Preventing Crises and Promoting Economic Growth

A Framework for International Policy Cooperation

A Joint Chatham House and CIGI Report

Paola Subacchi and Paul Jenkins

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William Jackson and Richard Varghese undertook the basic research for this report, provided figures and information and always found ingenious ways to express some tricky concepts in graphic form. Amalia Khachatryan and Nick Maxwell coordinated the project and with Deanne Leifso and Andrew Schrumm from CIGI made everything possible. We would also like to acknowledge the contribution of Mui Pong Goh who set up the project, but had to return to Singapore for family reasons before seeing the end of it.

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P.S.
P.J.

Executive Summary and Recommendations

The way in which nations design and implement their economic policies is woefully inadequate to prevent economic crises or to achieve balanced, stable and sustainable global growth. The recent financial crisis has shown how integrated the world economy is and how complex financial and economic interdependencies between countries have become.

In this report, we call on governments to evaluate thoroughly the international implications of relevant domestic policy decisions *before* these domestic policies are implemented, and set out a schedule for G20 leaders to achieve more cooperative solutions to international economic challenges.

Nations that wish to secure the benefits of an integrated world economy should recognize the implications of interdependencies and linkages in their domestic economic policy and upgrade their domestic policy-making as a result. This means taking into account the spillover effects of domestic policies on other countries and on the wider world economy, which – in turn – have impacts and feedback effects on the domestic economy.

In practice, as part of a proposed new 'framework for G20 policy cooperation', we recommend that internationally relevant domestic policies be accompanied by international impact assessments. Such public recognition, and the resulting international accountability, could provide a step-change in the way nations think about policy-making and about which policies are in the national interest.

The alternative – i.e. ignoring the effects of national economic policy on other nations – would encourage international instability and increasing national exposure to high-impact shocks, transmitted ever faster, in ever more complex ways.

The past two decades have been dominated by a substantial increase in the global integration of markets and economies. The choice, for most nations, to become more integrated has been guided by an appreciation of the enormous potential for welfare gains derived from economic connections. While such integration is not without cost or risk to nations, there is evidence that these risks can be managed by policy cooperation.

However, a historical review of policy cooperation, from the Bretton Woods agreement in 1944 to the G20 Summits in 2008–10, raises questions about whether cooperation is only feasible when interdependencies are made clear by incidents of instability and volatility as happens during crises, i.e. when the costs of non-cooperation are painfully evident.

While the recent financial crisis generated a period of unprecedented international cooperation and coordination, it was driven by severe economic stress. In some cases the measures were only temporary in nature. The challenge today is to foster an understanding that the benefits of an internationally integrated economy do not come without increasing national exposure to shocks, and that it is in the national interest to manage pressures in the system through a framework for multilateral policy cooperation.

Today's global economy faces an array of challenges, from volatile capital flows, current account imbalances, pressure within the international monetary system and commodity price volatility, to fragile growth and development. Sharp differences persist among the G20 regarding exchange rates and capital flows, leading to unilateral actions by important countries taken without reference to their global impact. The relative decline of advanced economies and an unbalanced global economy are leading to unilateral policy actions and a political discourse that tends towards a zero-sum game mentality. This has brought to the fore the risk that retaliatory measures taken in response to adverse, or perceived adverse, spillovers will undermine economic growth.

Policy cooperation is not an easy task. However, countries should see the incentive to cooperate coming from two overriding benefits: greater global economic and financial stability, and greater prosperity for all through growth of the global 'economic pie'.

Without a clear understanding of the nature and scale of economic interdependencies, and of transmission mechanisms, policy-makers will not possess sufficient evidence of the benefits of international policy coordination to make it appear desirable. To achieve such understanding we argue that it is necessary to promote discussions on the diagnosis of interdependencies and spillover mechanisms that justify cooperation and, at times, coordinated responses. The development and wider use of economic models to help quantify the benefits of cooperative versus uncooperative behaviour offer a potential solution. However, the macroeconomic models in current use, while intellectually advanced, tend to be limited in their geographical or sectoral coverage. A high degree of model uncertainty surrounds the characterization of economic relationships employed for modelling – a factor exacerbated by problems of small data samples. Moreover, there is a general perception that economic models failed to anticipate the financial crisis or even explain it *ex post*.

G20 nations need to invest in strengthening international and national diagnostic capabilities in order to better understand how cooperative action (or lack thereof) can enhance (or thwart) the likelihood of achieving both domestic and international objectives. In addition, sustaining international commitments requires improvements to the governance mechanisms so as to learn from the shortcomings of many historical examples of policy cooperation. The emphasis should be placed on developing and adopting processes that incorporate strong governance mechanisms – improving credibility through clear roles and responsibilities, individually and collectively, and improving accountability mechanisms through transparency.

We argue that, for each international challenge against which a cooperative solution would be beneficial, progress should be made to move up the cooperation spectrum from monitoring, to international benchmarking, to national benchmarking, to national policy, and finally to coordinated national policies. The pace and appropriate positioning along this spectrum will vary according to each specific challenge. The first crucial step is recognition in national policy-making of international interdependencies and spillovers.

The G20 has shown us that ad hoc policy cooperation is possible in times of crisis. In 2011, the G20 needs to look beyond its roots as a crisis steering committee. There is an opportunity to build a new framework for cooperation that can help policy-makers transcend the zero-sum mentality that sank earlier international cooperation efforts, and that still underlies much of the discourse and recriminations about economic policy and global imbalances in today's world. International policy cooperation should be the new *modus operandi* of policy-making.

To meet today's challenges the G20 will need to meet an ambitious schedule for international policy cooperation. We set out such a schedule, including developing adjustment paths to unwind current account imbalances and implementing measures to reduce commodity market volatility within five years; and moving beyond the dollar to a more stable multi-currency monetary system within 15 years.

The world is urgently in need of a more robust framework for international economic cooperation, and laying the groundwork for one should be the central task of the French G20 presidency. In this way, the G20 can become the forum that drives a framework for cooperation that is sustainable, flexible and allows countries to reap the benefits of international economic policy cooperation – greater economic and financial stability, and greater prosperity for all through sustained global economic growth.

Recommendations for the G20

1. Support and develop the G20 Mutual Assessment Process and the study of interdependencies: The G20 should invest in strengthening its diagnostic capabilities in order to better understand how cooperative action (or lack thereof) can enhance (or thwart) the likelihood of achieving both domestic and global objectives. The Mutual Assessment Process (MAP) will require support, resources and a suite of analytical tools that over time will allow better understanding of the benefits of cooperative outcomes. The G20 should also establish a working group of G20 country experts to study global economic interdependencies, perhaps in an independent office.

2. Publish* ex ante *international impact assessments for domestic policy: At a national level, G20 nations could develop international impact assessments for relevant macroeconomic, structural and regulatory policy decisions. Much in the same way that EU or UK regulatory impact assessments take into account the projected cost and benefits of decisions and the impact of policy on the national economy and sectors within the country, each relevant policy decision should be accompanied by a statement of projected international economic impact. This *ex ante* recognition of the international spillovers of policy decisions could provide a step-change in domestic awareness of the international implications of domestic policy.

3. Set the tone for cooperation from the top: Leaders' strategic focus on cooperation needs to be expressed and regularly reinforced. The ability of the G20 to sustain international economic cooperation lies in whether leaders and domestic audiences recognize the benefits of cooperation and the surrounding governance structure.

4. Reinforce a single statement of purpose for the G20: Leaders' strategic focus also needs to be expressed in the form of a clear message as to what the G20's priorities are. Attaining coherence of purpose and bridging the different multilateral institutions, groups and publics in the pursuit of effective cooperation requires a clear statement of purpose emanating from the G20. Therefore, as the G20 seeks to set more detailed objectives, improve diagnosis and implement a governance agenda based on credibility and accountability, the importance of a clear and focused message to sustain the impetus for cooperation both at home and within the G20 is critical.

5. Maintain strategic momentum and accountability for commitments: There is currently a very large backlog of G20 commitments. The leaders should remove roadblocks to meeting past commitments, but they cannot and should not be seen as being bogged down in technical details of meeting those commitments. Leaders therefore need to be mindful of keeping to the distinction between what is strategic and in need of political direction, and what is more technical and can be delegated to particular bodies, working groups or nations.

6. Publish national roadmaps for delivering international commitments: The G20 needs to turn the general objectives it has evoked in its communiqués into specific commitments, and clarify how these collective objectives tie into and support their individual national objectives. Further, leaders should publish national statements, or roadmaps, following G20 Summits about what specific action they are intending to take at a domestic level to fulfil the G20 commitments. Pressure would mount on countries that do not make such statements from the fact that other countries have published roadmaps.

7. Increase the transparency of the rotation of the G20 presidency: The G20 should develop an open and transparent appointment mechanism for determining how the G20 presidency is rotated. This could be developed as a group elected position, following an open process, among the G20 states. Such a system could encourage applicant nations to set out a cooperative agenda that appeals to other G20 nations and is likely to foster continuity from one presidency to another, supporting the function of the 'troika'. In any case, the 'troika' process at the leaders level needs to be strengthened if the G20 is going to provide the leadership, focus, clarity of messaging and continuity between summits needed for it to become a credible force in managing the world economy.

8. Develop regular 'Summit Reports' on G20 work to highlight progress against commitments and improve transparency and accountability: In taking on the responsibility as the premier forum for international economic cooperation, the G20 needs to become more transparent and accountable through regular 'Summit Reports' on its progress against commitments. A consistent G20 website should be developed and maintained with timely access to different publications, including a summary of the progress made on earlier commitments.

Introduction

Over the last two decades, the world economy has become increasingly integrated owing to the removal of trade barriers, the liberalization of capital flows and the spread of technology. Countries now trade much more with one another and international capital markets have deepened. As a result of these policy choices the world economy has grown at a pace unprecedented in recent economic history. Developing countries, in particular, have harnessed the opportunities offered by international trade and freer capital flows to develop and 'upgrade' their economies. Such a process is epitomized by China, whose ascendancy on the international economic stage has resulted in a large expansion of its share of the world economy and a significant increase in income per capita.

If trade and financial integration has increased prosperity, it has also made economic interdependencies and linkages more pervasive, stronger and deeper. More integrated networks through trade and financial linkages make the transmission of shocks and contagion much faster and more powerful, and increase the risk of macroeconomic instability and financial volatility.

The complexity of these interdependencies, and our inability to understand them fully and to guard against their adverse effects, became evident during the recent financial and economic crisis. What started in August 2007 as an episode of turbulence in the sub-prime niche of the US domestic mortgage market turned out to be the beginning of a far-reaching global crisis, with shockwaves extending to economies around the world. Even countries that, in the wake of the collapse of Lehman Brothers in September 2008, were thought to be safe because of the relatively modest size and limited sophistication of their financial sectors were dramatically affected through their export markets. The ripple effect of the crisis was conveyed across the world through an international network of trade and financial linkages.

Because of these linkages, one country's policies can have spillover effects on other countries. Policies are often made unilaterally, without reference to their external impact. The consequence is that countries that are affected often resort to defensive measures and even to retaliation. The impact and strength of these spillovers, and the consequent responses, depend on how deeply the countries concerned are plugged into the international economic and financial system. Systemically important countries tend to have a far stronger impact than countries that are less important in terms of the size of their economies and the breadth and depth of their networks.

Spillovers that have detrimental consequences need to be avoided. In some cases, even positive spillovers can be seen to be unfair, or unjust. When a country unilaterally undertakes fiscal stimulus, inevitably some of this stimulus 'leaks out' to other countries in the form of imports from these other countries. The agreed joint fiscal stimulus of the G20 (the Group of Twenty advanced and emerging economies) in November 2008 in response to the rapidly deteriorating global economic situation represented a boost to global aggregate demand and in that way was viewed, in design at least, as a shared response. The second round of US quantitative easing combined with the Chinese managed exchange rate, in contrast, spurred high – and potentially destabilizing – capital flows to some emerging market countries with concerns of 'beggar-your-neighbour' consequences for the exchange rates of these countries.

Policy cooperation is critical for reducing undesired spillover effects and instability. How to foster policy cooperation in order to manage the risks of international economic instability – and ideally prevent the next crisis – and to promote balanced and sustainable growth is the key question addressed by this report. By spelling out the need to recognize the implications of interconnectedness for countries' economic future, the report aims to provide substance to what is currently no more than a well-rehearsed concept based on broadly shared principles.

Bringing together different disciplinary streams, the report develops an innovative approach to the issue of policy cooperation. It looks at how domestic policies are designed and suggests that more attention should be paid to spillovers in policy areas where international interdependencies are stronger. A clear understanding of interdependencies and their implications for the economic future of individual countries deserves greater attention within the policy debate. Countries need to understand what connects them and to recognize those linkages in setting national policies. In an economically integrated world, countries should embrace economic policy cooperation as their *modus operandi*, agree on a common framework of multilateral objectives and commit to policy cooperation on its implementation.

Even if it is widely recognized that there are gains from the cooperation and coordination of policies among countries,[1] real-world efforts towards policy cooperation are not without obstacles. This is partly explained by the fact that countries perceive this as a zero-sum game and hence try to obtain a bigger share of the economic gains for themselves, even at the cost of exacerbating macro-economic instability and financial volatility. When global cooperation and coordination issues are – or are perceived to be – in conflict with national interests, politicians are often compelled to move away from cooperative outcomes to solutions centred on domestic interests. This effect is exacerbated by the lack of consensus on key economic objectives and the use of specific policy tools.

These instances highlight not only the weaknesses in our current analytic framework for understanding interdependencies and the potential benefits of cooperation, but also the difficulty of eliciting commitments to cooperate on the basis of such understandings, let alone ensuring compliance with these commitments.

When discussing how to put together and implement a framework for international policy cooperation we inevitably turn to the G20 as the multilateral forum which deals with international economic and financial issues. The G20 proved to be an effective firefighter during the recent financial and economic crisis. Its 'upgrading' to a heads-of-state forum in November 2008 was a *de facto* recognition that the broadening of the global economic order needed a change in governance – a change in approach that was triggered by the crisis.[2] However, if the rationale for working together is broadly recognized among the G20 countries, the modalities, processes and instruments are not clear at all. As a result objectives often diverge, and so do policy measures and outcomes.

Policy cooperation lies at the heart of the G20 work, and it is even its *raison d'être*. It is key to confronting both immediate and longer-run challenges – from improving growth and employment prospects for both developed and developing countries, to regulatory reform of the global financial system, addressing volatility in commodity markets, and the functioning of the international monetary system. Of course policy cooperation is easier and smoother in adverse times. During the recent crisis, leaders and ministers from the G20 were able to transcend their differences, agree on a common diagnosis of the situation at that juncture, and create a plan for stabilizing financial markets and restoring the flow of credit to support global economic growth. Having helped steer the global economy away from catastrophe, the G20 leaders began steps to cooperate on the broader questions affecting the long-term growth and stability of the global economy.

