1

Introduction

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The global financial crisis inflicted a huge shock to the world economy, and the legacy of that crisis will reverberate for many years to come. The massive economic and financial shock that started in the U.S. housing market rapidly engulfed the European financial markets and then spilled over to all parts of the global economy, leading to the largest recession since the Great Depression of the 1930s.

The crisis represented a turning point not only for the world economy but also for the world economic order. It challenged the prevailing intellectual economic framework, calling into question both the theoretical foundation of macroeconomics and the policy prescriptions. On the intellectual side, the prior economic orthodoxy of "benign neglect," in which each country looked after its own policies, as had been the case during the Great Moderation of the 1990s and early 2000s, has come under attack, and the tool box of available policy measures has been augmented with a range of monetary innovations and financial stability tools, raising further questions about policy coordination.

On the policy front, the world economic order has also been transformed. It is now very different from the global landscape during the Bretton Woods Conference in 1944 when capital controls were pervasive and trade imbalances were key. Now advanced economies, emerging markets, and developing economies are much more interconnected through finance and investment as well as trade.

These interconnections were clear in the way the shock was transmitted in the aftermath of the collapse of Lehman Brothers on September 15, 2008. Beyond the core of the crisis, other countries were affected to varying degrees, depending on their exposure to U.S. and western European banks and on the underlying strength of their economies and policies.

The crisis showed that any policy response had to be global in scale, reflecting these interlinkages. All regions were involved in the response, through the G-20 leaders who met for the first time in November 2008. Virtually overnight the G-20 was elevated to the premier forum for economic and financial affairs and became part of the search for a new global financial architecture and economic governance.

Several years after that inaugural meeting, economists, policymakers, and commentators are still grappling with the causes and consequences of the global financial crisis and adapting to its fallout. In some parts of the world, such as in the euro area, the impact of the crisis is still being felt.

There has been some progress, especially in the immediate aftermath of the crisis, in putting in place a more resilient and inclusive financial architecture and in reforming the existing international financial institutions, especially the IMF. But in more recent years progress has slowed, and an agreement to update voting power at the IMF has not yet been implemented.

Despite warnings about the risk of a "new mediocre" outlook for the world economy and complaints about significant spillovers from the unconventional monetary policies of the main advanced economies, international interest in policy cooperation or coordination has started to wane. Notwithstanding G-20 efforts in 2014, during the Australian presidency, to agree to policy measures for boosting global growth, the global economic outlook for the near future still presents risks and uncertainties. And despite widespread recognition of the risks from more volatile international capital flows, the international community is still struggling to design an effective global financial safety net and reform existing international institutions. In response, emerging markets are turning to initiatives to establish new financial institutions, such as the Asian Infrastructure Investment Bank and the New Development Bank[1] and BRICS' contingent reserve arrangement.

Policy Cooperation since the Crisis

In this book we look at how economic policy cooperation has developed since the global crisis and explore its different dimensions. The international spillovers from the crisis, and the policy responses to it, form the background and the common theme underlying all the contributions.

The book is organized around four aspects (intellectual, international, integrational, and institutional) where the precrisis consensus has proved to be wanting: the *intellectual* framework for cooperation to illustrate the benefits of cooperation (Part I), the *international* interlinkages and policy responses to the crisis (Part II), the *integration* of economic policies (Part III), and the *institutional* setting for cooperation (Part IV).

The Intellectual Framework for Cooperation

The first section of the book examines the intellectual framework underlying policy cooperation. It explores how the theoretical approach and its implications for policy frameworks have evolved in tandem with the integration of the world economy. The international linkages and spillovers

[1] Formerly known as the BRICS Development Bank, it was established in 2012 by the BRICS countries—Brazil, Russia, India, China, and South Africa.

laid bare by the crisis challenge the economic orthodoxy of "benign neglect" that prevailed before the crisis. Financial globalization especially has caused economists to look critically at the models and assumptions underlying the conventional precrisis view that if countries acted in their own national interests, this would be sufficient to deliver a good global outcome. As David Vines discusses in his contribution, this was the prevailing approach during the Great Moderation, but he argues that the crisis highlighted the shortcomings of this approach.

