. In other words, Greece's GDP divided by Europe's GDP is not a relevant metric when we try to assess the potential spillover effects of its default; rather, we should look at Greece's international debt at risk relative to the capital base of large European banks, which in turn are connected with other financial institutions around the world. If investors begin to fear that the capital base of these banks may be wiped out, concern about counterparty risks will lead to rising interest rates and exclusion of weaker financial institutions from the capital market, with enormous macroeconomic consequences. Furthermore, although Greece has benefited from low and stable inflation since joining the euro, it has forfeited its ability to adjust the exchange rate and must take drastic measures to improve its competitive position. Unless Greece is ready to leave the euro (*a la* Argentina's decision to break the dollar peg in 2001), with serious repercussions for the European project, its only option is to make nominal wage cuts and improve productivity. Last but not least, although German taxpayers were indignant about bailing out Greece, they were really bailing out German and other European banks with a large exposure to Greek debt—creating asset fire-sale opportunities and saving the euro along the way.

The Greek saga is not unique to Greece. Emerging market economies without recourse to reserve currency have had to live with the effects of financial globalization, as the increased availability of cheap and mobile capital has not only helped to finance productive investment projects but also raised the risks of unsustainable credit growth and asset price escalation as well as sudden capital flow reversals. Furthermore, international financial crises in Latin America, Asia, Russia and now the North Atlantic region have shown that debt restructuring is likely to be limited as creditors, backed by their governments and international financial institutions, typically minimize their losses and impose adjustment costs on debtor countries. This, in turn, reinforces expectations that governments provide implicit guarantees, creating moral hazard. If *ex post* debt restructuring is not credible, *ex ante* restrictions should be imposed to prevent crisis. For instance, monetary authorities should contain credit growth, looking at not only core inflation but also asset price escalation. Borrowers should be subject to regulations such as debt-to-income ceilings, and lenders should be subject to strengthened capital and liquidity standards and macroprudential regulations. For example, dynamic provisioning adopted by Spain and a few other countries can help contain credit growth and provide a countercyclical buffer. Macroeconomics as a discipline will have to catch up with the realities of financial globalization if it is to provide useful guidelines for policymaking.

Korea's Experience with Debt Crises

Korea's experience with debt crises shows how the balance between "demand interdependence" and "financial interdependence" shifted over time. Korea faced three major debt crises in 1972, 1980 and 1997 and averted a crisis in 2008 in the early months of the global financial crisis. On each of the first three occasions, the average debt-equity ratio for the Korean corporate sector exceeded 400 percent,[2] and its average interest coverage ratio was barely 100 percent. By contrast, the near-crisis in 2008 took place against the backdrop of low indebtedness and high profitability.

The crisis in the early 1970s primarily had to do with Korean firms' dependence on short-term curb loans from the informal domestic financial sector. Suffering from their crushing debt and a slowdown in exports due to a recession in advanced economies, Korean business leaders at the time went so far as to urge the government to reduce taxes, expand money supply, and have state-owned banks take over the "usurious" curb loans. In the end, the government issued an emergency decree in 1972 that bailed out the debt-plagued corporate sector by placing a three-year moratorium on the repayment of curb loans and converting short-term high-interest loans into long-term loans on concessional terms. The government in effect sacrificed the property rights of underground curb lenders to relieve the debt burden of entrepreneurs it had come to trust as agents to carry out its ambitious economic development plans.

The financial crisis in the early 1980s was a product of the government-orchestrated heavy and chemical industry drive of the 1970s. As such, the crisis had primarily to do with policy-oriented loans provided by state-owned banks, and the government could afford to take a gradual approach. In fact, the government took a number of industrial rationalization measures— spiced with "special loans" from the Bank of Korea to commercial banks—and waited for the economy to grow out of the problem.

Starting in the 1980s, liberalization and democratization weakened government control while expectations for government protection against large bankruptcies remained strong. Even as various entry restrictions and investment controls were lifted, institutional reforms and credible market signals (such as large-scale corporate failures) designed to replace weakening government control with market-based discipline were not introduced. The *chaebol* expanded their influence in the non-bank financial sector and took advantage of the government's implicit guarantees to make aggressive investments, systematically discounting downside risks. The liberalization of capital markets in the 1990s exacerbated the problem by making Korea vulnerable to sudden capital flow reversals. In fact, portfolio investment and bank lending accounted for more than 90 percent of total foreign investment in the years leading to the 1997 crisis, and their combined subtotal almost quadrupled between the 1990-93 period and the 1994-96 period.

Particularly problematic was the relative size of short-term foreign debt. In 1997, the amount of foreign debt coming due in a year was more than twice Korea's foreign exchange reserves, as Korea abided by the old rule of thumb of keeping foreign exchange reserves to cover three months of imports and neglected to prepare for the possibility of capital flow reversals. In fact, foreign bank lending declined sharply from the average of $19.9 billion in 1994-96 to $2.8 billion in 1997, as foreign creditors refused to roll over existing loans. Spooked by a series of major bankruptcies in Korea since the beginning of 1997 as well as the outbreak of the currency crisis in Southeast Asia, foreign creditors began to express doubts about the asset quality of Korean commercial banks that had provided substantial loans to failed companies. The foreign exchange liquidity problem in Korea was mainly caused by the creditors' run on Korean banks rather than by the speculation of short-term portfolio investors.

The Korean government, however, did not have effective policy tools to respond to foreign creditors' bank run because it could not credibly guarantee the repayment of foreign loans—short of securing credit lines in reserve currency and taking over debt obligations from financial institutions. The government had little choice but to go to the IMF for immediate relief and promptly recognize the latent problem of nonperforming loans. Although the weakening of investment discipline under asymmetric liberalization was the underlying cause of the 1997 crisis, financial globalization thus played an important role in the outbreak of the crisis.

After the 1997 crisis, Korea began to make serious efforts to strengthen prudential regulation and improve the transparency and credibility of market signals. It also began to run a current account surplus to accumulate foreign exchange reserves, having learned that a three-month import cover would not be enough to protect the country from sudden capital flow reversals. The precautionary motive explains much of international reserve accumulation in most non-reserve currency countries,[3] and Korea provides a prime example. In fact, prior to the 1997 crisis, despite its reputation as an export-oriented economy, Korea had consistently run a current account deficit, except for the 1986-89 period.