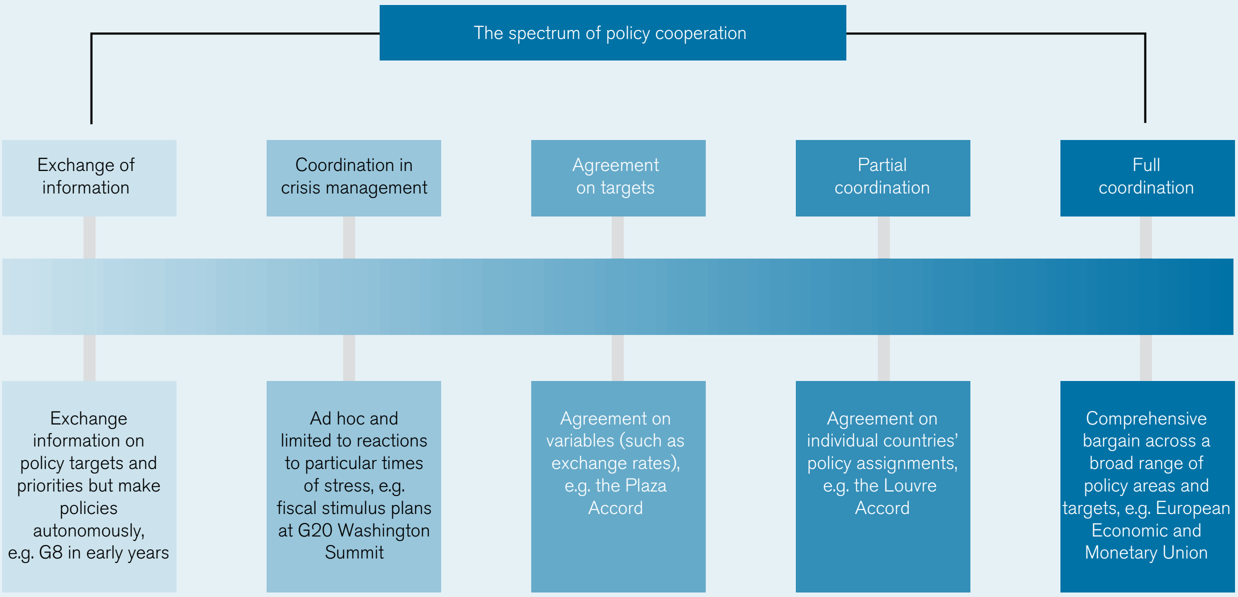
To meet today's challenges the G20 thus needs to look beyond its role as a crisis steering committee, and build a new framework for cooperation which can help it transcend the zero-sum mentality that sank earlier international cooperation efforts, and that still underlies much of the discourse about global imbalances and the recriminations heard in each country about others' economic policies. This requires an ambitious schedule for international policy cooperation and a broader remit than just ad hoc concerted policy measures – one that cuts across all of the G20 priority areas. It includes, for example, the need to go well beyond the search for 'indicative guidelines' for

1 Although there is a broad consensus on the rationale for economic cooperation, the issue is not without debate. For a comprehensive overview of the literature on economic cooperation and coordination see Bryant (1995). For further reading see Buiter and Marston (1985), Oudiz and Sachs (1985), Miller and Salmon (1985), Vaubel (1983), Fischer (1988), Rogoff (1985) and Carraro and Giavazzi (1991).

2 See Cooper and Subacchi (2010).

Box 1.0: A question of definition: cooperation vs coordination

In this report, the term 'cooperation' refers to the entire range of activities through which national governments might collaborate (Bryant and Hodgkinson, 1989). The framework or spectrum of cooperative action ranges from informal arrangements – such as consultation and exchange of information – to formal recognition of policy interactions and commitments to adjust policies in a coordinated fashion to achieve a mutually agreed set of multilateral objectives. These definitions broadly follow a spectrum of policy cooperation, composed of five distinct levels, as described by Currie et al. (1989):



For the definition of 'coordination', this report closely follows Kenen (1990), who defines 'coordination' as the most rigorous form of economic cooperation, because it involves mutually agreed modifications in the participants' national policies. The classical definition of 'coordination' as 'a significant modification of national policies in recognition of international economic interdependence' (Wallich, 1984), quoted extensively in the economic literature, fails to capture the underlying negotiated nature of the policy modifications.

Coordination involves an exchange of explicit, operational commitments about the conduct of monetary and fiscal policies. Full coordination, therefore, will entail jointly designed mutual adjustments of national policies – commitments about the realistic time paths of policy instruments and not merely aspirations about the time paths to achieve targets (Mooslechner and Schuerz, 1999).

the 'timely identification' of unsustainable current account imbalances to the identification of individual country policy actions necessary to correct global imbalances.

With imbalances continuing in the global economy, a persistent divergence in fiscal stances among G20 members, and a lack of follow-through on commitments made at previous summits, the sustainability of progress made by the G20 to promote global economic and financial stability is at risk. In order to integrate global and national economic priorities to produce strong, balanced and sustainable growth – and avert future crises – the G20 must strengthen its capabilities to analyse economic interdependencies within a durable framework for cooperation built on the principles of sound governance.

The analysis and recommendations in this report build upon a project on 'Rising Powers in the Shadow of the Crisis: A New Global Governance' funded by the UK's Economic and Social Research Council (ESRC). A broad international network was set up around this project with participants from different countries and different disciplines – from economics and finance to international political economy, international politics and international relations – and building on the collaboration between Chatham House and The Centre for International Governance Innovation (CIGI). It moved forward the work on 'Global Economic Governance in Transition' that culminated in a special issue of *International Affairs* published in May 2010. This report is therefore the outcome of many contributions, in particular the papers that were presented at two workshops held in Beijing in September 2010 and in London in December 2010 (see Appendix).

The report is organized as follows. Chapter 1 sets the context and looks at the changing dynamics of the world economic order and the shift towards multipolarity. The focus here is on the nature of the interlinkages between national economies and the varying ways in which economic shocks were transmitted between countries following the financial crisis. In Chapter 2 we assess several of today's global economic challenges such as current account imbalances, exchange rate arrangements and capital flows. Looking at the relative decline of advanced economies and the fast growth of emerging-market economies, we ask whether lack of convergence in growth and development may undermine the appetite for international policy cooperation.

A historical overview of international economic policy cooperation is provided in Chapter 3. Looking across the Bretton Woods era, the period from 1970 to the 1990s, including the Plaza and Louvre Accords, and from the 1990s to 2008, including European Monetary Union and the Chiang Mai Initiative, the chapter assesses the factors that encourage the success or otherwise of cooperation. It then discusses the development of a more vigorous and effective approach to policy cooperation and the elevation of the G20 as the premier forum on international economic cooperation in response to the financial and economic crisis of 2008–09.

The analytical framework that underpins the analysis of the interdependencies and the incentives to cooperate is discussed in Chapter 4. The challenge of achieving agreement on the benefits of cooperation and the limitations of the current economic modelling for interdependencies are also explored. Chapter 5 considers ways of building a framework of cooperation, and its necessary elements, as well as the lessons for cooperative arrangements from International Monetary Fund (IMF) surveillance, peer review and the G20 Mutual Assessment Process (MAP), in terms of governance, credibility and accountability. Here, we emphasize the importance of leadership and vision at both the national and international level, particularly during this fragile stage when the analytical framework for cooperation is underdeveloped.

Chapter 6 concludes with recommendations for improving the environment for international economic policy cooperation. These specifically address the agenda and discussion within the 2011 G20 process, chaired by France, but they also have a broader validity and are applicable to a longer time-horizon.

1. A More Interdependent World Economy

1.1 Shifting to a multipolar economic order

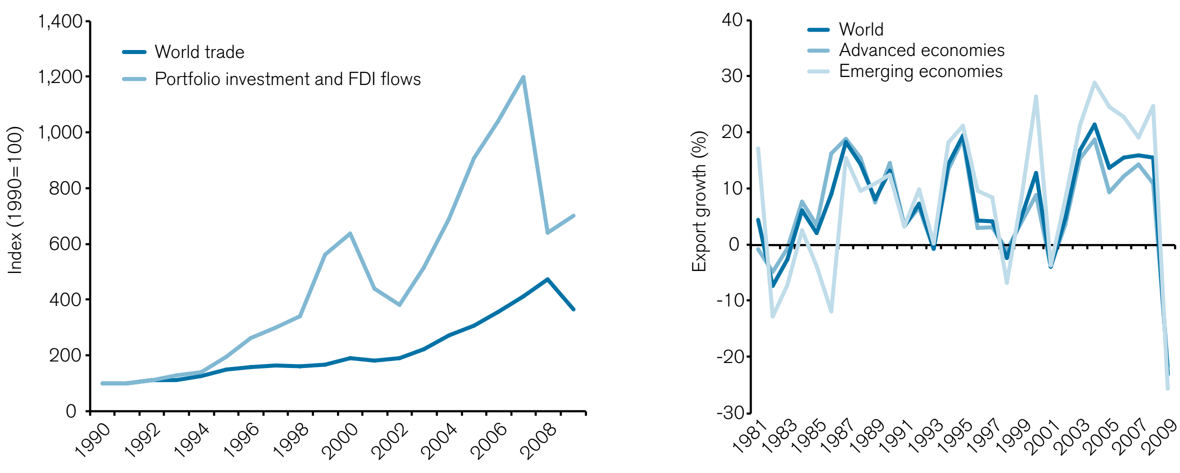
The rapid globalization of the last twenty years has been accompanied by increased integration of markets and greater interdependence among countries worldwide. The period has witnessed the opening up of large emerging economies, such as China and India, and their subsequent integration into the world economy.

These long-term trends are reflected in the growth and composition of international trade and capital flows as well as world GDP. As shown in Figure 1.1, world trade and capital flows (the latter measured as portfolio investment and FDI) have grown exponentially. The expansion of trade has been driven by stronger linkages between advanced and emerging economies. In 2008, the overall value of trade was US$18.5 trillion. Trade, at its peak in 2008, had more than doubled over the previous five years, and more than quadrupled over the previous 15 years. Meanwhile, capital flows expanded at an even greater pace, reaching a peak of over $5.5 trillion in 2007.

Since the early 1990s, emerging economies have, on balance, achieved strong growth.[3] This has expanded their share of global GDP while that of advanced economies has declined from 82% in 1995 to 66% today, at market exchange rates (MER) (Figure 1.2). In terms of purchasing power parity (PPP), the IMF projects that emerging economies will account for over half of world GDP by 2013.

The most noticeable trend, as seen in Figure 1.2, is that China's weight in the global economy has more than quadrupled between 1995 and 2010, squeezing the share of the G7 advanced economies. The other three members of the BRIC grouping (Brazil, Russia and India) have seen their share grow, and so has the rest of the world, although not at the pace experienced by China. The four BRIC countries

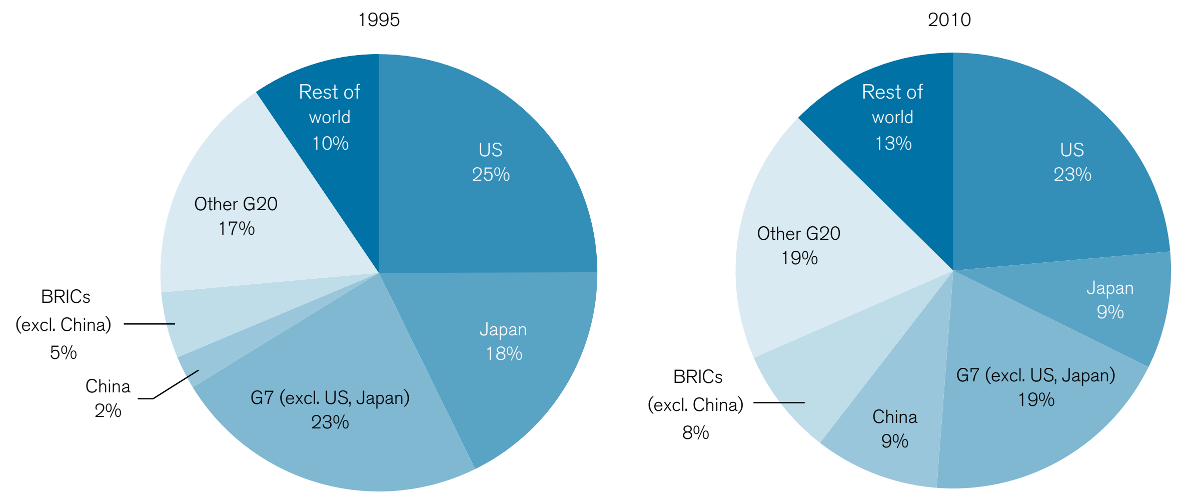
Figure 1.1: Development of world trade and global capital flows (lhs, index 1990=100) and trade growth (rhs, % p.a. of exports)



Sources: IMF Balance of Payments Statistics, IMF Direction of Trade Statistics

3 Despite the various Latin American economic crises in 1990s, the Asian financial crisis of 1997 and the Russian financial crisis of 1998, the period has been one of strong economic growth in the emerging market economies.

Figure 1.2: Share of world GDP (%, 1995 and 2010 at market exchange rates)



Source: IMF World Economic Outlook, October 2010

accounted for almost a fifth of global GDP in 2010, but China alone represented 9.3% of global GDP, the lion's share in the group (see Table 1.1).

China deserves particular attention. Its development has been driven by integration in global markets, while at the same time globalization has been pushed by China's rapid economic growth. China's accession to the World Trade Organization (WTO) in December 2001 represented a major step in its engagement with the world economy. It is now the world's second largest economy in US dollar terms, having overtaken Japan in the second quarter of 2010, and its economy played a fundamental role in both mitigating the economic downturn in the global economy in 2008–09 and spurring the recovery in 2010. It overtook Germany to become the world's largest exporter in 2009, with annual exports reaching over $1.2 trillion. China remains the fastest growing major economy in the world, far outpacing the advanced economies, to form one of the key pillars driving global growth. In all these respects, China, as an emerging-market power, has developed as a country of systemic significance to the world economy (see Box 1.1).