Rebuffing the "benign neglect" doctrine, however, does not mean switching to excessive attention to the international consequences of national policy actions. In their contributions, David Vines, Paola Subacchi, and Paul van den Noord argue that policy cooperation is effective only when it is needed—for example when two countries cannot adjust automatically.

The extreme conditions seen in the crisis and the policy response to these conditions—in particular, in the form of unconventional monetary policy—juxtapose financial stability and economic growth as two conflicting policy objectives. Policies implemented by advanced economies to support domestic output often generate adverse spillovers for other countries—both other advanced economies and developing countries. These spillovers, in turn, could jeopardize financial stability. How should countries manage this trade-off?

Subacchi and van den Noord conclude that coordination of monetary policies could help manage the trade-off, but only if countries share the same degree of exposure to financial instability and the same preferences regarding the welfare cost of financial instability relative to other macroeconomic objectives. If not, they need to pursue domestic structural policies to adjust the parameters that shape their respective policy reaction functions.

Prior to the crisis, the conventional economic wisdom was also that, while international policy cooperation could be beneficial for all countries, in practice the gains available were relatively small, and probably not great enough to overcome the practical difficulties of getting countries to agree. But these results were generally focused on cooperation over monetary policy, and assumed that cross-border linkages and spillovers were relatively limited. Newer models—and the experience of the crisis itself—have led to a rethinking.

In their contribution, Benes and others note that the conventional approach to estimating the benefits to policy coordination using linear models of "normal" times may miss the larger benefits that accrue from cooperation at "unusual" times when nonlinearities may be more important. They illustrate this by looking at how the benefits of coordination from differing fiscal measures, from the interaction of fiscal and financial measures, and from financial stabilization increase as the world becomes more "unusual." Their estimates suggest that the benefits of coordination are much larger in more turbulent times.

International Interlinkages and Policy Responses to the Crisis

The second aspect, addressed in the next set of contributions, involves the response to the crisis. Drawing on personal experience, Fabrizio Saccomanni argues that even countries that were members of the euro area—countries with a common monetary policy and close economic links—found it difficult to coordinate their policies at the time of the crisis. In his chapter he goes through the various stages of the European crisis and its transformation from a banking crisis to a sovereign debt crisis and back again to a banking crisis. Even though there were strong institutions in place such as the European Commission and the European Central Bank (ECB), the crisis was dealt with in real time with solutions agreed upon at the last minute, rather than through effective surveillance to anticipate the crisis or preventive actions to limit the consequences. Indeed, since the institutional framework of Europe's monetary union was badly designed to cope with a crisis, particularly one that affected different member states differently, real-time actions often amplified costs. While the final result has been to improve the monetary union, its institutional problems are by no means resolved.

International interlinkages have also shown up through policy spillovers, especially in areas beyond the United States and Europe. Emerging markets and smaller advanced economies had little responsibility for creating the crisis but have had to cope with its consequences. They experienced significant spillovers from the economic recession and financial turmoil of core advanced economies. And they have also been seriously impacted by the policies adopted in the United States and Europe. Quantitative easing policies followed by the U.S. Federal Reserve Board, and (much more recently) the Bank of Japan and the ECB, have been the focus of beggar-thy-neighbor complaints from emerging markets. The worry is that such policies have led to a search for yield by investors and decreased sensitivity to risk, and resulted in significant flows of capital into emerging markets, which has made them less competitive. The policy dilemma for some of these countries is how to cope with these inflows, and with their likely reversal when interest rates in the advanced economies start rising again.

In light of these significant spillovers, the view that other countries are having to go it alone is also the theme of the chapter on Japan by Masahiro Kawai. Faced with adverse spillovers from U.S. quantitative easing, with a long period of stagnation, and with monetary policy rates stuck at zero, in late 2012 the newly elected Japanese government of Prime Minister Shinzo Abe launched an ambitious program involving three arrows—quantitative monetary easing, “flexible” fiscal policy, and structural policies. If this program does not work, the author argues, Japan risks a sovereign debt crisis with further adverse spillovers to the rest of the world.

