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

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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.

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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)