1.2 The changing nature of interdependencies

Along with increased economic integration and the shift to a multipolar economic order,[4] the twenty years prior

Table 1.1: Share of the BRIC bloc in the world economy

Country	Population (mn)	Share of global GDP (%)[a]		Share of world exports (%)	
		2000	2010	2000	2010[b]
Brazil	195	2.0	3.3	0.9	1.3
Russia	140	1.0	2.4	1.6	2.7
India	1,234	1.5	2.3	0.7	1.4
China	1,348	3.7	9.3	3.9	10.5
Total	**2,917**	**8.0**	**17.2**	**7.1**	**16.0**

a Share of global GDP at market exchange rates
b Data for first three quarters
Sources: IMF World Economic Outlook October 2010 and Direction of Trade Statistics

4 For further discussion on the shift towards a multipolar world see Zakaria (2008) and Mahbubani (2008).

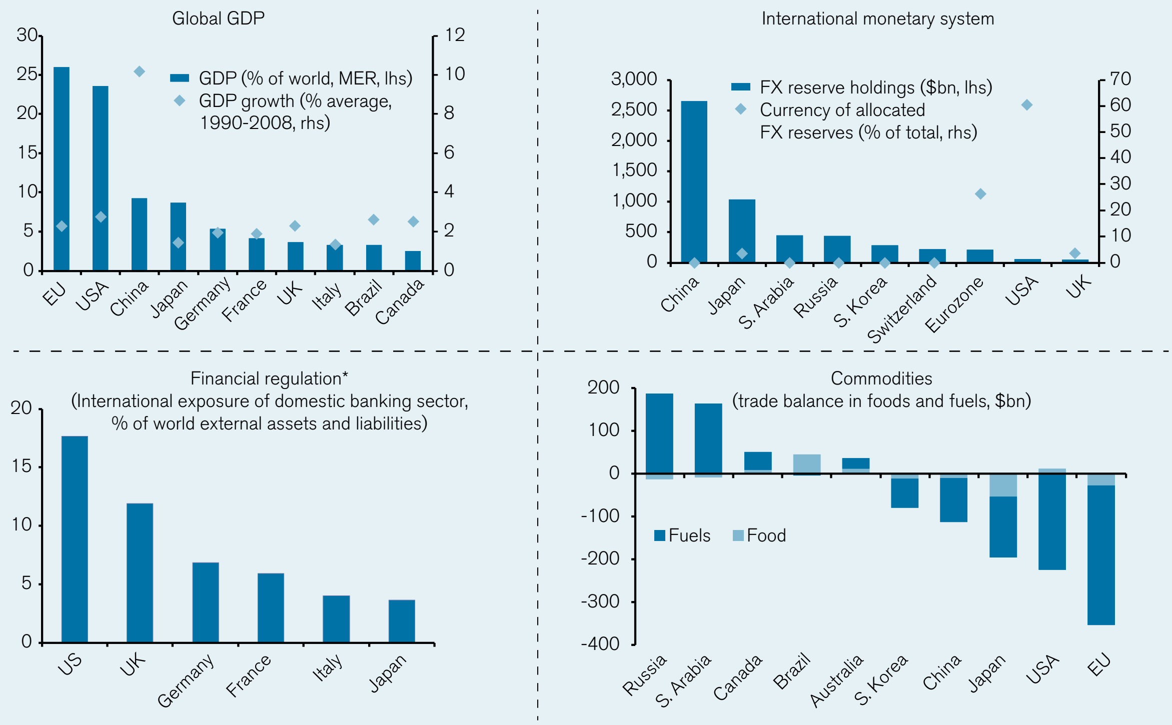
Box 1.1: Systemically Important Countries (SICs)

In this report we refer to the broadly used concept of 'Systemically Important Countries' (SICs), or countries of systemic significance to the world economy, to identify countries that are so large and integrated into the world economy that changes or shocks in one or more of them have spillover effects on other countries through direct or indirect channels.

Although the concept of SIC has crept into the body of economic and financial literature, the phrase remains largely undefined and is used loosely in varying contexts. On the one hand, the member nations of the G20, on the basis of their share of the world economy, are often listed as systemic countries. On the other hand, the new proposed IMF Spillover Reports – an assessment of spillovers arising from as well as falling on the five major economies deemed to be of systemic importance to the global economy – cover only the United States, China, the United Kingdom, Japan and the Euro area.

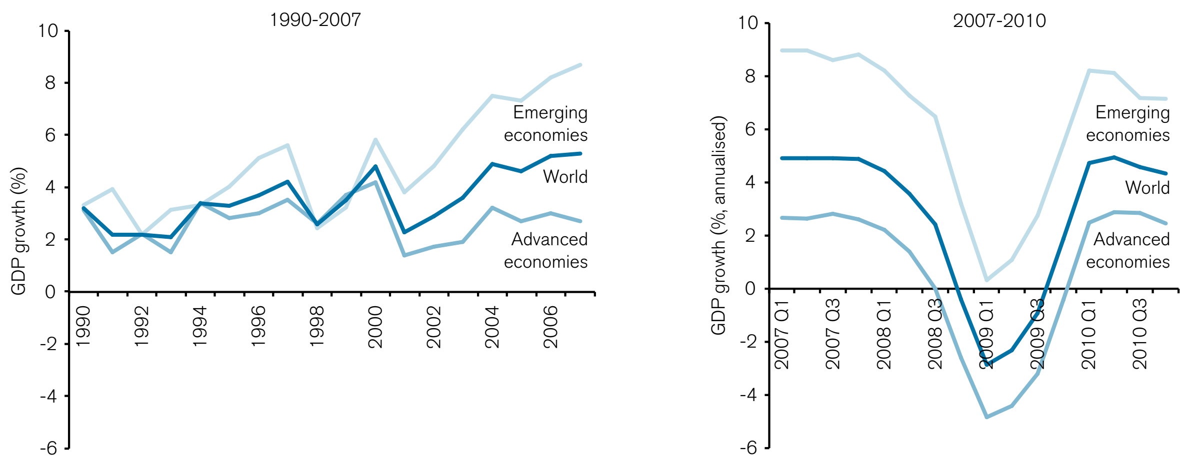
If the most common definition of SICs is based on the size of their economies, there are other criteria that can be used too. SICs are often defined in issue-specific contexts – for example in relation to commodity price volatility, reform of the international monetary system, or financial regulation. In the figure below we draw out the SICs in the context of global GDP, international reserve currencies, financial regulation and commodities. What comes across is that, while some developing countries – notably China – have become systemically important (especially in terms of the size of their economies and of this as a percentage of world GDP), this is not always matched in other spheres. In particular, the global financial system remains almost unipolar, with advanced economies (led by the United States and the United Kingdom) hosting the key global financial centres.

SICs measured by their importance in different global issues



Sources: BIS, IMF Composition of Foreign Exchange Reserves, IMF World Economci Outlook, WTO
Note: Data for 2010 except commodity trade data (which are for 2009) and average GDP growth (for 1990-2008).
* Financial regulation reflects the international risk exposure of domestically headquartered banks

Figure 1.3: GDP growth (%) – increasing divergence in growth and a synchronized dive in 2008–09



Source: IMF World Economic Outlook

to the onset of the global financial crisis saw a substantial decline in macroeconomic volatility – of both output and inflation – in major industrial countries (Bernanke, 2004). The pre-crisis period, however, also witnessed emerging markets outperforming advanced economies (Figure 1.3) and the beginning of large US current account deficits as well as the corresponding surpluses in the rest of the world, particularly in developing Asia, the Middle East and Russia. Despite the growing divergence in economic growth rates and persistent global imbalances, the period marked by 'the Great Moderation' was one of benign global economic conditions – low inflation, strong growth and low unemployment.

From 2002, in particular, emerging market growth pulled ahead of that of advanced economies and showed lower correlation with their business cycles, prompting the 'decoupling' hypothesis.[5] These observations led to suggestions that, from a macroeconomic viewpoint, there was less interdependence in international business-cycle fluctuations, and therefore less need for international coordination of policy responses.[6] These arguments, however, were quashed by the global crisis as growth rates across the board tumbled during 2008 and 2009.

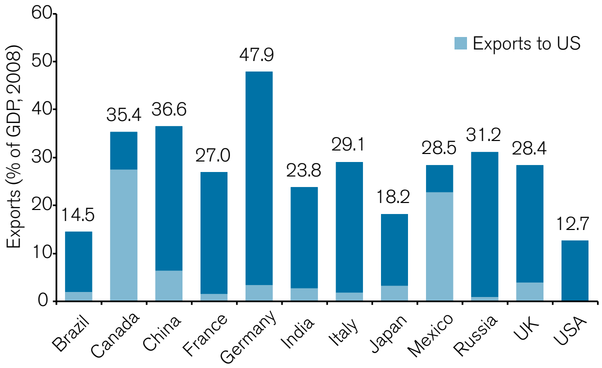
What started with the bursting of a housing bubble in the United States fed into a web of financial innovation 'supported by securitization, ratings creep, and leverage' (IMF, 2010b), leading to a collapse in liquidity in the US financial system and the insolvency of a number of major US financial institutions. The financial shock in America rippled through financial institutions and had an impact on real economies around the globe. This crisis exposed the build-up of interdependencies in the international financial system as institutions in many advanced economies were exposed to risks in the US market and had invested in financial instruments that were riskier than they appeared, exacerbating the financial shock.

The crisis exposed the multifaceted nature of the way in which the economic shock was transmitted, particularly the very different experiences of advanced economies and emerging markets in terms of the channels of transmission. Traditionally, international economic interdependencies have been thought of in terms of trade linkages. As observed in emerging markets, trade links still acted as the main channel for the transmission of the global financial crisis of 2008 as advanced economies cut back on consumption and imports. This had spillover effects on export demand throughout the global supply chain as well as through commodity prices acting as a brake on growth

5 That is, growth in one area of the world was perceived to have become less dependent on growth in another area and GDP growth rates appeared less correlated (see *Economist*, 2008).

6 The logic being if there is a highly synchronized world business cycle, then there really are common problems that should be addressed in a coordinated manner.

Figure 1.4: Exports as a % of GDP (2008)



Source: IMF Direction of Trade Statistics

in emerging markets (Devereux, 2010). This impact from the transmission of the shock led to a relatively high synchronicity of business cycles.

However, financial linkages to the United States[7] provide a stronger explanation for the scale of downturns in countries of the Organization for Economic Cooperation and Development (OECD) during the recession. Devereux and Yetman (2009) find that countries with greater financial linkages and with weak financial positions, in the form of lower-rated sovereign debt, did worse than other countries. This seems to support the widely held view that during the recession, financial linkages between countries were significantly more important than trade flows. Indeed, as observed in Figure 1.4, exports to the United States represent only a relatively small proportion of GDP among major economies (Canada and Mexico aside).

In summary, the financial and economic crisis, because of its global nature, contributed to refocusing the policy debate on interdependencies between countries, which had become more complex than previously understood or recognized. Not only were those economies with strong financial linkages to the United States affected by the crisis through a number of transmission channels, but the shock also proved contagious to those economies that had low levels of financial integration with it.[8]

7 Measured as total capital inflows from the United States, 2007 as percentage of GDP.

8 It is worth bearing in mind, however, that the large emerging economies, including the BRICs, in part because of their undeveloped regulatory framework and limited currency convertibility, have neither deep nor diversified international financial sectors.

2. Meeting Global Challenges in a Difficult Environment for Cooperation

2.1 Today's global challenges

On numerous fronts, the existence of high levels of complex interdependencies points towards areas for cooperation – where national priorities must be acknowledged and addressed and where countries, in particular systemically important countries, should recognize their impact on the global economy. If spillover effects are internalized by policy-makers, this offers the opportunity to mitigate macroeconomic volatility and improve welfare.

The post-crisis period is a crucial time to work towards greater recognition and understanding of both interdependencies and spillovers. The legacies of the global financial crisis have left us with a difficult, demanding economic policy environment. In addition to managing a global economy still characterized by vulnerabilities and downside risks, policy-makers must confront the medium- and longer-term need to put in place policies to promote macroeconomic and financial stability and sustained growth. The crisis exposed deficiencies in financial regulatory frameworks and vulnerabilities to sharp swings in commodity prices, while volatile capital flows and associated exchange rate pressures have cemented the relevance of discussions about the need to reform the international monetary system.

2.1.1 Volatile capital flows

Capital flows epitomize international spillovers that can arise from domestic policies. In response to the spillover effects from very accommodative domestic monetary policy stances in SICs (including in China through its managed exchange rate) – made without consideration of the international ramifications – a consensus has slowly evolved. It is now agreed that while capital flows bring benefits in terms of cheaper finance and the possibility of consumption smoothing, their pro-cyclicality can be destabilizing, prompting some countries to build up large foreign exchange (FX) reserves for self-insurance. The destabilizing effect of volatile capital flows is increasingly seen as a legitimate basis for using capital controls as a policy tool (IMF, 2010c).

However, the policy actions and instruments used to rein in capital flows have been uncoordinated. For example, FX interventions and reserve requirements on banks' FX positions,[9] rather than actually dampening capital flows and reducing their volatility across the board, may divert capital elsewhere. Absence of policy cooperation might lead to a domino effect as countries with trade interdependencies attempt to boost competitiveness through interventions in FX markets against each other, risking an extremely harmful outcome of restricted global capital flows. This poses a serious challenge and points to the need to improve the analytical framework, through a cooperative approach, for understanding the interactions between the provision of domestic and global liquidity, the drivers of capital flows, and the responses to destabilizing flow levels that could thwart needed adjustments.[10]

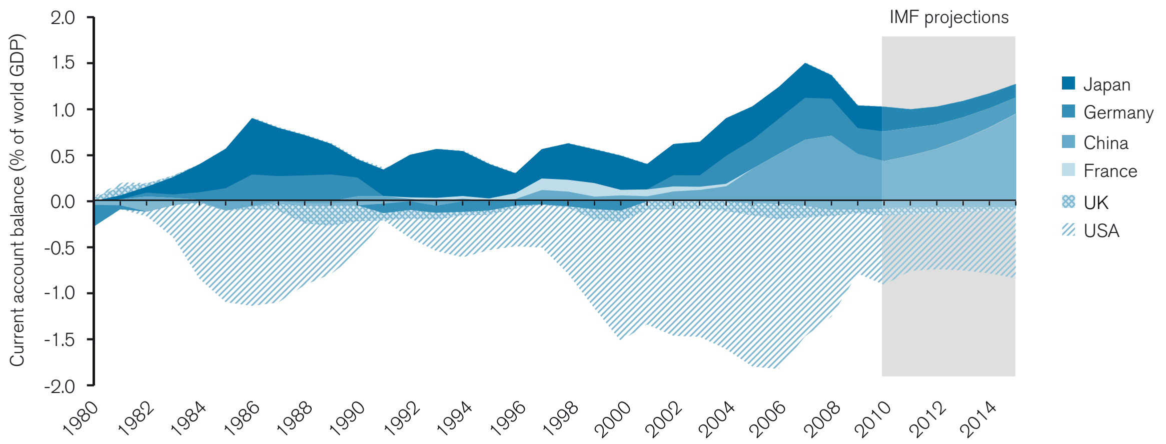
2.1.2 Current account imbalances

The debate on capital controls highlights the deeper concern facing policy-makers to resolve conflicts and find ways to rebalance the global economy by reducing current account imbalances. Capital controls have been implemented in

9 Such as, respectively, Chile's FX intervention to the tune of $12 billion and Brazil's policy initiative, both in January 2011.

10 The recent concerted intervention by the G7 in response to the devastating impact of the earthquake and tsunami in Japan in March 2011 represents the first coordinated action in foreign exchange markets since 2000. It was directed primarily to help stabilize the exchange rate of the yen, but it raises an interesting question whether other major G20 countries might in the future join such a coordinated effort to address a specific problem.

Figure 2.1: Current account imbalances (as % of world GDP)



Source: IMF World Economic Outlook

response to the upward pressures on domestic currencies caused by high and volatile inflows of capital. This has brought attention to the persistent attempts to drive growth through exports, underpinned by competitive exchange rates, and has resulted in a reversion to the pre-crisis trend of growing current account imbalances.

As with the pre-crisis period, worries abound that the United States' ability to run a persistent deficit could reach the point where the concerns of foreign investors lead to a disorderly adjustment including renewed market volatility and spillovers into the rest of the world. Not only do these imbalances vividly highlight the nature of international linkages, they also point to increased international exposure to the propagation of shocks.