In 2008, Korea's foreign exchange reserves amounted to 1.3 times its short-term foreign debt, and the Korean corporate sector had an average interest coverage ratio of well over 400 percent, but Korea came close to having another debt crisis. By this time, Korea had become one of the most liquid emerging markets with few restrictions on repatriation, and foreign investors sold more than $30 billion of Korean stocks in 2008 as they feverishly tried to make up for their losses at home and reduce leverage in the wake of the Bear Stearns and Lehman crises. To shield Korea from collateral damage, Korea's foreign exchange reserves had to cover not only its short-term foreign debt but also domestic bonds and stocks owned by foreign investors, who could create turbulence by taking "flight home" at any time. In the end, Korea managed to weather the storm by securing a currency swap arrangement with the United States in October. Unlike in 1997 when the financial crisis was largely confined to Asia, the U.S. probably found it in its own interest not to have another domino fall given the tumultuous global market conditions at the time.

Principles for Macroeconomic Policy Coordination

With increasing financial globalization, the nature of international macroeconomic interdependence has shifted in favor of financial, as opposed to real (demand), sources. The G-20's macroeconomic policy coordination should reflect this sea change.

On the whole, the management of "demand interdependence" is straightforward. Countries should adopt macroeconomic policies suited to their aggregate demand conditions, while avoiding what is likely to be counter-productive discussions on overhauling deeply ingrained institutional arrangements and practices in other countries. If they all suffer from deficient demand, they should coordinate policies to overcome the free rider problem. While current account imbalances are important, they tend to take their toll if countries allow them to persist on a significant scale. Persistent and significant surpluses raise the risks of domestic inflation and foreign mis-investment; whereas, deficits may trigger a collapse of confidence in the country's ability to pay back.

By contrast, the management of "financial interdependence" is much more challenging. The G-20 should focus on developing debt sustainability indicators such as debt-to-income ratios that cover the private sector as well as the public sector. The G-20 should also look at the ratio between short-term foreign obligations and foreign exchange reserves, for liquidity matters as much as solvency. As changes in the creditor's perception of the debtor's ability (backed by governments) to pay back can create significant macroeconomic spillovers, these indicators should be developed in conjunction with the G-20's work in financial regulatory reform, taking into account balance sheet effects and counterparty risks.

References

Aizenman, Joshua and Jaewoo Lee, 2005. "International Reserves: Precautionary vs. Mercantilist Views, Theory and Evidence," IMF Working Paper 05/198, October.

Blanchard, Olivier, 2011. "Rewriting the Macroeconomists' Playbook in the Wake of the Crisis," IMF Direct blog, March 4. (http://blog-imfdirect.imf.org/2011/03/04/2662/)

IMF Conference, Macro and Growth Policies in the Wake of the Crisis, Washington, DC, March 7-8, 2011. (http://www.imf.org/external/np/seminars/eng/2011/res/index.htm).

Lim, Wonhyuk and Joon-Ho Hahm, 2006. "Turning a Crisis into an Opportunity: The Political Economy of Korea's Financial Sector Reform," in Jongryn Mo and Daniel I. Okimoto (eds), From Crisis to Opportunity: Financial Globalization and East Asian Capitalism, pp.85-121, Shorenstein Asia Pacific Research Center, Stanford, CA.

Endnotes

[1] Blanchard (2011). See also background papers and presentations prepared for an IMF conference on *Macro and Growth Policies in the Wake of the Crisis*.

[2] Lim and Hahm (2006).

[3] Aizenman and Lee (2005).

Enhancing Global Coordination

Guillermo Ortiz

Chairman, Grupo Financiero Banorte; Former Governor, Bank of Mexico; Former Secretary of Finance and Public Credit, Mexico; Former Ambassador of Mexico to the International Monetary Fund

For several years, globalization has brought many benefits, boosted economic growth and increased welfare while intensifying interconnectedness among countries. The recent financial crisis made this link more evident, proving how closely the markets are tied together as a shock in one major country (the epicenter of the financial system) quickly propagated to the entire world. It has become clear that, given the degree of interconnectedness between different economies, macroeconomic policy actions in one country affect economic welfare in other countries. One of the issues that the current crisis has brought to the fore, and that it is shared by most of academics, analysts and some governments, is precisely that the level of cooperation among countries has to be stepped up both in terms of surveillance and in creating the appropriate mechanisms to encourage the needed policy adjustments.

Since the breakdown of the Bretton Woods system, there has been a proliferation of attempts to discuss and coordinate macroeconomic policies among the major industrial nations and within Europe. Informal discussions in the early 1970s among only a few advanced countries have evolved into regular meetings, involving several layers of leadership.

During the recent crisis, international cooperation successfully coped with the shocks that affected global financial stability and threatened a great recession. The fiscal and monetary policy actions taken by the main developed countries in order to prevent a deeper economic downturn were successful precisely because they were taken as part of a coordinated effort. Also, for the first time in recent memory, emerging markets were able to put in place countercyclical policies. The strengthening of the policy framework in emerging markets in the years prior to the crisis allowed them not only to resist the shock, but also to stage a remarkably successful policy-induced recovery.

Once the emergency passed, and the global economy seeming to find its way back to growth, attention has been drawn to the legacy of the crisis (fiscal problems in the developed markets, inflation threats in the emerging markets, etc) and to the magnification of some of the challenges the global economy was facing. These have to do with the way the system absorbs financial innovation and shifts in capital flows; and the structural internal and external imbalances that had been building for some time, even before the crisis, are increasingly becoming a liability for the sustainability of the recovery. So at this stage, there is an even more compelling case for international cooperation. It should aim to improve surveillance mechanisms in order to avoid the build up of imbalances that could put the system at risk in the future.