Indeed, Asia has been struggling for almost two decades with external financial instability, argues Julia Leung in her contribution. Regional safety nets—such as the Chiang Mai initiative—have been established, but they are not enough. There should be a global financial safety net to protect the so-called innocent bystanders that are affected by the spillovers from large economies, especially the United States as the issuer of the key international currency. Faced with such risks, emerging markets have been focusing on putting their own houses in order, as shown in Fatih Özatay’s contribution to this volume. Economies with good fundamentals have enough slack to withstand financial instability abroad, and retain some policy space to mitigate the impact of this instability. This does not mean, however, that countries should be left to their own devices to cope with adverse spillovers.

Integration of Economic Policies

In addition to challenging the intellectual underpinnings of economic policymaking, the crisis has also made the practice of economic policy much more complex. The third section of the book looks at three aspects of policy integration.

The precrisis world of the Great Moderation saw a spreading consensus about the conduct and organization of policy: monetary policy—the first aspect of policy—was primarily assigned to targeting inflation; fiscal policy—the second aspect—was aimed mainly at keeping debt levels and deficits under control; and supply-side measures—the third aspect—were the principal tools for governments to boost growth. To the extent that short-term demand measures were required, interest rates were the chosen instrument.

The crisis brought into question this neat assignment of targets and instruments, just as it had challenged the intellectual underpinnings of "benign neglect." Tamim Bayoumi highlights how both international and domestic policy cooperation, which were live issues in the 1970s, fell out of favor as macroeconomic policy roles became highly compartmentalized. This contribution discusses the intellectual and policymaking undercurrents behind "benign neglect," and explains why they are less relevant after the global crisis. The focus here is on cooperation across policy areas—how to engender a "new domestic cooperation" to complement international cooperation—and on how the various arms of macroeconomic policy need to be coordinated in a world of more fiscal activism.

The rest of the section focuses on financial policies, where the financial causes and consequences of the crisis led to a major rethinking of the framework for policy. Financial stability at both the micro and macro levels—the health of individual financial institutions and of the system as a whole—became a key consideration for governments. Both the reckless behavior of individual banks and the asset bubbles that had been allowed to build up were important causes of the crisis, and the wider economic disruption and dislocation they caused were immensely damaging.

As a result, instruments to deal with these problems have had to be devised, revised, and strengthened. Both microregulation (of banks, insurance companies, credit rating agencies, and the like) and macroregulation (to prevent the buildup of asset bubbles and wider risks to financial stability) have been transformed. Because of the international nature of the financial system, and the global significance of large institutions, much of this work has had to be coordinated across national borders. The Financial Stability Board (FSB), set up by the G-20 and stronger than the institution it replaced due to its inclusion of all G-20 members, has played a key role in managing efforts to improve microregulation and macroprudential policies.

The chapter by G. Russell Kincaid and C. Maxwell Watson and the chapter by David Green look at the case for international coordination of financial policies and conclude that the gains from coordination are large, given the international interconnections and the possibility of spillovers across borders. Common international regulatory standards not only reduce the possibility of regulatory arbitrage and the risk of a "race to the bottom" by countries, but also help provide a level playing field on which international banks can compete.

Against this background, the challenge for financial policymakers has been the assignment of targets and instruments and their institutional separation, in particular the dominance of central bank independence. Microregulation and macroprudential policies have clear implications for monetary and fiscal policies. The effects of macroprudential policies—loan-to-value ratios, credit controls, and the like—have many similarities to interest rate management. Indeed, in earlier days they were common elements of a central bank's monetary policy armory. And Kincaid and Watson point out that under fixed exchange rates (such as in the euro area) macroprudential instruments can help make up for the loss of monetary policy tools. Green shows how microregulation can also have serious implications for the fiscal authorities, since ultimately the taxpayer often foots the bill when financial institutions fail.

So the neat precrisis world of self-contained policies and instruments has become much more complex, messy, and interconnected. And the institutions and agencies responsible for these policies have had to adapt accordingly. Consequently, all three chapters in this section argue for the need for stronger coordination (or at least cooperation) mechanisms between policymaking agencies in each country, in addition to international cooperation.