Arguments that imbalances were a major contributing factor to the global recession[11] bring starkly into question the sustainability of nascent recovery and raise concerns about widening imbalances (see Figure 2.1). In addition, the current set of large imbalances suggests a problem of the misallocation of capital. The flow of surplus funds from emerging economies with large current account surpluses to advanced economies comes at the expense of domestic investment and welfare initiatives in poorer societies (Adams and Park, 2009).[12] Thus accumulation of FX reserves, as in China and other surplus countries, has associated risks and costs. Overall, as Blanchard and Milesi-Ferretti (2011) argue, cross-border effects of sudden stops, unfair competitive advantage and worries about global demand if part of the world economy is in a liquidity trap form important multilateral considerations for reducing current account imbalances.

China and the United States – respectively major surplus and deficit countries – are pursuing economic strategies that are in direct conflict with each other, even if the policy objective for each is the reduction of the these imbalances. Moreover, in both cases current account imbalances – whether deficits or surpluses – reflect underlying distortions linked to domestic saving and investment behaviour (Blanchard and Milesi-Ferretti, 2010; Chen, 2010).

Unwinding global imbalances is neither a simple task nor one that can be done through unilateral one-dimensional policy actions in a single economy. Instead, it requires a cooperative, multifaceted policy response. In the case of the United States and China, while the level and degree of flexibility of the Chinese renminbi grab headlines, debate must also focus on the long-term structural reforms to the savings and investment incentive structure in both

11 With excess savings from emerging markets flowing to the United States, in turn depressing the real interest rate and encouraging the financial sector to seek high returns in risky products. For a detailed discussion on the link between global imbalances and the crisis see Obstfeld and Rogoff (2009).

12 However, it is to be noted that the investment rates in China have been high and financial repression has played a role in contributing to the surpluses in the country by shifting the wealth from consumers to the corporate and government sectors (i.e. there is low private consumption).

economies. For China, reducing the surplus requires higher domestic consumption levels, which can be incentivized through consumer credit expansion, industrial policy that promotes domestic competition, and services-sector liberalization. In addition, the precautionary motivation for households to build private savings can be reduced through improved social security provision. The incentives for using retained earnings as a main source of investment funding in the private business sector should also be reduced.[13] In the United States, private savings need to be encouraged through tax policies and financial-sector reform, and public savings through a combination of restrictive fiscal policy measures. Policy measures can also be applied to boost the competitiveness of the United States' export sector.

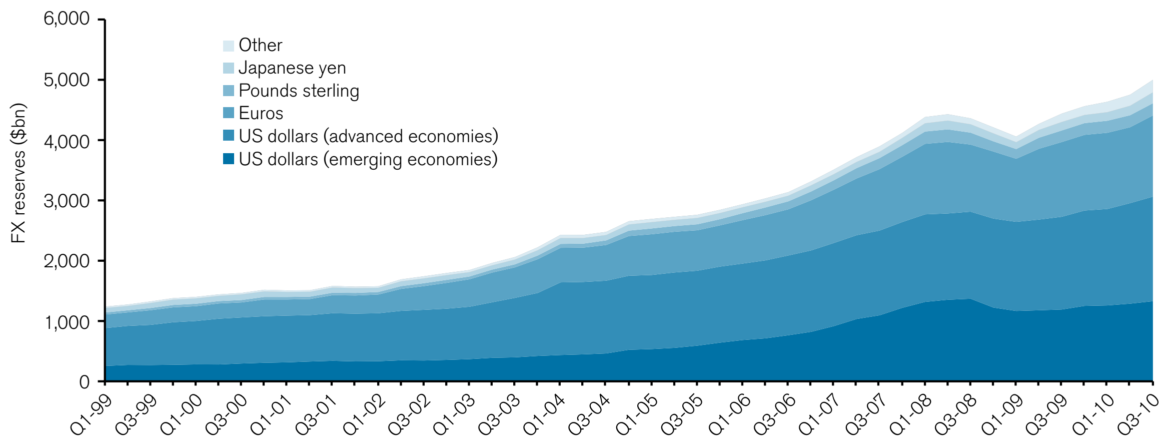
The adjustment paths for unwinding current account imbalances in SICs require a common diagnosis of the policies required. This can ease the international tensions surrounding the topic by allocating the burden of adjustment. While ensuring that macroeconomic stability remains a critical short-term goal, the unwinding of current account imbalances needs to be tackled in the medium term to facilitate a sustainable global solution in the long run.[14]

2.1.3 Reform of the international monetary system

America's reliance on exchange rate depreciation to help correct its current account deficit is increasingly being viewed by other countries as incompatible with its role as the issuer of the international reserve currency. Phases of dollar weakness in the pre-crisis period were beginning to challenge confidence in the dollar as the world's reserve currency and, along with recent capital flows, have stoked interest in reforming the international monetary system. At the same time, however, there has been a massive accumulation of reserves, most notably in China, where it is linked primarily to its own domestic policy stance. These episodes, along with the problems of the immediate post-crisis recovery period, have shown that the US dollar, which is at the core of the current system, has been subject to competing forces in its role in promoting domestic policy goals – price stability, growth and employment – and its role as the primary reserve currency. Figure 2.2 indicates a growing interest in diversifying FX reserves by increasing use of the euro (which is reaching around a third of total allocated reserves).

Consideration of these trends raises the question of how to improve the functioning of the international monetary

Figure 2.2: Currency composition of known allocated reserves ($ billion)



Source: IMF

13 The issue, often, is that private businesses have limited access to credit from state-owned banks, commercial banks and financial markets, leading them to rely on retained earnings as a main source of investment.

14 The G20 meeting of finance ministers and central bank governors in Paris in February 2011 led to an agreement on a set of indicators that would be used to measure global economic imbalances including public debt and fiscal deficits, private savings and borrowing, the trade balance and other components of the balance of payments such as net investment flows. However, a few other key indicators – real exchange rates, foreign currency reserves and current account balances – were not listed in the February agreement.

system in facilitating adjustment within countries and across the system to economic and financial shocks. The common lesson offered by the gold standard, the Bretton Woods system (see Chapter 3) and the current system is that what matters is the adjustment mechanism, and not the choice of reserve asset. This relates directly to the role that a more market-determined exchange rate system can play in helping countries respond to current and changing circumstances. Fundamentally, what is called for is agreement on the rules of engagement to promote well-functioning markets.

The reform of the international monetary system should not be expected to be a 'big bang' (Subacchi, 2010), but instead a long, gradual process of incremental change and adjustment. The potential options, looking out over the longer term, include a partial or total switch to a multi-currency reserve system that would better respond to the needs of a multipolar economy, the internationalization of the Chinese renminbi, and a switch to the use of a supra-national reserve currency – likely to be built upon the Special Drawing Right (SDR),[15] used with the IMF. Of immediate concern to the global economic community should be how to ensure and manage liquidity in the system while avoiding the over-accumulation of FX reserves in order to support sustained growth and high levels of employment.

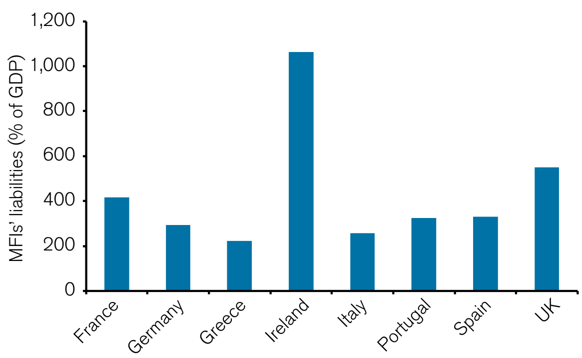
However, to bring about the long-term systemic changes in the international monetary system and to ensure the transition does not cause any negative shocks to the global economy, international economic cooperation is needed. By acting in an uncoordinated, unilateral fashion, countries could potentially incur a longer than required period of high unemployment as well as transition costs of capital losses on reserve holdings and loss of network benefits (Meissner, 2010). Even the best interim solution – governments collaborating to ensure the current international monetary system functions as smoothly as possible – requires some degree of policy cooperation by all major economies. This would entail exchanges of information about current and future policy decisions although countries will retain their ability to pursue policies that are in their best interest (Subacchi, 2010).

2.1.4 Financial regulation

International economic cooperation is important in the field of financial regulation. Reform in that field took a prominent place on the G20 agenda in the wake of the global financial crisis and is essential in preventing repeated instability. Furthermore, because of the possibility of regulatory spillovers and arbitrage, regulatory reform needs to be carried out in a coordinated way at the global level. Already, significant steps forward have been taken in financial regulation through policy cooperation; however, there are numerous challenges ahead on which sustained cooperation needs to be maintained. Cooperation is required to develop a framework for monitoring national and external balance sheets, and understanding the costs and benefits of expanding the banking sector. Countries with large banking sectors carry disproportionate risks – as demonstrated by the crises that afflicted Ireland and Iceland following their banks' collapse (see Figure 2.3). This may also instigate discussion over whether banking systems should be restricted to a proportion of the domestic economy to limit international exposure.

International policy cooperation is also critical for sustaining commitments to implement reforms towards the creation of a globally consistent financial system. The time-horizon for financial regulatory reform is often misaligned with political time-horizons. For example, the

Figure 2.3: Monetary and financial institutions' liabilities (excluding Euro system and national central banks, % of GDP)



Sources: ECB, IMF (2010 GDP projection)

15 The SDR is a unit of international reserve asset, created in 1969 by the IMF to supplement IMF members' official reserve assets. Its value is defined by the value of a basket of currencies.

Basel III reforms, such as raising capital requirements for banks and introducing counter-cyclical capital requirements, will be phased in between 2013 and 2019. During this period, policy-makers, facing shorter time-horizons, are likely to face incentives to deviate from a cooperative solution by not complying with internationally agreed standards because that may improve the competitiveness of their financial sector.[16]

Moreover, for successful financial regulatory reform, implementation needs to be coordinated by advanced and emerging economies alike. Currently, the SICs within the financial system remain concentrated in advanced economies, yet developing economies' financial sectors are evolving rapidly and will play an increasing and more systemically important role in the global financial system. The key benefit from internationally concerted reform of financial regulation is preventing a repeat of the crisis of 2008–09 and its lasting impact on the real economy. Therefore, continuing and improving engagement among economies in the G20 for financial regulatory reform is crucial.

2.1.5 Commodity price volatility and development[17]

The G20 has also made development a key issue on the agenda with the 'Seoul Development Consensus' unveiled at the November 2010 summit. While a significant proportion of the world's poor live within G20 member states, promoting development is a key ingredient for broadening the horizon of the G20 so that it is accepted by non-members as a legitimate body to make decisions that shape the world economy. Under the French presidency, commodity prices have moved up the agenda, reflecting concerns about commodity price volatility and food security, especially for those underdeveloped countries and regions exposed to high levels of poverty and unemployment.

During the global financial crisis, the world's poorest countries experienced a deep recession as a result of a sharp fall in both export volumes and (in the case of commodity producers) commodity prices (Draper, Freytag and Bauer, 2010). This interrupted two periods – pre- and post-crisis – when poverty levels were pushed upwards by spiking commodity prices, in particular for agricultural goods. The unrest caused by rising inflation and poverty in large food-importing countries has also dramatically demonstrated how destabilizing commodity price volatility can be.

A cooperative approach to monitoring commodity prices and improving the functioning of these markets to reduce volatility could generate significant welfare gains.[18] For advanced economies, it might reduce the incentive to provide substantial safety nets for their domestic agricultural sector, thus boosting the trade prospects for developing countries. For the latter, specific measures to foster the exchange of scientific progress on increasing agricultural yields and improve the distribution infrastructure would reduce supply bottlenecks and price inflation.

2.2 A difficult environment for cooperation

2.2.1 The relative decline of advanced economies

The pre-crisis episode of credit-fuelled growth and housing market bubbles proved unstable. While the United States may still be able to generate respectable growth rates on the back of strong domestic demand, other economies, for instance Spain and Ireland, which were also afflicted by the collapse of the property market, face great difficulty in re-stimulating growth and stabilizing their financial sectors.[19] Economies with existing strengths in advanced

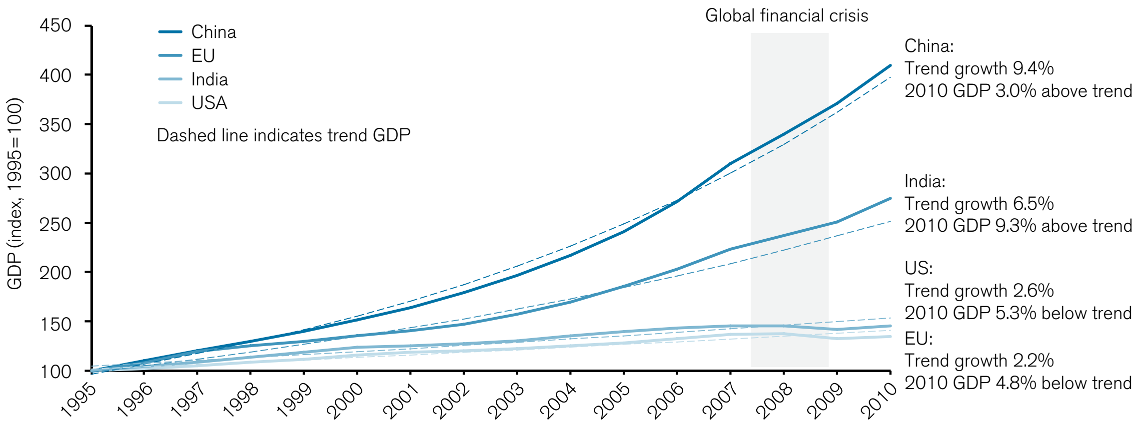
16 For example, not imposing the surcharge on financial institutions as the Basel III counter-cyclical capital requirement package requires.

17 This discussion on the agenda for commodity price volatility and development builds upon presentations made by Helmut Reisen and Peter Draper in London in December 2010 at the Chatham House–CIGI workshop on 'International Policy Co-operation' (see Appendix).

18 For emerging economies, significant welfare gains could also be made through liberalizing trade. Calculations by the OECD suggest that the highest benefits exist in reducing tariffs on trade between emerging economies. If these were reduced to the levels of advanced economies, the potential welfare gains could total $59 billion, over twice the potential benefits to emerging economies if the same reduction were applied to their tariffs on trade with advanced economies. See Reisen (2010).

19 Prior to the crisis, Spain had the largest housing market in the European Union, with 900,000 housing starts recorded in 2006. Nearly 20% of GDP was in some way related to real estate or construction, and one-sixth of the workforce employed in it. Meanwhile, the Irish housing construction boom, at its peak, resulted in one house being completed for every fifty people. Following the collapse of their housing markets Ireland and Spain have suffered from weak financial sectors, burdened by bad debts, as well as high unemployment (reaching over 20% in Spain).

Figure 2.4: Real GDP (index, 1995 = 100) and trend GDP



Source: Chatham House calculations and IMF data

manufacturing, such as Germany, have improved the competitiveness of their exports in response to the increasing demand from emerging markets. Yet for other advanced economies taking similar advantage would require a radical restructuring of their industrial base.

Moreover, the rise in public debt associated with government stimulus packages and bail-outs for the financial sector, alongside weak domestic consumption and high unemployment, make the future prospects for advanced economies uncertain and fragile at best.

With these structural factors in play, there is a clear possibility that potential output growth in advanced economies has been lowered by the crisis (European Commission, 2009; Furceri and Mourougane, 2009). Figure 2.4 illustrates how actual output is well below trend in advanced economies, while above trend in the major emerging economies. The economic challenges are particularly notable on the periphery of the Eurozone, but they are also clearly a cause for concern in major economies including the United States and the United Kingdom.