Moreover, the G-20 would seem the appropriate forum for these discussions. While it is clear that successful global coordination remains critical for stronger, more balanced and sustainable growth, cooperation depends on the willingness of governments around the world to coordinate. Political will to cooperate can only be achieved if it is perceived as advancing national agendas within a context of shared power and responsibility. It is common that, once emergency conditions have ebbed away, government priorities are no longer necessarily in sync with those from other governments. In addition, economic policy actions can even raise conflicts among countries and global policy coordination usually entails some surrender of sovereignty, which governments are naturally reluctant to give up. Furthermore, there is a lot of debate around various dimensions of international coordination: (1) the type of problems that should call for coordination; (2) the kind of policies to be taken together; (3) the means to enforce the agreements; (4) the role of uncertainty and information sharing and (5) the measurements of the gains.

Given the process of global integration and the experience of the recent crisis, the framework for cooperation ought to be formulated so that it is in the interest of the major players of the global economy to cooperate. One would think that the huge costs associated with the crisis would provide sufficient incentives. Nonetheless, one has to recognize that the costs were asymmetric. Major emerging markets were largely unscathed by the crisis; this asymmetry has accelerated the shift of the center or gravity toward emerging markets and, in some ways, made cooperation more difficult as major surplus emerging markets show great reluctance to engage in adjustment, given the domestic success of past policies. It is important for other emerging markets to actively participate in the process of peer review.

A key aspect to consider when it comes to international cooperation is that it involves commitments by its participants to be effective. Commitment is possible when there is some mechanism that can assure accountability and even some kind of sanctions in case of departure from the agreement. If countries can commit themselves, they can act in effect as a single entity and choose their policies by joint maximization. In this context, one of the G-20 main lines of work regarding cooperation is the formal system that is being established for coordinating and supervising macroeconomic policies. The Mutual Assessment Process (MAP) aims at helping attain the G-20's principal economic goals of strong, balanced and sustainable growth.

At all levels of cooperation, there should be a clear understanding of macroeconomic fundamentals as well as a way to identify sources of instability and misalignment. Here, the agreements made by the G-20 leaders in Seoul at the end of 2010 and the ones taken in Paris this past February seem to be heading in this direction. An important action has been the agreement on a set of indicators or benchmarks that will be monitored to avert future economic crises; they will focus on persistently large imbalances that require policy actions. They will also help move the process of cooperation forward by turning the measures taken by the MAP into more concrete ones.

Such indicators will be used as guidelines and not yet as targets, assessing the progress on reducing imbalances. They will take into account national or regional circumstances, including large commodity producers and will be used to assess the following: (1) public debt and fiscal deficits; and private savings rate and private debt (2) and the external imbalance composed of the trade balance and net investment income flows and transfers, taking due consideration of exchange rate, fiscal, monetary and other policies. If approved, the list of indicators is expected to be presented in April after the next G-20 meeting. One of the main complexities of these guidelines is that they will need to take into account national circumstances of countries in diverse stages of recovery and with different economic structures. Still, it is crucial to come up with these set of indicators that are efficient in signaling the building up of imbalances that could eventually put the global system at risk. This is not an easy or trivial task. After approving the guidelines, the second step would be to use them to asses the policy adjustments needed in each country in order to adjust internal and external imbalances.

Fostering international cooperation has become a greater challenge in the post-crisis world with countries facing different problems. Nevertheless, sustained growth and global stability is a shared goal that can be achieved through greater reliance on supranational institutions and processes (like the MAP). Within the G-20 agenda, the global imbalances indicators could provide a good start for effective action. The G-20 leaders have also agreed to improve the international monetary system in order to ensure system stability, promote orderly adjustment, and avoid disruptive fluctuations in capital flows, disorderly movements in exchange rates—including being vigilant against excess volatility in advanced economies with reserve currencies—and persistent misalignment of exchange rates. In this context, they also agreed to take measures to deal with potentially destabilizing capital flows and the management of global liquidity.

To conclude, the crisis demonstrated the degree of interconnectedness of the global economy. It also demonstrated the risk of uncoordinated and inconsistent policies both at the macro level and in the sphere of financial sector regulation and supervision. In addition, it confirmed the clear benefits of cooperation when the world was at the brink of debacle. This next step is crucial for the assertion of leadership of the G-20 in creating confidence on the strength and sustainability of the recovery and on the mitigation of future systemic risks. It will be the test of the G-20 as the primary forum for cooperation and for the IMF to assume a central role in the system.

Corporate Governance of the World's Financial System: Extend the Financial Regulation Franchise to Emerging Economies

Sergei Guriev *Rector, New Economic School, Moscow*

Aleh Tsyvinski *Professor of Economics, Yale University; Professor, New Economic School, Moscow*

The Quality of the Developed World's Financial System and Global Imbalances

There is a conventional view that global imbalances—in which developed countries, in particular the United States, are the net borrowers and emerging markets, in particular China, are net lenders—are a symptom of inefficiency in the world financial system, a potential cause of financial crises, and therefore need to be corrected through government or multilateral interventions.

However, many economists argue that the global imbalances per se are not a symptom of inefficiency.[1] The argument in a nutshell is as follows: let us consider the case of two countries—a developed country (for example, the United States) and an emerging economy (for example, China). For the purpose of this analysis, there are two key features of the emerging economy. First, there are more risks that firms and households are exposed to in the emerging market economy. The shocks to the firms and households in such an economy are typically larger. Higher uncertainty and volatility at the level of the households and firms translate into a desire to save more for precautionary purposes. Second, emerging capital and financial markets are much shallower than developed capital markets. Importantly, there are few, if any, domestic long-term assets and relatively few domestic safe shorter-term assets in which to channel these large precautionary savings. It is natural then that emerging economies would invest in the financial assets in developed economies. In other words, a key "export" of an economy with a developed financial market to emerging market consumers is the depth and sophistication of its financial system.[2]

Consider an example of Russia. In the last 10 years, Russia became a significantly larger economy that is also more integrated and reliant on the global financial system. Its income depends on a volatile and risky stream of revenues from commodities. Despite impressive development in the recent years, Russia's financial markets are rudimentary and do not offer long-term assets to households and firms. Nor can they can adequately hedge their long-term and short-term risks. It is not surprising that foreign assets are a popular means of savings and insurance for Russians; the only viable alternative is real estate, which is by definition illiquid and cannot hedge most of the risks. Households in Russia hold a large amount of foreign currency in dollars and euros. The government and private sector in Russia invest in long-term foreign assets that are not provided by local financial markets. As we argued above, the ability of markets in the developed countries to provide high quality assets superior to those in other countries can explain why developing countries accumulate foreign assets. In other words, developed countries' financial systems export the services of financial assets to countries that need them but cannot produce them. The availability of these foreign assets is important from the welfare point of view as it provides the necessary insurance and financial intermediation that are not available through the domestic financial system. It is not surprising that the largest foreign reserves are held by developing countries, such as China and Russia.

