Macroeconomic Policy Interdependence and the G-20

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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.

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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).