This relative decline of the advanced economies has led some to view the post-crisis world economy as a zero-sum game – i.e. one country's gain is another's loss. In addition, the expansion of the emerging markets within the global economy represents a decline in the relative prosperity of advanced economies (as discussed in Chapter 1).

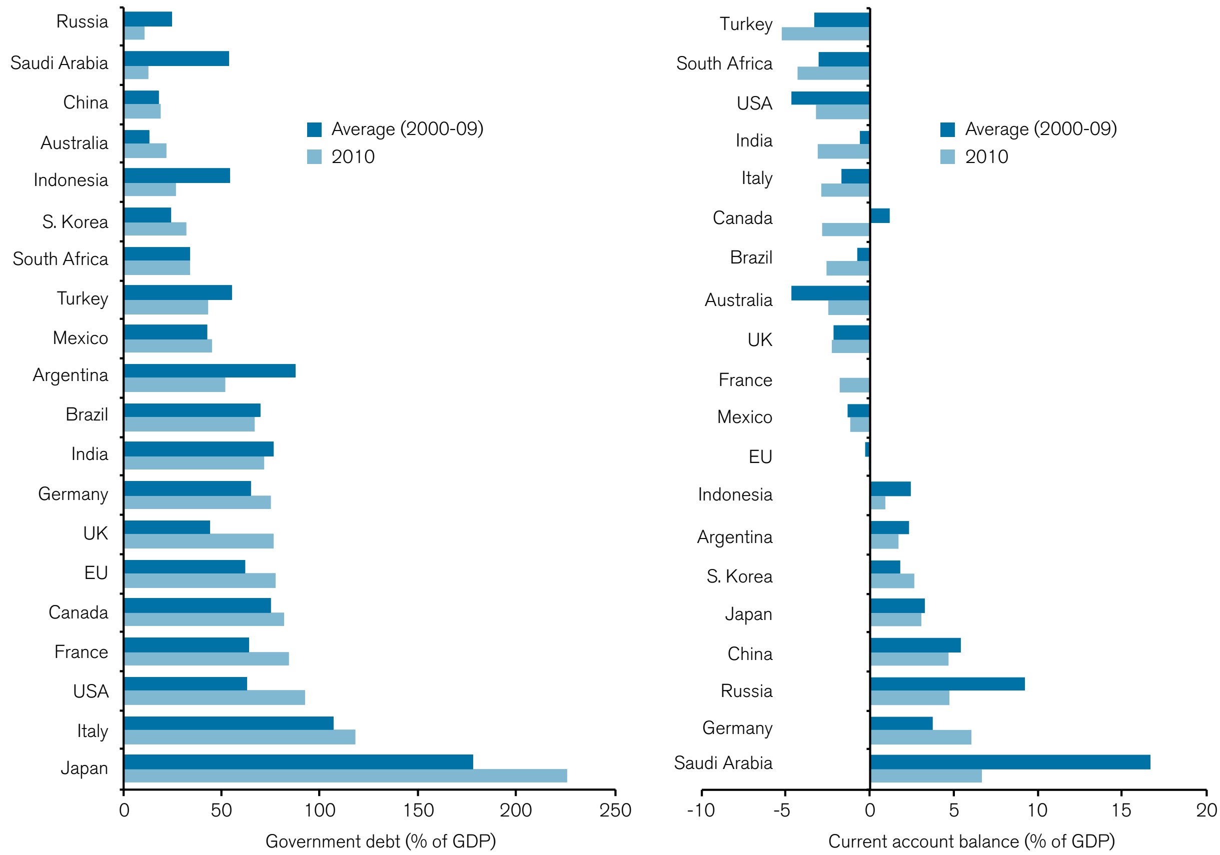
It is clear that, alongside long-term adjustments needed in advanced economies, the shift towards a multipolar world also implies additional pressures for short-term changes involving shifts in industries, labour markets and competitiveness. While there are net gains for all at the aggregate level, within countries there are groups that stand to lose. While certain sectors in advanced economies have suffered a decline as a result of emerging-market competition, what is overlooked in such an assessment is that there are gains to be made for individual economies from a stable and growing world economy, even if the distribution of the gains is uneven.

2.2.2 An unbalanced world economy

In the aftermath of the financial crisis, the world economy is not balanced on several critical fronts: differing pace of economic recovery, large and growing current account imbalances, and private- and public-sector balance sheet imbalances. With stimulus measures set to unwind and fiscal consolidation under way in some economies, a rotation of demand with higher savings in advanced countries and stronger domestic demand in emerging economies is needed to address the multi-speed recovery and current account imbalances. As shown in Figure 2.5, the government debt situation in advanced economies had deteriorated significantly by 2010, while emerging markets generally managed to improve their fiscal situation over the last decade.

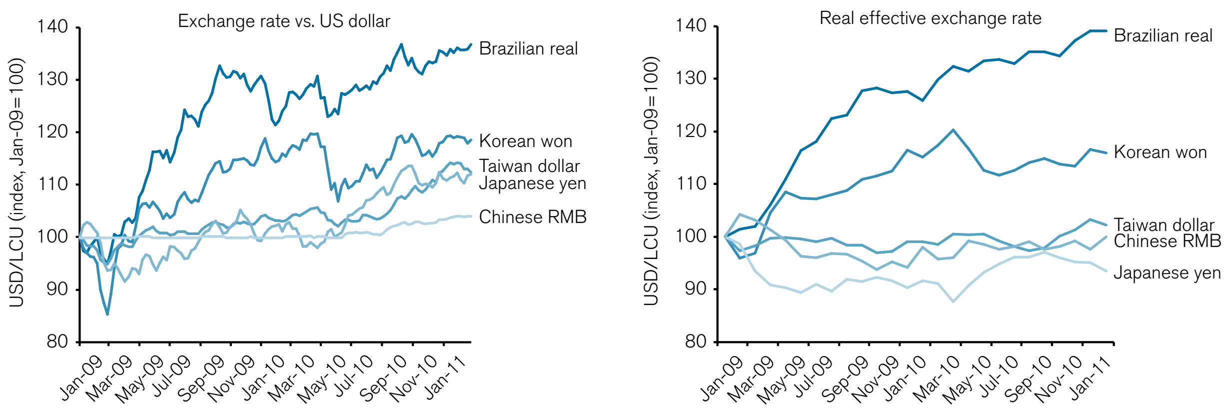
In the light of their circumstances, many advanced economies have aimed to boost growth through exports

Figure 2.5: Imbalances in the global economy – G20 government debt (lhs) and current account balance (rhs), both as % of GDP



Source: IMF World Economic Outlook

Figure 2.6: Selected currencies against the US dollar (lhs, index, Jan-09 = 100) and real effective exchange rates (rhs, index, Jan-09 = 100)



Source: BIS, Oanda

Box 2.1: The current global economic setting

While the 2008–09 recession saw a convergence of national priorities as the world's economies were peering into the abyss together, the recovery in 2010 brought with it familiar short-term economic trends. GDP growth in the emerging economies has pulled far ahead of their still struggling counterpart in advanced economies, while current account imbalances are growing. The IMF expects advanced economies to grow by 2.5% in 2011, in contrast to 6.5% for developing countries.[a]

Levels of output and employment vary considerably across the G20, with some countries back to, or above, pre-recession levels, while other countries remain well below previous levels. Thus considerable unused capacity and unacceptably high unemployment still exist in many advanced economies, with consequential disinflationary pressures, while production capacity limits are being approached elsewhere, placing upward pressure on inflation. For example, in the United States and the United Kingdom, unemployment is well above its long-run trend (by almost 5% of the labour force in the former). Nevertheless, in some European economies, where rigid labour markets and low productivity growth have contributed to stubbornly high unemployment rates, unemployment is more or less consistent with its long-run trend. In contrast, many emerging-market economies are contending with excess demand and rising inflationary pressures. Their efforts to contain these pressures are being complicated in some cases by a lack of exchange rate flexibility.

The pressure on prices is most vivid in terms of the recent surge in energy and food prices. The strong economic growth and domestic demand coupled with high levels of government spending have contributed to inflationary pressures in emerging-market economies such as Brazil, India and China. However, with commodity prices, in particular energy prices, surging over the recent political turbulence in North Africa, there is a clear potential for inflationary pressure in many parts of the world.

Growth, albeit weak, has returned to advanced economies, yet the repercussions of the crisis will weigh heavily for an extended period. The rise in public debt associated with government stimulus packages and bail-outs for the financial sector dampen the outlook for growth. Given falling tax revenues accompanying the increase in expenditure, governments have taken on significant fiscal deficits – of over 10% of GDP in many advanced economies. High deficits sustained over a period of several years, in turn, bring rising government debt levels. The IMF estimates that general government debt for the G20's advanced economies reached 97% of GDP in 2009 and could rise to 115% by 2015.

a Although these projections do not take into account recent events such as the natural disaster in Japan and political unrest in North Africa.

while pursuing fiscal consolidation (the United States being a notable exception). At the same time, many emerging-market countries have resisted the implied adjustments for them. As a result, economic policies have become increasingly unilateral, with spillovers arising from economic interdependencies not being fully considered. This has brought to the fore the nature of policy conflicts facing the world economy and the risk that retaliatory measures taken in response to these spillovers will undermine the nascent global recovery.

Another sign of tensions arising between what is viewed as desirable domestically versus what is desirable internationally is the very accommodative monetary policy in the United States. Since the crisis the American policy objective has been to boost US aggregate demand and domestic output growth. However, while stimulating the American economy is beneficial for the rest of the world, the drop in the value of the US dollar that has accompanied loose monetary policy has raised the spectre of 'currency wars' – a phrase first used by Brazil's finance minister in

September 2010 to denote tit-for-tat competitive depreciations to boost exports and reduce imports. A number of Asian and Latin American economies (notably Brazil, Taiwan and South Korea), with their exports coming under increasing pressure from the dollar depreciation and China's managing of the value of the renminbi, have intervened in the FX market or imposed capital controls to manage the volatile capital inflows and to halt the associated appreciation of their currency (on the back of high inflows; see Figure 2.6).

These pressures mounted at the time of the United States' $600 billion second round of quantitative easing announced in November 2010. The stated objective of this measure was to provide further support for the US recovery, and therefore indirectly help the rest of the world, given that the US economy is still one of the main drivers of global economic growth. However, those countries that depend heavily on exports to the United States perceived its monetary policy as a competitive measure to depreciate the dollar that encouraged high capital inflows from the United States into emerging economies (in the quest for high returns). At the same time, however, those countries resisting exchange rate appreciation risk higher inflation in response to the underlying strength of their economies and rising commodity prices. As noted earlier, fundamentally these currency conflicts are a symptom of deeper disagreement on the distribution of adjustment burden in addressing global imbalances.

In summary, despite the recognition of greater interdependency between economies, and of the nature of today's global challenges, the prospects for economic cooperation are by no means assured. The following chapter provides historical analysis to help assess the factors that encourage the success or otherwise of international economic policy cooperation.

3. Cooperation and Coordination: Lessons from the Past

The need for international economic policy cooperation is not new, although it can be argued that the rapid pace of economic integration over the last two decades has made the need more evident and urgent. In particular, past experience suggests that cooperation is strongest when interdependencies that bind nations together also create instability. Ideally, all policies that generate spillover effects need to be harnessed within a cooperation framework. However, this is difficult in practice, and what can be coordinated are the adjustment policies, even if this is a second-best outcome.

The post-war period offers several prominent examples of international economic cooperation[20] and a reading of the history of economic cooperation confirms that the most successes came as the result of a crisis – Bretton Woods following the Second World War, the Chiang Mai Initiative after the Asian financial crisis of 1997, and G20 cooperation during the global financial crisis.

This observation raises the critical question of whether cooperation is only feasible when interdependencies are made clear by incidents of instability and volatility, as happens during economic crises, i.e. when the cost of non-cooperation is made painfully evident. The challenge is to design a framework for multilateral policy cooperation and turn it into common practice. As the world's economies are no longer 'diving together',[21] it is important for policy-makers to recognize that in certain policy areas – those that generate identifiable spillovers – the net gains from cooperation are higher than those from non-cooperation. This recognition, coupled with greater understanding of the interdependencies and spillover effects, should provide policy-makers with the essential information to tackle a number of challenges facing the global economy. However, in tackling the current set of challenges detailed in Chapter 2 it is prudent to bear in mind the lessons offered by past instances of international economic cooperation.

3.1 The Bretton Woods era

In the light of the crisis of 2008–09 and, in particular, the global imbalances that have emerged in the past couple of decades, the Bretton Woods system is an attractive example for international economic cooperation today, for three reasons. First and most importantly, current account imbalances were much smaller during the Bretton Woods era than in the ensuing period up to 2008. This period of moderate imbalances was followed by a serious deterioration in the post-Bretton Woods period (Walter, 2010). Secondly, the recent threat of a return to 'beggar-your-neighbour' policies – resisting exchange rate appreciation, the imposition of taxes or fees to limit capital mobility, and the ever-looming threat of trade protectionism – is not conceptually different from the protectionist measures that contributed to the economic misery of the late 1920s and 1930s that preceded – and motivated the design of – the Bretton Woods system (Siklos, 2010). Thirdly, the Bretton Woods system was adept at 'tying the hands' of policy-makers. This is an appealing factor because 'individual members cannot be trusted to deliver policies that evince a concern for the collective or because a desire for "fairness" or balance in international arrangements is deemed to be a desirable objective' (Siklos, 2010: 5).

20 Economic policy-makers also interact on a regular basis in international financial institutions – the World Bank, the IMF and the regional development banks – and international organizations such as the Bank for International Settlements (BIS) and the OECD.

21 'As the financial crisis entered its latest, explosive phase, the leading OECD economies were already diving into an unusually synchronized recession, driven by a simultaneous collapse in consumer and business spending and the rising threat of job losses and bankruptcies' (Rossi, 2008: 2).

Box 3.1: Historical examples of international economic policy cooperation – a brief overview

The Bretton Woods agreement (1944)

Following the collapse of the gold standard in 1931 and in the aftermath of the Great Depression and the Second World War, the Bretton Woods Conference of 1944 sought to rebuild the international monetary system. Specifically, it attempted to prevent the 'beggar-your-neighbour' policies such as competitive devaluations that contributed to the breakdown of the gold-based international monetary system and prolonged the Great Depression.

The agreement established a set of rules, institutions and procedures to govern the international monetary system that lasted from 1946 to 1973. This included a commitment to monetary policy consistent with maintaining exchange rates aligned to the price of gold and/or the dollar.

The Bonn Summit (1978)

The collapse of the Bretton Woods system led to the gradual advent of a floating exchange rate system for major advanced economies with the US dollar as the key reserve currency. In addition, it led to the informal meeting of the finance ministers of the world's major industrialized nations. The economic summit held in Bonn in July 1978 brought together the leaders of seven major economies – Canada, France, West Germany, Italy, Japan, the United Kingdom and the United States, along with delegates from the European Community.