Importantly, even small differences in the deepness of financial markets can generate very large "imbalances".[3] The quality of the financial system in the developed world is a key determinant of the flow of funds and the prices for U.S. assets. The very fact that U.S. dollar assets are still in high demand even after several bankruptcies and near-bankruptcies of major financial institutions as well as an unprecedented peace-time expansion of government debt implies that the U.S. financial system and the dollar are still superior to competitors. But further deterioration of the financial system may destroy the "superior and unique" U.S. export—the long-term dollar-denominated assets. On the contrary, if the U.S. manages to improve, even if marginally, its financial regulation and macroeconomic policy, then global imbalances will be "aggravated"—the inflow of capital to the U.S. will grow with the respective current account deficit in the U.S. and current account surplus in China.

Should we be worried about such a development? Probably not. The crisis did not happen because of global imbalances per se. The crisis happened because investors in Western financial institutions overestimated the quality of these institutions. Therefore, the major task now is to improve the regulation of Western financial markets and institutions. The good news is that the global imbalances provide at least a partial solution to this problem.

Emerging Economies as Key Stakeholders in the Developed World's Financial System

The two major determinants of the West's comparative advantage in financial intermediation and financial asset creation are good economic policy and high quality of financial regulation. While there is now at least a beginning of a "peer review" process for macroeconomic policy with the Mutual Assessment Process[4], there is much less international coordination in financial regulation. We believe that the world should not miss an important opportunity here.

Who can monitor the quality of the developed countries' financial systems? It is crucial to involve the largest non-OECD economies in the debate on financial regulation and in the design and subsequent enforcement of a new system of regulating global financial markets and institutions. The global financial system strongly benefits from extending a regulatory and oversight franchise to these countries. Even though the vast majority of the global financial institutions are in the West, the new financial system should incorporate the interests of emerging markets. The standard reason for this is promotion of global welfare. Indeed, the cross-border externalities of the West's financial system on other countries should be internalized. In the post-crisis world, the large emerging economies will remain important providers of capital to the OECD markets. These economies will continue to grow faster than the G-7 countries and will feel the constraints of the underdeveloped financial system and the lack of safe and credible investment instruments. As the crisis re-confirmed the importance of reserves and stabilization funds, emerging market countries will also resume building up their sovereign funds. Conservative finance ministers in countries, such as Russia, Chile and China, who argued for keeping higher reserves, are now viewed as heroes and will likely wield even greater influence in the aftermath of the crisis.

As large investors in the G-7 financial system, the developing countries will have a stake in enforcing investor protection in a broad sense and therefore improving the quality of regulation. This is similar to the main principle of corporate governance: providers of finance should have a say on how their resources are used.

But there is also another reason. Including emerging markets in regulating OECD financial markets is not only fair and good for developing countries, it is also good for investors in OECD countries. The interests of the developing countries that lack their own financial institutions are aligned with those of all investors in the OECD financial markets. Hence, if emerging markets are given the effective participation in the design and enforcement of new regulation, they can effectively promote investor interests. This is especially important given that investors are not organized and are usually underrepresented in the debate. Thus, developing countries can help resolve a collective action problem.

Yet another important advantage of extending the financial regulation franchise to developing countries follows from their incentives to take into account not only the benefits of stricter financial regulation but also its costs. Being major stakeholders in the Western financial system, they are interested not only in preventing crises and bankruptcies of individual institutions but also in the long-term performance of assets. Therefore, it is in their interest not to throw away the baby with the bathwater; emerging markets have very strong incentives to preserve the global financial system's ability to innovate. The voters in the developed countries are looking for a culprit for the financial crisis, which may create a temptation for the policymakers to over-regulate. On the other hand, those developing countries, whose financial systems lag behind, are important beneficiaries of financial innovation. For many of those countries, the stakes in promoting efficient financial intermediation and economic growth are much higher than the stakes in the developed countries; it is an issue of political survival. While the OECD democracies can afford a slower growth rate, for many emerging markets, a growth slowdown also implies significant threats to political and social stability.

References

Blanchard, Olivier, and Gian Maria Milesi-Ferrett, 2011. "(Why) Should Current Account Balances Be Reduced?" IMF Staff Discussion Note.

Doepke, Matthias and Martin Schneider, 2006. "Inflation and the Redistribution of Nominal Wealth." Journal of Political Economy, Vol. 114, No. 6, pp. 1069-1097.

Mendoza, Enrique, Vincenzo Quadrini, and Victor Rios-Rull, 2007. "Financial Integration, Financial Deepness and Global Imbalances." Journal of Political Economy, Vol. 117, No. 3, pp. 371-416.

Caballero, Ricardo, Emmanuel Farhi, and Pierre-Olivier Gourinchas, 2008. "An Equilibrium Model of "Global Imbalances" and Low Interest Rates." American Economic Review, Vol. 98, No. 1, pp. 358–93.

Endnotes

[1] See Caballero, Farhi, and Gourinchas (2008) and Mendoza, Quadrini, and Rios-Rull (2007)

[2] Blanchard and Milesi-Ferreti (2011) describe this situation as a "distortion" which developing countries should be willing to correct. Certainly, all countries are interested in developing a world-class financial system. However, it is unrealistic to expect that the major emerging markets will be able to catch up with the West in terms of the quality of financial institutions. Also, as we argue below, even a small gap in efficiency of financial systems results in large imbalances. The other important consideration is that some countries may just have a substantial comparative advantage in financial intermediation (e.g. due to the Anglo-Saxon origin of the legal system). This comparative advantage may determine these countries' long-term export orientation in exporting financial services. This is similar to the fact that resource-rich countries export resources and tropical countries export tropical agricultural products. Such a comparative advantage is not carved in stone. For example, the U.S. is "resource-rich" and has the most advanced technology in the oil and gas sector, being the largest producer of natural gas and one of the largest oil producers in the world, but it has no *comparative* advantage in these industries anymore. But it is difficult to imagine that the developing countries' financial systems will close the gap with Western ones in any foreseeable future.

