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.