Putnam and Henning (1989) consider the agreement announced at the Bonn summit conference to be 'the clearest instance yet of discretionary international economic policy coordination'. West Germany and Japan agreed to adopt fiscal stimulus measures in exchange for a commitment from the US to raise the domestic oil price to world levels and the European consent to successful conclusion of the multilateral trade negotiations within the General Agreement on Tariffs and Trade (GATT). However, the fall of the Shah of Iran and the second oil price crisis changed the priorities of policy-makers worldwide and made the Bonn agreement rapidly obsolete.

The Plaza Accord (1985)

American domestic policies aimed at boosting competitiveness had significant spillovers on other countries, often needing multilateral discussions and concerted interventions. To respond to the US concerns about the strength of the dollar, in January 1985 the G5 (France, West Germany, Japan, the UK and the US) agreed to work together in order to achieve greater stability of exchange rates and reaffirmed the commitment made at the Williamsburg Summit (in 1983) to undertake coordinated action in the markets. This achieved very little, partly because FX markets were unsure about the discordant signals emanating from the United States. The rest of the year was therefore spent in carving an agreement that would see the full involvement of the United States in the stabilization of currencies as just one element in a much bigger picture of economic policy coordination aimed at achieving sustainable growth of output and employment levels as well as monetary stability.

The Plaza Accord succeeded in alleviating the United States' trade deficit with West Germany. But it failed to do so for the trade deficit with Japan, which was defined more by structural factors and therefore was generally insensitive to relative prices.

The Louvre Accord (1987)

Despite the careful US management of the depreciation of the dollar following the Plaza Accord, underlying tensions between the United States, Europe and Japan on policy efforts to revive economic growth persuaded the market of the intrinsic weakness of the accord. The dollar, as a result, continued to depreciate. The Louvre

Accord, signed in February 1987, aimed to prevent further dollar depreciation and stabilize international currency markets. It was in fact the G6 (Canada, France, West Germany, Japan, the United States and the United Kingdom) that agreed to 'cooperate closely to foster stability of exchange rates around current levels' (Saccomanni, 2008).

The Louvre Accord was ambitious. It considered not only currency realignments but also the coordination of fiscal and monetary policy. France, West Germany, the United States and the United Kingdom all agreed to reduce public spending and enact tax cuts.

However, the accord collapsed within a year. German interest rate rises to combat inflation sparked similar rises in the United States, which in turn raised the yield on long-term US government bonds. This prompted liquidity interventions in the United States and a fall in the value of the dollar.

The Chiang Mai Initiative (2000)

The regional Chiang Mai Initiative (CMI) came about as East Asian countries sought to improve liquidity in the aftermath of the Asian financial crisis of 1997. Under CMI multilateral currency swaps are arranged between the ten member states of the Association of South-East Asian Nations (ASEAN) as well as China, Japan and South Korea.

The CMI achieved further importance during the crisis of 2008–09 with the multilateralization of the currency swaps in 2009. The core objectives of these swaps are to address balance-of-payments and short-term liquidity difficulties in the region, and to supplement the existing international financial arrangements. The initiative has successfully amassed financial resources totalling some $120bn.

Coordinated interest rate cut (2008)

As the world economy entered recession in 2008, the central banks of the United States, Canada, the United Kingdom, Sweden and Switzerland, as well as the European Central Bank, coordinated a 50-basis-point interest rate cut in October 2008. The coordinated cut was intended to send a strong signal to the public and to markets of their resolve to act together to address global economic challenges.

Although the coordinated rate cut failed to calm the markets at that time, its important signal to markets was followed up by further significant interest rate cuts across most developed countries The nature of this policy coordination was unprecedented.

European Financial Stability Facility (2010)

The creation of the European Financial Stability Facility (EFSF) supported by the Eurozone members and the IMF was an emergency response during the Greek sovereign debt crisis in May 2010. It played a significant role in reassuring the markets and preventing the contagion.

However, the success of the Bretton Woods arrangement in constraining global imbalances is debatable. Other features of that era, such as capital controls and financial repression, also contributed to constraining global imbalances. Thus in a world characterized by fewer capital controls, greater financial openness and floating exchange rates, the suitability of a Bretton Woods-style arrangement for unwinding global imbalances is questionable.

The Bretton Woods system did recognize the inherent problems related to global imbalances. Although the negotiations in the early 1940s sought to assign special responsibilities for the main reserve centre countries and implement symmetric adjustment responsibilities between surplus and deficit countries, they did not produce any lasting agreement on adjustment principles. Even during the 1960s and 1970s, notably during the reform negotiations, the United States continued to refuse special reserve centre responsibilities and the surplus countries refused symmetric adjustment responsibilities (Walter, 2010). Domestic political constraints on all policy-makers and power asymmetries favouring the United States, West Germany and France also provide explanations for the inability of Bretton Woods to produce an agreement on adjustment responsibilities (Walter, 2010).

In the early 1970s the mounting pressure on the US currency from a confluence of factors including growing trade deficits and the cost of the Vietnam War led to abandonment of the fixed exchange rate and the introduction of floating exchange rates. The breakdown of Bretton Woods had three significant consequences relevant to contemporary discussion on international economic cooperation. First, it led to the informal meeting of the finance ministers of the world's leading economies that evolved into the G7, which helped to coordinate currency adjustment in the Plaza and Louvre Accords in the 1980s. Secondly, it led to greater economic integration among European countries, which eventually resulted in monetary union in 1999. Thirdly, it led to greater financial integration in the following decades, encouraged by the deregulation of currency markets, and rules about banking and investment. This also caused increased flows of funds globally, tightening the financial linkages between economies and therefore fundamentally changing the nature of interdependencies with ramifications for the stability of economic growth.

A significant lesson needs to be drawn from the Bretton Woods agreement. As Pierre Siklos (2010) argues, policy-makers promised too much and failed to instil the logic of collective action among the system's members. In particular, they failed to elucidate the governance issues at the outset. This eventually resulted in the collapse of the agreement.

3.2 The 1970s to the 1990s – the Plaza and Louvre Accords

Following the collapse of the Bretton Woods system, attempts to cooperate on economic policy did not cease. Informal discussions developed into formal meetings – such as the G5 and then the G7 – at which, although there was generally no agreement on the coordination of policies, 'the exchange of information and views that takes place on these occasions is considered an important vehicle for enhancing the quality of economic policy-making among participating nations' (Meyer et al., 2002).

Several trends during this period shifted the emphasis away from attempts at international economic cooperation. The emergence of central bank independence and the focus on price stability as the appropriate mandate for central banks brought with it a reduced emphasis on international considerations. The realization that floating exchange rate regimes, combined with a suitable anchoring of domestic inflation, might yield desirable economic outcomes, as reflected in the Great Moderation, caused formal attempts at international economic cooperation to be undertaken at a lower level (Siklos, 2010).

While these decades saw reduced levels of – or even reduced perceptions of the need for – cooperation, the second half of the 1980s still witnessed several examples of major industrial economies cooperating with a focus on exchange rates as countries struggled to put in place sound policy frameworks after the collapse of the Bretton Woods arrangement. This resulted in the Plaza Agreement of September 1985 and the Louvre Accord of February 1987 (see Box 3.1). These attempts to resolve currency misalignments met with some success and have implications for current attempts at economic cooperation.

The Plaza Accord was significant for three reasons. First, it recognized Japan's emergence as a real player in the international monetary system. Secondly, it introduced a strategy for dealing with macro imbalances that was based on a combination of exchange rate movement and macroeconomic policy adjustments (Chin, 2010). Finally, the accord displayed the American influence over Japan and reasserted US hegemonic status in the global economic order of the 1980s. Japan, plausibly owing to its Second World War history and the threat of the US economic restriction, submitted to American dominance of the world economy. However, what distinguishes the current debate from that of the 1980s is that China, unlike Japan, wants to play a more active role in the world economy.

It can also be argued that the impact of the strengthened yen in Japan's export-dependent economy created an incentive for the expansionary monetary policies that led to the asset price bubble of the late 1980s and the two 'lost' decades after the agreements that allowed the yen to appreciate. This experience weighs heavily on the minds of Chinese policy-makers today in any negotiations over exchange rate adjustments sought by the United States. In the context of today's more dispersed economic power, it is unlikely that a single policy-maker would be able to forge such an agreement (Siklos, 2010). Last but not least, in a situation reminiscent of Bretton Woods, the agreed exchange rate levels established in the Louvre Accord lacked a governance mechanism. When domestic policy goals – in this case, Germany seeking to clamp down on inflation and the United States seeking to boost investor confidence through expansive monetary policy – conflicted with the international agreement to maintain fixed exchange rate levels, domestic goals took priority and the agreement collapsed.

3.3 The 1990s to 2008 – from European Monetary Union and the Chiang Mai Initiative to the global crisis

The 1990s witnessed a trend towards greater regional economic integration, with arrangements involving a limited number of members linked by shared interests. This includes the establishment of the European Monetary Union (EMU) and the Chiang Mai Initiative in Asia.

With EMU, the topic of coordination again found its way onto the policy agenda. The establishment of the monetary union and the adoption of a single currency and a common monetary policy have tied the hands of European policy-makers by removing one tool of economic policy while setting explicit fiscal targets in the Maastricht Treaty. Writing at the end of the 1990s, Mooslechner and Schuerz (1999) observed that Europe's currency union had not only raised a number of new and important questions concerning policy coordination but could also be interpreted as a surrogate for far-reaching forms of policy coordination.

The Asian financial crisis resulted in a significant milestone in the history of regional economic cooperation in Asia. In its aftermath, the shared need of East Asian countries to promote regional financial cooperation and manage regional short-term liquidity problems led to the Chiang Mai Initiative. This achieved further importance in the wake of the global economic crisis of 2008 with its multilateralization of the currency swaps in 2009.[22]

Also in the 2000s, various reform initiatives within the G8 architecture sought to address the challenges of policy cooperation and dialogue within the context of a changing global economic order. The 'Heiligendamm Process' or the 'G8+5' system, a dialogue between the members of the G8 and the major emerging economies (Brazil, China, India, Mexico and South Africa) on the biggest challenges facing the global economy, failed to take off significantly in terms of influencing international economic cooperation efforts.

As noted above, it was the global financial crisis of 2008–09 that introduced a new dimension to the policy cooperation efforts. With the world economies 'diving together' into recession, explicit attempts at policy coordination were made.

3.4 The crisis and the upgrading of the G20

In the aftermath of the collapse of Lehman Brothers it was recognized that the severity and global reach of the financial crisis required a broader, more representative group of countries to direct international policy-making than the G7/8. Criticized for being a 'talking shop' for the rich, the G7/8 did not have the capacity or the legitimacy to get things done (Cooper, 2010). Taking advantage of a pre-existing organization of the G20 forum of finance ministers and central bank governors, originally established in September 1999, a G20 summit at the leaders' level was promoted to fill the international governance gap at a time of crisis.[23]

This elevation of the G20 was cemented by the success of the November 2008 G20 Leaders' Washington Summit on Financial Markets and the World Economy, which led to an agreement on an unprecedented fiscal outlay – over $800 billion of discretionary measures in 2009 (IMF,

22 However, it is to be noted that the Chiang Mai Initiative Multilateralization (CMIM) has not been activated and the financial significance of the arrangement remains debatable.

23 Former Canadian prime minister Paul Martin was one of the first advocates of a leaders' forum at the G20 level (Martin, 2005).

2009a). Further, the summit produced a remarkably broad and ambitious consensus action plan. What was termed the 'Washington Declaration' resulted in agreement on 47 short- and medium-term objectives to promote growth and reform financial markets.[24]

Given the speed with which events were unfolding and the unprecedented nature of developments, coming to a common view of what was to be done was not easy. The Washington Declaration was important for restoring confidence in the world economy and mitigating the shock of the crisis. There was also a concerted effort by the G20 economies to avoid protectionist trade measures.[25]

Agreement by the G7 and then the G20 in October 2008 on common standards to restore the health of financial markets and prevent any further collapse of banks, following that of Lehman Brothers, accompanied by agreement on the need to provide significant fiscal stimulus to boost aggregate demand and confidence levels collectively produced a shift in the narrative of policy cooperation. Notwithstanding some detractors, the perceived success and the legitimacy of the G20 as an international forum have confirmed its credibility as a valuable forum.

In addition, during the financial crisis, other policy levers at the time were coordinated internationally in effective ways. The coordinated interest rate cut of 50 basis points by six major central banks in October 2008 sent a clear message to financial markets that they were alert to the crisis and willing to act together. The US Federal Reserve's authorization of the temporary foreign exchange swap lines with fourteen different monetary authorities was put in place to ensure liquidity provision. Furthermore, currently the central banks in the United Kingdom, the Eurozone, Switzerland, Canada and Japan have access to unlimited swap lines across different maturities. These arrangements alleviated the global shortage of dollar funding. Meanwhile, as the downturn spread through Central and Eastern Europe in 2008-09, foreign banks, which dominated the banking sectors in this region, faced an incentive to withdraw their activities – an incentive heightened by uncertainty over what other banks were doing. However, the capital flows associated with banks leaving could have had extremely detrimental consequences for the economies involved. In concert with the IMF and the European Bank for Reconstruction and Development (EBRD), at least 15 parent banks pledged to maintain their exposure to Bosnia, Hungary, Latvia, Romania and Serbia – economies all undergoing IMF assistance programmes (the so-called Vienna Initiative) – averting what was potentially a systemic crisis (IMF, 2009b).

The London Summit of G20 leaders in April 2009 transformed the G20 from a one-off event into an ongoing process with a rolling agenda (Subacchi and Helleiner, 2009). The September 2009 Pittsburgh Summit completed the power transfer from the G7/8 to the G20. In Pittsburgh, the G20 listed a number of objectives under a new 'Framework for Strong, Sustainable and Balanced Growth'. These objectives – both macroeconomic (such as price stability, addressing unsustainable fiscal deficits, avoiding destabilizing credit booms and busts) and structural (such as boosting long-run growth potential and strengthening social safety nets where warranted) – were complemented by other initiatives such as the establishment of the Financial Stability Board (FSB) to advance financial-sector regulatory reform and cooperation.[26]

The G20 also designed an ongoing Mutual Assessment Process (MAP) to gauge, on the basis of individual country inputs, how well they were expected to do collectively against the objectives of the framework, and what type of action they should be contemplating to effect progress towards them. In addition to these initiatives, existing commitments, such as the attainment of the UN Millennium Development Goals and maintaining an open trade regime, were confirmed at the 2010 G20 Summits in Toronto and Seoul.

The elevation of the G20 to a heads-of-state forum recognized the need to govern in new ways to reflect the rise of emerging markets to become sizable players in the world

24 In addition, the G7 October 2008 Plan of Action was an important first step in tackling the crisis.

25 However, some economies did not honour their commitments and implemented trade protectionist measures shortly after the summit.

26 For further details on the creation of the 'Framework for Strong, Sustainable and Balanced Growth' see Schwanen (2010). For more on the establishment of the Financial Stability Board see Helleiner (2010).

economy and the shift towards a multipolar world. With membership reaching beyond the traditional G7 lines, the G20 was empowered to operate more effectively with its cross-regional reach as a global 'steering committee' for problem-solving (Cooper, 2010). Indeed, the shift towards a multipolar world and the efforts to confront the legacy of the crisis have culminated in the elevation of the G20 to the premier forum on international economic cooperation.