[3] See Mendoza, Quadrini, and Rios-Rull (2007)

[4] In this article, we focus on financial regulation. But the macroeconomic policy in the G7 countries is certainly a major concern. The unprecedented rise in the government expenditures during the crisis has resulted to an increase in debt that may prove unsustainable. This is no longer a domestic policy issue. As shown in Doepke and Schneider (2006), foreigners hold a large amount of the U.S. government debt and increased U.S. inflation constitutes a substantial tax on them. An increase in inflation redistributes wealth from the foreigners to the young, middle class households who hold mortgages. Politicians faced with an increased debt may be tempted to inflate instead of taking more unpopular measures such as decreasing government spending. The developing countries with their large reserves will lose the most from irresponsible macroeconomic policies in the West.

Macroeconomic Policy Coordination: Reducing External Imbalances and Difficulties and Inducing Cooperative Behavior

Izak Atiyas *Professor, Sabanci University*
E. Fuat Keyman *Professor and Director, Istanbul Policy Center, Sabanci University*

Introduction

The Mutual Assessment Process (MAP) is seen as a step in the direction of attempting to manage cross-country externalities generated by macroeconomic policies undertaken by individual countries. More specifically, it seems that the short-run or perhaps urgent focus of the effort is to monitor external imbalances possibly as a prelude to reducing the extent of current account surpluses and deficits over time and preventing them from becoming unsustainable.

The general perception behind such a coordination effort is that "coordination" is to the benefit of all countries involved. Hence, the G-20 Seoul Summit's Leaders' Declaration states that "uneven growth and widening imbalances are fueling the temptation to diverge from global solutions into uncoordinated actions. However, uncoordinated policy actions will only lead to worse outcomes for all." In the specific context of current account imbalances, many economists are convinced that there may be good arguments—even if not yet a complete consensus[1]—for establishing mechanisms toward reducing excessive and unsustainable deficits and surpluses under certain circumstances.

Of course this may be so ex-ante, "behind the veil of ignorance", that is in a hypothetical situation where countries do not know whether they will end-up being surplus or deficit countries. But in most situations, where such rules of the game are discussed and negotiated, the actors are not in an ex-ante role. Rules contemplated or designed behind the veil of ignorance can provide useful benchmarks. However in the real world, agreeing on a set of guidelines about how to achieve external sustainability is probably difficult since any guidelines would likely have distributional consequences, generating winners and losers.

What Sort of a Game is This Anyway?

How can one describe the MAP analytically? One way is to describe it as a game of "pure coordination". This is a situation where the conflict of interest between the parties involved would be limited; as long as the parties agree on which path to take, actually taking that path would be in the self-interest of all the parties involved. It does not seem that the strategic characteristics of the MAP resemble a game of pure coordination. An alternative construction is one of a prisoner's dilemma. This is a situation where reaching a collectively beneficial outcome is possible. However because of spillover effects and the consequent free rider problems, each party would have incentives to act unilaterally and the mutually beneficial outcome would not be reached. In such a scenario, credible commitments by the parties involved that they will act in accordance with the agreement would be needed to reach the mutually beneficial outcome. Such commitments could be legal instruments, such as agreements, or simply public statements that would be self-enforcing on the assumption that the parties would care about maintaining a good reputation.[2]

In the case of the current issue of external imbalances, the situation may be a bit more complicated. In a prisoner's dilemma, the collective benefit is clear; what are missing are instruments of trust and commitment that will ensure that each party will act in accordance with the requirements of that collective benefit. In the case of reducing external imbalances in the short run and given the status quo situations of the surplus and deficit countries, the collective benefit seems more elusive and conflicts of interest are more apparent. This makes the game more "zero sum".

The benefit of reducing a surplus for a surplus country seems more elusive than the benefit of reducing a deficit for a deficit country; for the latter, the danger of sudden stops would be reduced, for example. After pointing out that "smaller current account surpluses in surplus countries might actually benefit growth in the rest of the world," Blanchard and Milessi-Feretti (2011, p. 11) state that "the relevant question is why surplus countries should oblige." The answer they provide is that reducing the domestic distortions behind excessive current account surpluses may actually benefit the surplus countries. In the current discussion, however, it seems that surplus countries, especially China, would not be easily convinced about the benefits of reducing these distortions

There may be several reasons for this. One reason could be the political economy. For example, China's export-oriented growth has generated vested interests and favored investors over consumers. Reducing surpluses by increasing domestic consumption may run against the interests of investors.[3] As stated by Garrett (2010), "… the overriding instinct of the government remains to use state-controlled banks to invest in infrastructure and state-controlled companies rather than to empower the consuming middle class that might one day form the base for political liberalization in China."

Another reason could simply be that policymakers in deficit and surplus countries have different models ("mental constructs of the world" to use the terminology of North, 1990) of how the global economy works.[4] Some of this may be moral hazard; policymakers may defend the validity of an economic model because it serves their interests, for example, by enhancing their bargaining power during negotiations. However, in a world where economists in a single country have vastly different opinions, it would not be surprising that economists of different countries may have genuinely different opinions about how the global economy works. In the specific case of China, it may be difficult to convince Chinese policymakers of the importance of domestic distortions given that China's economic performance has been successful.

Time horizons may matter as well. One could argue that the zero-sum features of the external imbalances game discussed above are more visible in the short run. In a longer-term perspective, surplus countries may be more cognizant of the fact that sharp reductions of consumption in deficit countries would be harmful for surplus countries as well. If a longer-term perspective were to prevail, the short-run conflicts would look more like bargaining chips in allocating the costs of adjustment rather than irreconcilable differences. The longer-run mental constructs of the different players may be more similar and the countries may be more willing to place themselves behind the veil of ignorance. However, we also need to underline the fact that the long run takes a long time to come about. If the experience and literature on the political economy of domestic policy reform provide any guidance, one would need to conclude that long-term benefits of significant policy changes are often overshadowed by short-run costs.

