

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

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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.
- 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.

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 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.

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