The G20 continues to be focused on the reform of global economic governance, including reform of the international financial institutions. Those established at the time of the Bretton Woods agreement need radical overhaul to reflect the changing dynamics of the global economy. Nevertheless, gradual steps are being taken to transform key institutions such as the IMF and the World Bank. For example, the meeting of the G20 finance ministers and central bank governors in Gyeongju, South Korea, in October 2010 reached an agreement to reform the IMF, aiming to give developing countries a bigger voice by the annual meetings in 2012. Albeit small, these are steps in the right direction.

While the financial crisis generated a period of unprecedented international cooperation and coordination, it was driven by severe economic stress, and in some cases the measures were temporary in nature. The challenge going forward is to put arrangements in place to ensure that policies at the domestic level are also the right policies at the global level.

Box 3.2: Attempts at post-crisis coordination in the Eurozone

European economies have faced severe difficulties, first in establishing a cooperative solution to respond to the aftermath of the crisis and secondly in establishing policies to restore economic growth and reduce sovereign debt risks.

Recently there has been some progress towards improving recognition of interdependencies for moving beyond the crisis phase and seeking to improve growth and stability. In September 2010, European countries agreed to the European Commission's proposal for a 'European Semester' whereby members will *ex ante* coordinate budget and economic policies. As part of this process, the European Commission is considering establishing a scorecard of economic indicators for surveillance of imbalances within the region. However, this faces a number of problems. Indicators are backward-looking and the time lag between the release of indicators and policies being taken in response could undermine cooperation (Deutsche Bank Research, 2011). Moreover, actually enforcing responses to the build-up of imbalances is challenging, as was proved by the flouting of the Maastricht Treaty fiscal criteria before the global financial crisis.

Beyond the proposals made by the European Commission, the governments of France and Germany made proposals in February 2011 for a Eurozone 'competitiveness pact' to enhance policy coordination in the Eurozone, for example by making breaches of certain levels of public debt a constitutional violation. However, this proposal has raised controversy among Eurozone members over its likely effect on certain sectors. For example, recommendations to remove indexing of wages to inflation are likely to be contested in Belgium and Portugal where it remains commonplace, while suggestions that corporate tax rates could be harmonized could threaten Ireland's position as a hub for companies that benefit from low rates.

4. What Ties Us Together? Why Should We Cooperate?

The crisis of 2008–09 has contributed towards increasing awareness of how complex the world economy has become through trade and financial interdependencies. The global nature of the crisis made common interests and the costs of non-cooperation clear to policy-makers, and this resulted in the high levels of policy cooperation during this period. This observation is consistent with historical evidence, as discussed in Chapter 3. Past experience indeed suggests that countries tend to find cooperation easier at times of crisis and on specific policy areas. But, as happened in the post-war period, attempts at international economic cooperation tend to break down over tensions between national and international goals. In addition, the governance mechanisms of cooperative arrangements cannot cope when placed under the stress of conflicting national and international objectives.

Macroeconomic interdependencies, spillover impacts, transmission effects and risks of macro and financial instability make the case for policy cooperation – at all the different levels presented in Box 1.0 – compelling. Even if the world economy is no longer on the verge of collapse it is critical that nations cooperate on macro adjustment policies to address global imbalances, put the recovery on a robust and sustainable path and strengthen the international monetary and financial systems.

But even if these benefits are evident, and it is therefore easy to argue the case for policy cooperation at the theoretical level, it is much more complex to turn such a case into concrete policy action. Governments focus their economic policy-making on mostly domestic issues, where the gains to be reaped are more evident or tangible or appear larger. They are also not used to taking into account the potential for adverse spillover impacts of their policies and the fact that these create the ground for defensive responses from other governments and the markets. Such spillover effects can push the world into Pareto inefficient outcomes[27] and into a situation of disequilibrium and uncertainty.[28]

In this chapter we argue that the case for policy cooperation needs to be strengthened by helping countries to avoid Pareto inefficient outcomes with the potential for instability. This means identifying policy issues that need to be addressed through cooperation and assessing how policy goals, instruments and outcome are interconnected, and how wrong policies, or right policies inappropriately sequenced, could result in adverse spillovers and consequent instability. International policy cooperation is more likely to happen when there is agreement among countries over their respective economic outlook, the nature of the challenges they face individually and collectively, and the effectiveness of policies they wish to undertake. Cooperation should therefore be underpinned by an analytical framework where economic objectives, interdependencies and policies are consistent with the desired outcome, and where benefits from cooperation are clearly spelt out. Such an analytical framework should take into account countries' domestic policy goals and therefore be developed in such a way that domestic interests can be informed, and not weakened, by international goals. This requires clear identification of

27 Pareto efficiency is obtained when a distribution strategy exists where one party's situation cannot be improved without making another party's situation worse. An outcome is Pareto inefficient if redistribution of resources can improve one party's situation without making another party's situation worse.

28 As we discuss in section 4.1, in a Prisoner's Dilemma situation, while in a non-Nash equilibrium outcome each party can gain from 'beggar-your-neighbour' type of policies.

domestic policy goals as well as the interdependencies and spillover effects between domestic policy and the global economy.

Without a clear understanding of the nature and scale of economic interdependencies and of transmission mechanisms, policy-makers will not possess sufficient evidence of the benefits of international policy coordination to make it appear desirable. To achieve such understanding it is necessary to promote discussions on the diagnosis of interdependencies and spillover mechanisms that justify coordinated responses, and to consider the existing intellectual frameworks and determine their utility. Progress on such analytical frameworks is long overdue and will help us understand the nature and magnitude of interdependencies, see early signs of downturns and develop early warning signals, and create mutually consistent conditions geared towards economic growth and macro stability.

4.1 A game-theory framework – cooperation vs unilateral interventions

In this section, a game-theory framework is used in a stylized way to discuss the incentive structure facing policy-makers involved in international economic cooperation (Subacchi et al., 2010). Game theory provides a useful framework for analysing the strategic aspects of policy conflicts and coordination as well as the possible outcomes when international spillovers are present. Game theory's focus is on the actors, the strategies available to them and the potential payoffs, gains and losses that can elicit the conditions that may make cooperation more feasible.

In particular, this section looks at the incentives for cooperative behaviour versus unilateral intervention within the context of achieving the international goal of rebalancing the world economy together with the domestic goal of sustaining growth. The critical question is: if policy-makers face incentives to cooperate in an interdependent world, why do we observe unilateral action, i.e. defections from cooperative solutions, so frequently?

In some circumstances, cooperative strategies are clearly in the interests of all players. Consider a two-country world with countries A and B faced with the choice of implementing one of two different but equally good financial regulatory standards (Table 4.1). The desired outcome is that they implement the same regulatory structure (play the same strategy) while the sub-optimal outcome occurs when they implement different structures. In the latter case, there are likely costs arising from regulatory arbitrage and international spillovers.

Table 4.1: Payoffs for two countries facing a financial regulation policy choice

Payoffs (A,B)		Country B	
		Regulatory Standard-1	Regulatory Standard-2
Country A	Regulatory Standard-1	(10,10)	(5,5)
	Regulatory Standard-2	(5,5)	(10,10)

The above is an example of a Coordination Game. In the stylized example, it is clearly in the interest of both countries to pursue common strategies. However, in other circumstances, the incentives to coordinate facing policy-makers are less clear. Consider two symmetric countries, A and B, with mutual trade linkages, and both facing an exchange rate policy choice. For simplicity, we restrict the analysis to a static (one shot) game. If countries wish to boost their growth, *ceteris paribus*, they resort to exchange rate policies – currency intervention via the FX market – to achieve depreciation. This depreciation, to shift the demand away from imports as well as to promote exports, is a non-cooperative strategy as it has a 'beggar-your-neighbour' impact on trade partners. The country that depreciates its currency stands to gain at the expense of the other, *ceteris paribus*, by decreasing the foreign price of domestically produced goods and services and raising the domestic price of foreign products. Thus when a country takes an action that improves its own welfare and reduces the welfare of the other country, the country taking the action generates a negative externality for the other country. Moreover, competitive depreciation sparks a tit-for-tat reaction from the other country.

Table 4.2: Payoffs for two countries facing an exchange rate policy choice

Payoffs (A,B)		Country B	
		No Intervention	Currency Intervention
Country A	No Intervention	(3,3)	(1,4)
	Currency Intervention	(4,1)	(2,2)

For each country, unilateral 'currency intervention' is the dominant strategy because it generates a larger payoff irrespective of what the other country chooses to do. For instance, if country A chooses to intervene in the FX market while country B stays on hold, country A gains from changing its strategy. But this solution is unstable as country B, having slipped from a payoff of 3 under 'no intervention' to a payoff of 1 (Table 4.2), would now improve its position by intervening in the FX market. The situation where both countries play their dominant strategy (both intervene in the FX market) results a Nash-equilibrium outcome[29] in which they can no longer improve their position by unilateral action. However, this outcome is sub-optimal – the overall payoffs are lower than in the cooperative outcome (where both countries do not intervene in the FX market). This is because both countries bear the cost of FX intervention, yet relative prices (i.e. exchange rates between the two countries) will be at the same level as in the cooperative outcome.

This is an example of Prisoner's Dilemma where two players play non-cooperative strategies leading to a sub-optimal outcome – the payoffs are lower for both the countries than in case of cooperative outcome. This situation tends to prevail when one or both players are unsure whether the other player will stick to cooperation. In the example of intervention in the FX market, the risk of currency instability might induce countries not to cooperate rather than risk losing by adopting a cooperative strategy.

The Nash equilibrium in this Prisoner's Dilemma policy game is clearly inefficient – as both countries intervene in an attempt to depreciate their currency, relative prices remain unchanged, yet both countries will bear the cost of foreign exchange market intervention. Thus in a static game a non-coordinated economic policy outcome is typically inefficient, with both countries intervening in an effort to depreciate the currency. However, efficient outcomes can be achieved through 'cooperation'.

This stylized analysis provides an analytical framework for considering the incentive structure facing nations involved in international economic cooperation when they are interdependent.

In a static game 'cooperative' (efficient) outcomes are not sustainable without binding commitments, and a binding commitment is possible when there is a supranational authority that can punish departures from announced cooperative policies so severely that departures are not in a country's interest. By committing themselves, the countries can internalize the spillovers and maximize their joint gains. Nevertheless, it is difficult to conceive of countries surrendering significant sovereignty to supranational organizations, rendering sustainable cooperative outcomes unlikely (Mooslechner and Schuerz, 1999). However, certain instances of formal agreements between countries exist: with the adoption of the euro, member states delegated monetary policy to the European Central Bank, while in the area of trade relations, the World Trade Organization has the power to sanction retaliatory trade measures (Mooslechner and Schuerz, 1999).

In reality, countries are playing a repeating, or dynamic, game because policies can be made at any point in time and can be made more than once.[30] In dynamic games, countries are more likely to cooperate than in a static game. The long-run gains from cooperation outweigh the immediate gains from defecting if each policy choice can be made multiple times. Diffuse reciprocity may develop as international economic relations are marked

29 A Nash equilibrium is an outcome where no player benefits from changing his/her strategy unilaterally. This means that when deciding on a strategy each player takes into account the decision of the other player. In the case of the Prisoner's Dilemma the non-cooperative outcome (in this example, when both countries intervene in the FX markets) is a Nash equilibrium, but the equilibrium strategy is a non-cooperative one.

30 When the long-run gains from cooperation outweigh the immediate gains from defecting, countries playing an infinitely repeated game are more likely to cooperate.

by trust, and accepted forms of behaviour are built up. Nevertheless, recent events such as unilateral interventions in FX markets suggest that cooperation in the field of exchange rate policy is not being sustained.

A number of factors weigh heavily on the utility of a game-theoretical analysis. First, as shown by recent events, there is a time inconsistency between political (short-term) and economic (long-term) horizons. Politicians prefer policies that deliver economic gains in parallel with short-term political, and electoral, cycles. Such time inconsistency makes it difficult for political leaders to stick to, and implement, international agreements. This raises the question of whether a static or dynamic Prisoner's Dilemma game is more useful for analysis of current events.

Secondly, 'both the strengths and weaknesses of this analytical perspective rest on its unitary-actor, rational-choice assumptions' (Bryant and Hodgkinson, 1989). At a stylized level, game theory is extremely useful in illustrating the strategies available to countries. However, this stylization assumes away the more complex mechanisms through which decisions are made. In particular, it does not take into account the political context, both domestic and international.

Thirdly, domestic political concerns and a diffusion of power between domestic institutions means that a strategy may not be pursued by a country, even if this is in its own interest. Furthermore, domestic political concerns may lead to policy-making that, despite being aimed at domestic goals, has international spillovers. This, in turn, may be interpreted as uncooperative behaviour by other countries, provoking retaliation, or simply a defensive response, on their part.

Fourthly, there is a high degree of uncertainty surrounding the situations in which policy decisions are made. Policy-makers have imperfect information about other policy-makers' motivations and objectives as well as the actual impact of their own policies, both domestically and through spillovers.

Fifthly, even if cooperation can be forged in a repeated game, the mechanisms for sustaining cooperation present another challenge not tackled by game theory. In a repeated game, whereby one country cooperates on the condition that the other does, a monitoring mechanism is essential to convince each country that the other has not defected. Overcoming this challenge might require delegation of monitoring to a supranational body or a complex set of reliable indicators. The cost of compliance is therefore high, and it increases if the number of countries involved in cooperation rises (Bryant and Hodgkinson, 1989).

Finally, excluding issues highlighted above, without empirical evidence, game theory presents only a stylized account of the gains that can be reached from international policy cooperation. To persuade policy-makers to act cooperatively requires convincing evidence either of the gains from cooperation or of the losses from non-cooperative behaviour. The widespread use of economic models to project the impact of cooperative versus uncooperative behaviour offers a potential solution to this concern, yet it too is not without its problems.

4.2 Economic models

Economic models can help analyse global economic interdependencies, quantifying the benefits of cooperation. However, the macro-economic models in current use, while intellectually advanced, tend to be limited in their geographical or sectoral coverage. Moreover, there is a general perception that economic models failed to anticipate the financial crisis or even to explain it *ex post*.[31] Economic models in current use also lack the capacity to provide the necessary analytical framework for identifying the nature and complexity of economic and financial interdependencies. There is also a lack of agreement over their ability to demonstrate the benefits of international cooperation, certainly for all G20 countries. As a case in point, no one model stands out as having won a consensus of opinion. 'If the processes of model evaluation and model improvement worked ideally, inconsistencies across models would be gradually eliminated and a single model would become the encompassing, consensus model' (Bryant, 1995).

31 For example, the commonly used dynamic stochastic general equilibrium models do not model financial markets. See Tovar (2008).

There are a number of reasons why economic models may be inadequate for quantifying the benefits of cooperation. A high degree of model uncertainty surrounds the characterization of economic relationships employed for modelling – a factor exacerbated by problems of small data samples. More detailed issues that can be subject to dispute include exogenous parameters, such as how to treat expectations of private agents, and identifying when structural breaks in relationships may occur. As the IMF notes of its own Global Integrated Monetary and Fiscal (GIMF) model, 'as with any modelling framework, the analysis of policies and their effects is stylized and indicative. The simulation results are subject to uncertainty' (IMF, 2010a).