Given these problems, it would not be surprising if the process of enhancing the degree of coordination in short-run macroeconomic policies turns out to be a difficult process. Nevertheless, the MAP is a good start. It allows members to design their own policies with better information about the policies of other members of the group. However if managed well, the MAP might also help members develop a better understanding of the concerns of other countries. More importantly, it would provide information about the economic models policymakers from other countries use implicitly or explicitly to analyze global economic developments.

One wonders whether this process of learning about "the models of policymakers of other countries" could be carried out in a more structured way so as to achieve more clarity about the exact roots of divergences of opinions. That would entail structured and regular debate on data, policies and their effects not only on the external imbalances but also on other variables that are regarded as important in the different country settings. More frequent interaction among economists and policymakers from different countries also provides opportunities to better understand the concerns and real policy objectives behind individual country policies and positions, which in turn may also expand the set of feasible mutually beneficial "concessions".[5]

A "Global Public Goods" Perspective?

Increasing the degree of coordination over short-run macroeconomic policies and more specifically over the MAP would obviously be encouraged by an overall more cooperative approach between the members of the G-20 and a stronger sense of shared goals. This would suggest that putting the MAP in a broader perspective of overall developmental goals may help the MAP.

Even though it has gained prominence because of immediate concerns during the global crisis and its aftermath, the macro-coordination effort and macroeconomic/financial stability that this process is designed to facilitate is not the only global problem that requires the collective attention of the G-20. One is reminded of literature on global public goods, which is simply defined as goods that are non-rivalrous and non-excludable, but whose benefits accrue to anyone living anywhere around the world. Hence what differentiates global public goods from national public goods is that "their benefits are quasi universal in terms of countries …, people …, and generations".[6] The literature lists a number of prominent global public goods, including the environment, equity and distributive justice, global health problems and peace and security (ibid.).

Economists tend to think that national public goods and the market failure they give rise to are one of the important factors that justify collective intervention at the national level. Global public goods, on the other hand, point to a fundamental *political failure* on a global scale. Like national public goods, global public goods are under-provided absent collective action, but collective action on a global scale is much more difficult to establish. As the international system is characterized by anarchy and there exists no overarching international government to regulate the provision of and payment for global public goods, agents of global governance (international organizations like the World Trade Organization and the International Monetary Fund) are required to play a role in correcting these international political market failures. The effective involvement of international organizations in regulating the provision, use and distribution of global public goods is thus extremely important in minimizing global inefficiencies.

Among the public goods mentioned above, the issues of equity and distributive justice are especially related to the crisis and the macroeconomic preoccupations of the G-20. Indeed the Seoul G-20 Leaders' Declaration states that "the crisis disproportionately affected the most vulnerable in the poorest countries and slowed progress toward achievement of the Millennium Development Goals (MDGs)… At the same time, narrowing the development gap and reducing poverty are integral to achieving our broader framework objectives of strong, sustainable and balanced growth by generating new poles of growth and contributing to global rebalancing." Furthermore, the Annex to the Seoul Declaration provides a multi-year action plan to achieve developmental goals. However, the visibility of these activities has been very low. It seems that the debate on macroeconomic policy coordination is carried out too much in isolation from other global economic and social issues that require collective intervention.

It seems putting the macroeconomic policy coordination into such an overall perspective is worthwhile for a number of reasons. First, it underlines the fact that the MAP is an important first step in an ongoing process of increased interaction, consultation, collaboration and increased mutual understanding.

Second, it would seem that cooperative behavior would be more easily achieved when the number of dimensions being negotiated is increased and interconnections are established between dimensions. The crucial point here is to find issues that are negatively correlated; for example, find dimensions which have trading or logrolling value. If there are policy changes that create small domestic costs and larger benefits for trading partners, then there is potential for gains from exchanging policy reforms. Again, this requires ongoing negotiations and better understanding of the needs and worries of the different parties. This process may also allow the parties to better focus on which instruments are better suited to deliver results.

Third, this could create more legitimacy for the whole G-20 effort and global efforts to coordinate macroeconomic policies. At this juncture, macroeconomic policy coordination is also about allocating the costs of adjustment. This is not necessarily a very popular effort. A clear indication that the process of macroeconomic policy coordination is complemented with efforts to address serious long-term global social and economic problems such as poverty and distributive justice may over time help relax political economy constraints that hinder macroeconomic policy coordination. Again, this is an issue of emphasizing long-term gains over the costs of adjustment of policy reform in the domestic context.

Fourth, the scope for collaborative action may be wider and conflicts of interest smaller in some of the other areas that require the G-20's collective action. For example, increases in food prices from 2006-2008 and more recently with the recovery from the global crisis have raised a debate over possible adverse effects on poor households around the world. In addition, the increase in food prices has led to limited increases in supply in low-income countries and almost no increase in very small countries.[7] Efforts to increase production and productivity would affect millions of households in poor regions of the world, especially Africa. A concerted effort by the G-20 that shows determination and ownership could have an important impact.[8] Perhaps a successful realization of such a concerted effort would help develop more cooperative behavior in areas where conflicts are more acute.

References

Aksoy, M. Ataman and Bernard Hoekman, 2010. Food Prices and Rural Poverty. Centre for Economic Policy Research, London, and The World Bank, Washington, D.C.

Beetsma, Roel and Massimo. Giuliodori, 2011. "The Effects Of Government Purchases Shocks: Review and Estimates for the EU." The Economic Journal, Vol. 121, Issue 550, pp. F4–F32.

Blanchard, Olivier, and Gian Maria Milesi-Ferretti, 2011. "(Why) Should Current Account Balances Be Reduced?" IMF Staff Discussion Note.

Frieden, Jeffry, 2010. "The Political Economy of Rebalancing," in S. Claessens, S. Evenett and B. Hoekman (eds), Rebalancing the Global Economy: A Primer for Policymaking. VoxEU.org. (http://www.voxeu.org/reports/global_imbalances.pdf)

Garrett, Geoffrey, 2010. "China-US imbalances and Europe's Fiscal Crisis: Plus ça change?" in S. Claessens, S. Evenett and B. Hoekman (eds.), Rebalancing the Global Economy: A Primer for Policymaking. VoxEU.org. (http://www.voxeu.org/reports/global_imbalances.pdf)

Kaul, Inge, I. Grunberg and M. Stern, 1999. Global Public Goods: International Cooperation in the 21st Century. Oxford University Press, New York.