The Institutional Setting for Cooperation

The crisis has also forced a reevaluation of the role of international institutions. The fourth section of the book looks at two aspects of this—the conduct of economic surveillance and the design of institutions for international cooperation.

The rationale of economic surveillance is to identify risks and improve policymaking. Almost all the surveillance mechanisms in place at the time failed to spot the crisis in advance. In part this was because surveillance methods had not kept pace with increasing interlinkages across countries. But also they were not well placed to cope with the widening scope of issues and policy instruments. Financial supervision was especially inadequate.

Since the crisis began, many changes have been made to strengthen surveillance methods and procedures, and new elements have been introduced. The G-20 launched its Mutual Assessment Process (MAP) to critique members' policies; the IMF has brought together its bilateral and multilateral surveillance and introduced reports on spillovers and risks; the EU has started its Macroeconomic Imbalance Procedure (MIP); and the FSB, IMF, and regional and national regulators have strengthened financial surveillance.

Stephen Pickford's chapter looks at the experience of these new surveillance mechanisms in recent years in assessing fiscal policies, unconventional monetary policies, and financial stability. These mechanisms have improved the quality and coverage of surveillance, but there still remain big challenges to finding ways to persuade national authorities to change policy.

Some of the central problems that hampered cooperation in the run-up to the crisis remain. For countries to want to cooperate, they had to share a common view of the causes of the crisis and of the actions that needed to be taken. There also needed to be processes to ensure that countries followed up on their commitments, and agreement that (if fully implemented) these actions would deliver significant benefits for all.

The onset of the crisis and the response to it have reawakened interest in how to design the most effective institutional setting for cooperation to deliver better outcomes for all involved. The G-20 summits put in place a number of different models. The initial attempts at macroeconomic policy coordination were essentially self-policing, with the IMF as scorekeeper. On the other hand, detailed rules for action were drawn up for the reform of financial regulation, and peer review mechanisms were put in place to review how well countries had implemented the rules.

In the final chapter of this book, Narayanan Raman, Lucy Qian Liu, and Sonali Das explore the most effective choices for coordination mechanisms. They argue that two dimensions are key to success. First, the design of mechanism depends on how alike (and like-minded) the countries are. Where the countries are very homogeneous, formal agreements and institutions to back them up are most appropriate. The more heterogeneous the countries are, the more discretion is needed to allow countries to adapt to their own circumstances.

The second dimension is what issue countries are trying to coordinate on. If the issue is relatively well defined and technical, detailed rules are likely to work best. However, on issues that are less well defined and also highly politicized, rules are unlikely to work. In these cases, setting broad objectives while allowing each country to decide how best to achieve these outcomes may be the way forward.

The international institutions can and should play an important role in fostering economic policy cooperation. They can provide the technical tools and expertise to identify areas where cooperation is necessary, and to facilitate and monitor this cooperation. What their role should be, and how this role should be designed, will vary between different areas of policy.

Concluding Remarks

We draw a number of general conclusions from the contributions to this book. The first is that the world did indeed rally around and coordinate effectively on policies as the depth and severity of the crisis started to become clear. It is easy to underestimate the speed and efficiency of the global economic policy response. Two months after the collapse of Lehman Brothers the leaders of the G-20 concluded their first ever summit. It produced a communiqué that promised closer economic policy cooperation and provided a detailed plan for financial regulatory reform—all this from an organization that few had thought in early September had any significant standing. Four months later they met again and agreed on a set of concrete actions on joint fiscal support and on expanding the global financial safety net provided by the IMF to respond to the deteriorating outlook for the global economy.

This speedy response occurred in the face of a massive negative jolt to the global economy that emphasized how interconnected the major players were and laid bare the risk of a new global depression. It also reflected the willingness of the United States—the country at the center of the crisis—to take responsibility and to act rapidly and decisively. Other countries were willing to follow this lead as the costs of inaction started to become apparent.

Over the subsequent seven years much of the energy has gone out of this new approach to policy cooperation. Some of this was almost certainly inevitable. The very speed and novelty of the new system—annual leaders' summits, biannual finance ministers' meetings—left little time for colder calculation.