North, Douglass C., 1990. Institutions, Institutional Change and Economic Performance, Cambridge University Press, Cambridge.

Sachs, Jeffrey, 2011. "To end the food crisis, the G-20 must keep a promise," Financial Times, February 17. (http://www.ft.com/cms/s/0/e5e854fe-3ad0-11e0-9c1a-00144feabdc0,s01=1.html#axzz1HSPBLtpJ)

Suominen, Kati, 2010. "Did global imbalances cause the crisis?" VoxEU.org, June 14. (http://www.voxeu.org/index.php?q=node/5175).

Endnotes

[1] See, for example, Blanchard and Milessi-Feretti (2011) and Suominen (2010).

[2] It seems that the coordinated effort of fiscal expansion by the G-20 countries carried out in 2008-9 is a good example of this kind of a situation. See Derviş and Kharas in the introduction to this volume. Beetsma and Giuliodori (2011) provide evidence that there was an economic rational for coordination for the case of the European Economic Recovery Plan of the European Union launched in November 2008.

[3] See Frieden (2010)

[4] To quote Blanchard and Milessi-Feretti (2011, p. 10): "We have been struck not only by the importance of differences in objective functions, but also by the relevance of differences of opinion about macroeconomic mechanisms across G-20 members in the G-20 mutual assessment process". It is not clear what the term "objective functions" might refer to but it would not be surprising to find out that they are correlated with the interests of different social groups.

[5] For example, if indeed the main concern behind, for example a country like China's pursuance of a policy of competitive exchange rate is to maintain high levels of employment, that country will not be willing to make concession along that policy instrument. She may be willing to increase social protection, however, which, as mentioned by Derviş and Kharas in the introduction to this volume, may eventually increase domestic demand and reduce policymakers' incentives to undervalue exchange rates. Ultimately, this would help reduce current account surpluses, which may be the main objective of negotiations. This example is admittedly oversimplified, but the main point is that better understanding of objective functions of the different parties, their perceived constraints and their and subjective models of the world may enhance the negotiation space.

[6] Kaul, Grunberg and Stern (1999, p. 11)

[7] Ataman and Hoekman (2010)

[8] Sachs (2011)

The Global Rebalancing and Growth Strategy Debate

Colin Bradford

Nonresident Senior Fellow, Global Economy and Development, Brookings Institution; Senior Fellow, Centre for International Governance Innovation

Introduction: Major Issues

The run-up to the Seoul G-20 Summit in November last year brought into full light the challenges of forging a global strategy for economic recovery and growth. In Korea, the effort to advance a G-20 framework for "strong, sustainable, and balanced growth" through efforts to engage in global economic adjustment of major imbalances between external surplus and external deficit countries also encountered more frictions than convergence with the specter of U.S.-China currency wars gaining attention. Currency disputes were further fueled by the untimely decision by the U.S. Federal Reserve to engage in quantitative easing to spur U.S. credit expansion and domestic growth which looked to China as being currency manipulation.

There is a mind-set among summit observers, which used to include myself, that anticipates visible "grand bargain" outcomes from leaders' level summits. Born in the G-8 era, this is a kind of maximalist international cooperation outlook that overemphasizes memories of the Plaza Accord and the Louvre agreement, which were really the exceptions rather than the rule. In the G-20 era, we need a new mindset that accepts policy conflicts and more modest progress in resolving them because the G-20 embodies global diversity rather than the "like mindedness" of the G-8.

The intensity of the G-20 debate on strategies for global growth and rebalancing led to a pledge in Seoul to come up with a set of indicators and try again for agreement at the next G-20 summit in France in November this year. The world economy has moved on through several phases since the triggering of the great recession in 2008. So now, we might ask several questions: is a G-20 strategy for global growth desirable or even necessary? And is it feasible? Is global rebalancing crucial to global growth? Is the lens of external deficit and external surplus countries useful in generating a G-20 global growth strategy? And finally, what are the implications for the G-20 economic agenda if the answers to these questions are negative? Does the G-20 need to either change the subject or shift its focus, as some have argued?

A G-20 Coalition for Global Growth: Facts and Feasibility

First, it seems useful to examine the structure of the world economy and the weight of G-20 economies in it in order to determine whether there are indeed clusters of G-20 countries which have enough weight to constitute a feasible coalition for global growth—what Gordon Brown called developing a "plan for global growth". This gives us an understanding of the skeleton of the world economy, if not its muscle and direction.

Broadly speaking, we can divide the G-20 into four groupings:

1. Three advanced G-20 countries with significant current account deficits (excluding the United States), who therefore feel a need to adjust;

2. Four advanced G-20 economies, who could potentially be more aggressive with expansionary macroeconomic policies;

3. Ten emerging market economies (including Russia but excluding China) that are experiencing rapid growth and receiving considerable capital inflows from abroad; and

4. The U.S. and China, who essentially feel they are in a position to take whatever action they deem necessary for their own growth. The U.S. has the special "privilege" of being the issuer of the global reserve currency, while China has the advantage of $3 trillion in foreign exchange reserves.

The three advanced current account deficit countries are the United Kingdom, Australia and Italy. Together they account for 8.9 percent of the world economy.

The four non-deficit advanced economies that might provide more global stimulus are Japan and Germany, two surplus countries, and France and Canada, two countries in a relatively strong position. Together they account for 20.7 percent of world GDP. But Japan with 8 percent of global GDP is likely to slow in the short term due to the recent earthquake, tsunami and nuclear crisis. Continental Europe, including the European Central Bank, seems filled more with caution than ambition. Germany has resisted pressure to engage in expansionary policies and France is now moving toward fiscal consolidation despite possible social unrest. So, the core group of four non-deficit advanced economies of the G-20 coalition for growth is not really in a potentially expansionary stance.

The 10 emerging market economy members of the G-20, other than China, have a weight of 15 percent of global GDP. But this group is quite diverse and fragmented so building a lasting coalition is hard. The top five members—Brazil, Russia, India, Mexico and Korea—are together 11.2 percent of global GDP. They are too small to play a pivotal role alone even if their efforts are amplified by the other five emerging market economies, who account for 3.6 percent of GDP; this larger emerging markets group would only account for 15 percent of global GDP. It is also unrealistic to expect all countries in this group to be at a similar business cycle stage. Several of these emerging market economies are running significantly large current account deficits. Brazil and India are looking at current account deficits as a percentage of GDP of 3 percent and Turkey and South Africa in the range of 5-6 percent, making it difficult for them to be more expansionary. In fact, their fears are of overheating, not of deficient demand.

This implies that the pace of the global recovery will still depend heavily on the United States and China, who together make up 31 percent of global GDP. The U.S. will have to try to combine fiscal consolidation with monetary easing to boost employment growth through credit expansion fueled by quantitative easing while shrinking budget deficits and public debt. China is trying to slow growth to avoid budding inflationary pressures. In both cases, the balance will be hard to strike, but together it suggests neither will be able to sustain very rapid growth at the rate of the pre-crisis boom years.

The conclusion has to be that the feasibility of a G-20 coalition to actually accelerate global growth that combines economic weight with national policy thrusts is not there. That is not necessarily a major problem given that global GDP growth for 2011 is expected to surpass 4 percent. This diminishes the urgency for the type of expansionary action that G-20 leaders felt necessary in London in 2009 and Toronto in 2010. Therefore, we have to probe more deeply into the current context and what it really means for macroeconomic policy coordination.

The Current Context and Debate

The current context is one where the real engines of global growth now are the United States and the big emerging market economies. The dynamics of current patterns of growth follow from the quantitative easing policy of the U.S. Federal Reserve in the fall of 2010, which not only has lifted U.S. growth but also has encouraged massive capital flows to the larger emerging market economies, increasing their growth but also posing some risks of volatility. If anything, this creates some pressure in the big emerging market economies toward more contractionary policies to cool down overheating, dampen inflationary expectations and control capital flows. The problems in Greece, Ireland, Italy and Portugal have increased sensitivity in international financial markets.

All of this brings the focus back to the U.S. and China as the main sources of growth. But part of the value of the G-20 for these countries has been the opportunity to try to pluralize and multilateralize the global growth strategy to spread the heavy lifting around rather than relying on the two giants. A renewed focus on the G-2 tends to conflate again the challenges of global growth and global rebalancing in a single conundrum, reducing the possibility of separating them.

For both G-2 countries, the central issue is not external imbalances but domestic economic policy adjustments to correct internal imbalances. Correction of the U.S. fiscal deficit and low domestic savings and stimulating greater domestic consumption in China should be the central focus. These internal adjustments would automatically help correct the external imbalances even without global coordination. So perhaps U.S. and Chinese policymakers should shift their focus from global external imbalances in trade and capital accounts to internal shifts which will in turn rebalance the world economy.

Looking back over recent decades, it certainly seems as if the concentration of huge external deficits and surpluses in a very select few of the world's largest economies has contributed to patterns of global instability. In the 1980s, massive U.S. fiscal, trade and capital account deficits were mirrored by Japanese internal savings, trade and capital account surpluses. In the 1990s, as the Clinton administration gradually restored fiscal and trade balance to the U.S., a select few then-creditworthy Asian developing countries (Thailand, Indonesia, Korea and Malaysia) attracted capital from the Japanese surpluses, triggering the Asian financial crisis in 1997. In the 2000s, the booming Chinese economy ran huge savings, trade and capital surpluses which financed the continuing U.S. deficits, allowing the U.S. to postpone necessary internal adjustments. While these imbalances did not directly trigger the 2008 global financial crisis, they revealed some underlying weaknesses in the global financial system.

The concentration of massive global imbalances in a very few countries for three decades is clearly not conducive to global stability. When capital is attracted by big power deficits and surpluses, it may not be spread around the world to finance investment in an efficient manner that would diversify risk, reap higher and more stable returns, and be more conducive to financial stability. Hence, even though domestic imbalances are central, one cannot conclude that external imbalances are irrelevant for global policymaking.

Conclusions and Implications

The conclusion for the G-20 in 2011 is that, although domestic and external balances need to be focused on and dealt with, there may not be any "grand bargains" to be negotiated which could effectively deal with the diverging economic contexts of each G-20 country. We have to put aside the old G-8 mindset and accept a more complex, conflicted and diverse world in which G-20 policy differences and tensions are part of the game and not just obstacles to it. As much as the G-20 could be a possible vehicle for pluralizing and multilateralizing global growth and rebalancing, the current context does not yield a clear cut scenario for addressing these two problems.

Therefore, the pathway forward would be to put some distance between the technical track of what needs to be done to improve the economic functioning of the global economy from the political track of forming bargains or coalitions to implement policy. The technical work needs to proceed through the G-20 finance ministers' and central bank presidents' process to address global growth and rebalancing in workmanlike fashion during

2011, delving deeper into sources of disequilibria and disturbance in macroeconomic policy conduct. This should remain a technical and policy discussion among senior economic policy officials from G-20 countries with technical support from the International Monetary Fund through the Mutual Assessment Process (MAP).

But it would seem to make sense not to put this policy work center stage into the French G-20 summit this fall unless there appears to be new convergent views on a feasible concerted political deal among G-20 countries. In 2010, the G-20 finance ministers' meeting in Gyeongju in late October spilled over into continuing discord in the G-20 leaders' summit in Seoul in mid-November, making G-20 leaders look as if they were not able to resolve matters and achieve consensus even though some technical progress was indeed made. There seems to be no point in repeating that scenario again. The situation is still more complex today and margins for incremental expansionary policies are thin. As a result, there is every reason to lower expectations on macroeconomic policy coordination for now and to perhaps bring other issues, including development, to the forefront of the leaders' summit in November. Finance ministers and central bank governors, with support from the IMF, may need another year or more before the MAP really yields results. Recognizing this reality should not imply abandoning the effort. In the longer run, macroeconomic policy coordination can indeed be a key benefit of the G-20 process but it is not the whole show, especially not continuously at the leaders' level.

The views expressed in this publication are those of the authors and should not be attributed to their affiliated organizations.

BROOKINGS

1775 Massachusetts Avenue, NW
Washington, DC 20036
202-797-6000
www.brookings.edu/global