However, the subsequent loss in momentum was largely due to two factors. First, as the crisis unwound, countries started to learn to live with the consequences and to act to minimize the impact on themselves. Second, it became clear that processes and institutions for cooperation needed to be well designed, and that the existing ones had limitations. The chapters in this book seek to illustrate these deeper issues and to provide practical conclusions and solutions that can be of use to policymakers.

The first issue has been the difficulty in defining the size, and even the signs, of interconnected policy spillovers. Unconventional monetary policies in the main international reserve asset countries are a case in point. When those were initiated, the reserve country central banks generally claimed that the boost they would give to domestic growth would help the global recovery, despite the fact that capital outflows also led to currency appreciation and potential financial overheating in recipient countries. Recipients (including at times other reserve asset central banks) were not so sure.

Another example of the difficulty of identifying policy spillovers is the analysis of fiscal policy. The early consensus over the need for a coordinated stimulus was quickly overtaken by differences in view about the policy response, based on different assessments of the risks and the impact across national borders. The analysis in the first section of the book helps highlight the mechanisms by which spillovers could occur, thereby taking forward the intellectual debate on policy spillovers, which are at the heart of any discussion about policy cooperation.

A second issue has been a lingering distrust of the policy decisions of the countries at the center of the global crisis—the United States and the countries in western Europe. The second section of the book illustrates this concern and the difficulties that other countries have had framing policies in response to the largely self-induced crises and subsequent emergency measures taken by the United States and western Europe.

A third insight is that most progress has been made on more "technical" policy aspects, such as financial regulation, compared to more "political" macroeconomic and structural policies. Part of this reflects the lesson from the crisis that financial stability is an important global public good (just as the lesson from the Great Depression was that international trade was an important public good). It also reflects the fact that these issues were seen to be shared broadly across all countries and to be relatively uncontentious domestically. As a result, countries were more willing to delegate detailed decisionmaking and implementation of these issues to international agencies and institutions.

In contrast, consensus on the conduct of macroeconomic, macroprudential, and structural policies—and their correct mix—has been much more difficult to achieve. As discussed in part three of the book, this partly reflects limited knowledge of the policies themselves—in particular the macroprudential policies that have become a major focus after the crisis. But it also reflects the fact that such policies are not well coordinated within countries. Why should the United States and China cooperate closely if the U.S. Treasury and Federal Reserve do not?

A final issue is that the design of the mechanisms for international policy development is important, but remains a work in progress. The assumed gains to policy cooperation often come from game-theoretic approaches that do not account for the difficulties of implementation, trust, verification, and the like. The last part of the book therefore looks in detail into the nuts and bolts of how policies can be coordinated, including, for example, the insight that very different mechanisms are likely needed for "hard" issues (such as trade) versus "soft" issues such as monetary policy.

Common themes running through all these chapters are also the reform of the global financial and monetary architecture, and global economic governance. Who sets the rules and who is responsible for their implementation? And how should international institutions be managed? As the crisis made clear, global institutions have not adjusted properly to the shift from the postwar hegemonic international order. The United States is in the process of losing its status as the world's most important economy, but international decisionmaking is still concentrated in U.S.-dominated institutions—the IMF, the World Bank, and G-7.

Emerging markets view the crisis as the result of advanced economies' policies and of their unbalanced models of economic growth. They see the international monetary system, and the international institutions overseeing it, as dominated by advanced economies. The emerging markets, which are increasingly central to the global economy, want to have a greater say in global governance.

In summary, the crisis has forced a major rethinking of the approaches to policy cooperation. The potential for cooperation to improve policymaking and economic outcomes domestically and internationally is significant. Spillovers from one country's policies on others have become larger, but cooperation has become harder and messier, because governments now have to deal with a wider range of issues and have more instruments to use.

Governments have responded with a number of different approaches and institutional structures. Some have been more successful, and more inclusive, than others. The challenge is to continue to improve methods of cooperation, and the institutions to help achieve them, in ways that are accepted as legitimate by more countries.