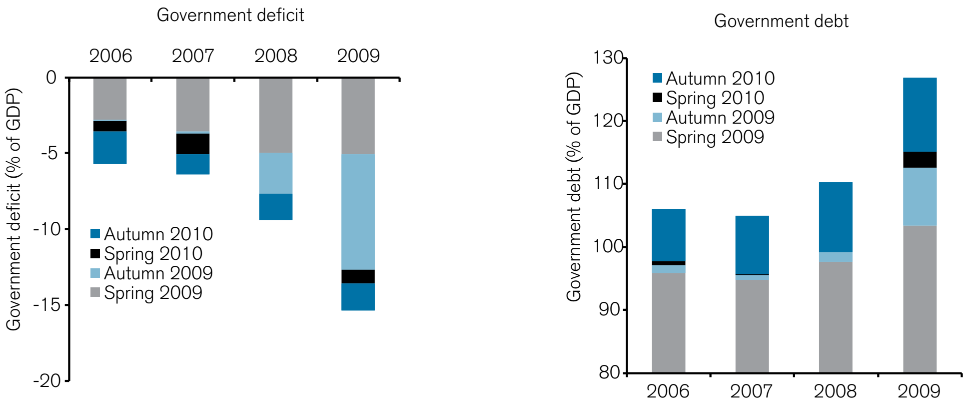
Owing to the computational requirements of economic modelling, current sophisticated models work at a low level of disaggregation. For example, the IMF's GIMF model, used in the G20's MAP to collate the policies of G20 countries and demonstrate the benefits of cooperation through scenario analysis, uses only five stylized regions – the United States, the Eurozone (split between Germany and the rest), Japan, Developing Asia and Rest of World. Without the finesse to consider the G20 economies as standalone components, it seems unlikely that this process can convincingly capture all the parameters and variables to promote cooperation across a range of issues.

Models are thus poor masters, but good servants. The G20 needs to consider supporting the development of a suite of models that over time will deepen its analytic capabilities for measuring the benefits of cooperative, collective outcomes.

Indeed, the financial interdependencies highlighted by the crisis bring to light new complexities in analysing the transmission of shocks and the scale of these shocks. This adds a new layer of detail into the development of economic models, which require more detailed incorporation of financial linkages. This would need to build on earlier work recognizing that financial markets do not operate without frictions or distortions, but are beset by agency, enforcement and coordination problems (Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997). The recent crises revealed 'liquidity spirals' that amplified the crisis caused by high leverage ratios and maturity mismatches, and highlighted the necessity of incorporating banks into models and the interplay between leverage and asset prices (ECB, 2010).[32] Devereux and Yetman (2009) demonstrate that when investors, with diversified portfolio holdings in a financially integrated world, are faced with binding leverage constraints, shocks are powerfully transmitted between countries. The scale of the transmission of the shock depends, in turn, on the level of financial integration and the degree of portfolio diversification.

Even with more disaggregated and sophisticated economic modelling that wins consensus on its working mechanisms, a concern must be raised about the consistency and reli-

Figure 4.1: Greek deficit and debt figures (% of GDP) based on biannual submissions to the European Commission in 2009–10



Source: European Commission

32 The IMF is currently undertaking work on addressing and incorporating these issues in the GIMF model. See Kumhof et al. (2010). See also Dib (2010) and Meh and Moran (2010).

ability of statistical data that countries are providing as inputs into models. Among some international groupings, bodies such as the OECD and Eurostat have encouraged the gathering of consistent statistics. However, some statistical data are politically sensitive and prone to manipulation (for example, unemployment and inflation figures are frequently rumoured to be subject to political manipulation in certain instances). Furthermore, producing consistent statistics becomes a more complex process when involving developing economies as well as advanced economies.

Capacity-building is therefore vital. Alongside developing consistent statistical standards, the data disseminated must be reliable and trusted by the countries' international partners. The dangers of misreporting of statistics are starkly illustrated by the Eurozone debt crisis during 2010, sparked by Greece unveiling drastic revisions to its debt and deficit figures (Figure 4.1). Not only did its statistical revisions destroy the credibility of its data, but they also occurred within the Maastricht Treaty, one of the most internationally rule-bound constraints on fiscal policy.

4.3 Towards an analytic consensus

A sound analytical framework is a crucial element for fostering cooperative agreements as well as a basis for stronger governance mechanisms. This leads to the question: what will help move us towards an analytic consensus?

The starting point for such progress is to recognize that the incentives to cooperate come from two basic overriding benefits: global economic and financial stability, i.e. avoidance of future crisis, and greater prosperity for all through growth of the global 'economic pie'. Moreover, in a multipolar world all countries stand to benefit from recognition of interdependencies and spillovers by the very fact that there is now more than one systemically significant player at the global level.

Taking into account the incentives for international cooperation, the current analytical toolkit contains the building blocks for a stronger framework for cooperation. Despite its shortcomings, it is important to appreciate that it does have considerable strength. Game theory is analytically valuable in terms of simplifying and analysing political decision-making processes and the outcomes of various strategies in a world of global interdependencies, as well as the incentive structure facing global actors. The key issues that game-theoretical analysis of economic cooperation brings out are that an analytical framework must be supported by:

- clear evidence of the costs and benefits of cooperation for policy-makers; and

Box 4.1: Incentives to cooperate

With the realization that the world economy is not a zero-sum game, contrary to what recent international economic events might suggest, and that we live in a tightly correlated world economy, there exist significant incentives to cooperate:

- Economic growth in one country has positive impact on other countries when policies across countries are collectively consistent in promoting growth and macroeconomic and financial stability.
- Business cycles have become highly synchronized. Recognition of this should motivate cooperation to better manage macroeconomic stabilization policies.
- Non-cooperation can endanger countries' own self-interest. Protectionism and closing of markets represent serious risks of non-cooperation.
- Timely and effective crisis management can be marshalled through channels of cooperation, especially if those channels are already well established. Prevention of crises through risk mitigation can also be fostered through regulatory cooperation.

- sophisticated tools and credible monitoring entities which can demonstrate that all parties are complying with the cooperative agreement, and potentially with the ability to sanction defections.

Economic models complement the insights offered by game theory by quantifying the costs and benefits that policy-makers face in pursuing different policy strategies. By evaluating the nature and scale of international transmission mechanisms, policy options and spillover effects, models provide policy-makers with choices and trade-offs for different adjustment paths. The challenge for models is to come to an agreed characterization of the functioning of the global economy. In reality, what this means is having a suite of models that over time will help to build a better understanding of what ties countries together.

5. A Framework for G20 Cooperation and Governance

As discussed in previous chapters, ad hoc international policy coordination tends to happen in times of crisis. In this chapter we argue that a framework for cooperation is needed – one that is sustainable over the long term and flexible enough to adapt to changing circumstances. Such a framework should be built on principles of good governance and should inform the G20 work in dealing with global challenges. The complexity of the immediate challenges facing individual countries sharpens the need to better understand the interdependencies that tie countries together and, accordingly, to adopt 'cooperation' as the *modus operandi* for conducting economic policy at the domestic and international level. Crucially, the framework for cooperation should be founded in the understanding that policy cooperation is more likely when it is recognized to be in a country's self-interest.

5.1 The need for a common diagnosis

Cooperation, to be effective, needs to be based on common economic objectives. While G20 summits have resulted in broad agreements on overarching principles and objectives for the world economy, it could be argued that the G20's goal of strong, sustainable and balanced global growth leaves much open to interpretation. This provides SICs with leeway to make domestic policies without due consideration of their international spillovers. Achieving common economic objectives, however, will involve distinct domestic policies that cater to varying national circumstances.

While a framework for G20 cooperation implies each country's responsibility for the health of the world economy, it has long been recognized that countries – especially SICs – are reluctant to subordinate their decision-making to any international authority enjoining them to cooperate, unless it secures clear advantages for them. This raises the question as to what specific policies for achieving global goals will in fact be domestically feasible.

Agreement on specific policies will require these to be recognized and explained in terms of domestic benefits, so as to gather domestic political support. The gains from cooperation must outweigh the gains from defection for it to be in policy-makers' interests, as we discussed in the previous chapter using the game-theory framework. It might also prove necessary to provide compensation for the domestic sectors that bear the greatest burden from adjustment policies.

A basic problem confronting the G20 is that the analytical foundations for understanding the costs and benefits from cooperation are not strong enough. Without a clearer

Box 5.1: Necessary elements of a framework of cooperation

The 'framework of cooperation' should comprise the following elements:

- an agreement on common economic objectives;
- a common diagnosis and agreement on the policies to deliver objectives;
- sequencing of the agreed policies to deliver objectives;
- monitoring progress against objectives; and
- accountability through openness and transparency.

comprehension of economic interdependencies, their mechanisms and magnitudes, spillover effects cannot be conclusively quantified. This prevents us from arriving at a consensus on the diagnosis of economic challenges and therefore achieving the adjustment paths that countries need to undertake to address these. Such a situation threatens to tip the balance of incentives towards unilateral action because individual countries are unable to evaluate the benefits from international cooperation and from unilateral domestic policies.

The G20 should therefore invest in strengthening its diagnostic capabilities in order to better understand how cooperative action (or its lack) can enhance (or thwart) the likelihood of achieving both domestic and global objectives. This is a tall order, one that cuts across all of the G20 priority areas. It includes, for example, the need to go well beyond the search for 'indicative guidelines' for the 'timely identification' of unsustainable current account imbalances to the identification of the policy actions by individual countries that are needed to correct global imbalances.

There are significant benefits to be gained from international agreements to devote more resources to institutions such as the IMF to improve their technical capacity. In addition, there are benefits if countries agree to exchange information. Greater information flows would allow each country to understand its partners' perception of its own and the rest of the world's position in terms of economic circumstances and the economic shocks by which they are being affected, as well as the scale and nature of interdependencies. Thus greater information flows, in the absence of consensus on key issues, will help domestic policy-makers when considering the international spillovers of domestic policy, even if the potential scale of these cannot be convincingly quantified.

5.2 Learning from experience to improve credibility and accountability

Even if the G20 countries can agree upon a diagnosis of current economic challenges and commit to undertake specific adjustment policies, sustaining these commitments requires improvements to the governance mechanisms so as to learn from the shortcomings of many historical examples of policy cooperation. The emphasis should be placed on developing and adopting processes that incorporate strong governance mechanisms – improving credibility through clear roles and responsibilities, individually and collectively, and improving accountability mechanisms through transparency.

Two processes that have been used in the past to monitor the progress on agreed objectives are *surveillance* and *peer review*. Although these processes fit well with the current G20 initiatives, there are concerns about their effectiveness and about how these processes have been implemented in the past. In meeting today's challenges, therefore, there are important lessons to be learnt from these earlier experiences of the global economic community.

First, the credibility of the surveillance process has been challenged by several factors. The objectives of surveillance[33] have been subject to various interpretations, both over time and among the membership. Secondly, the diagnosis of economic challenges has been negatively affected by the perception in many emerging economies that IMF surveillance is biased towards the interests of advanced countries. Thirdly, gaps in the surveillance process have also limited the usefulness and relevance of the diagnosis, further adding to credibility concerns. The most significant gap has been inadequate attention to outward policy spillovers, although the IMF has sought to regain the initiative in this area by proposing a new mechanism – spillover reports – that will show, on a trial basis, how each country's policies are affecting others. Finally, the accountability for the results of the surveillance exercises has been highly asymmetric, being more effective on the part of actual or potential borrowers from the IMF, but not effective at all on the part of SICs.

Peer review, commonly associated with the OECD and the European Commission, offers an alternative way for countries to talk to one another at a level that emphasizes trust, openness and the search for best practices. By eliciting the acceptance of evaluation of a country's policies by its 'peers', the process takes international cooperation efforts

33 These are specified in Article IV of the IMF Articles of Agreement.

Box 5.2: IMF surveillance

Surveillance is one of the core IMF functions and a critical element of its toolkit to promote global financial stability through international monetary cooperation. Bilateral and multilateral surveillance activities seek to promote policies that are consistent with 'the continuing development of the orderly underlying conditions that are necessary for financial stability' (IMF, 2006).

Bilateral surveillance refers to the IMF's surveillance over the policies of its individual members, typically conducted through periodic consultations with them, whereas multilateral surveillance refers to the surveillance of economic linkages and policy spillovers between countries as well as international economic and market developments. Bilateral surveillance is associated with dialogue with policy-makers and a well-defined output. Multilateral surveillance is associated with some well-defined outputs – the *World Economic Outlook* and the *Global Financial Stability Report* – but until recently it had little policy dialogue.

A new facet of IMF multilateral surveillance, the Multilateral Consultation (MC) was then designed to foster action-oriented debate and policy actions on a problem of systemic or regional importance. It aimed to bring together a small group of systemically or regionally important countries relevant to a particular problem to promote strengthened dialogue and ultimately action to address it.

The first MC, which took place in 2006–07, was intended to address two long-running concerns facing the international community: the sustained escalation in the size of global imbalances and the need to strengthen the effectiveness of IMF surveillance. China, the Eurozone, Japan, Saudi Arabia and the United States participated in the process, which began with bilateral visits to the five participants to hold confidential sessions with leading policy-makers to ascertain their views of the global imbalances – the causes and risks, the likely consequences of multilateral action, the feasibility of national action, and the role and impact of policy actions in other countries (IMF, 2007a; 2007b). This was followed by three multilateral meetings.

Following these discussions, the participants and IMF staff issued a joint report on the results of the MC which included each participant's policy progress and plans. In hindsight, however, it is clear that the process did not deliver on its ultimate goal of addressing widening global imbalances.

a few steps further than mere publication of indicators and their assessment against benchmark measures. Peer review is also an important process for gauging how well countries are doing against objectives and commitments, while providing a better understanding of the links between domestic and external developments. The improved understanding of an individual country's circumstances can be effective in assessing its commitments and, while resting on a foundation of accountability through mutual transparency, is fully respectful of sovereignty.

However, the downside of peer review is that, if accountability mechanisms are not in place, it can easily become 'peer protectionism', hampering the credibility of the process. 'Peer protectionism' occurs when countries reviewing each other make a strategic decision that if they review their peers preferentially, this treatment will be reciprocated, making it necessary for any credible peer review to be a multilateral rather than a bilateral process. The continued integrity of the peer review process or other surveillance mechanisms may need to rely on some credible independent audit mechanism of the process itself. This may explain why such a process is well suited to the OECD, where members' circumstances and goals are relatively uniform. However, in the G20 context, the best guarantor of the success of peer review or similar processes remains a sustained commitment by the leaders to make their cooperation commitment truly effective.

The G20's MAP draws on some elements of both surveillance and the peer review process, but it is also an attempt to overcome the credibility and accountability shortcomings

Box 5.3: Peer review

Peer review, within a group of countries, is the systematic assessment of the policies and performance of one country by others. The goals of peer review are the improvement of policies over time through identification and advancement of best practices, and compliance with established standards, principles and agreements. Once a group agrees to the peer review process, usually all the countries in the group are subjected to it, creating a sense of ownership and equality of treatment.

The peer review examination is conducted on a non-adversarial basis and functions effectively if there is mutual trust and confidence in the process. Thus, peer review works when the countries under review cooperate with the reviewers, for example by making relevant documents and data available and facilitating relevant contacts.

The success of peer review relies on the influence and persuasion exercised by the peers during the process. This 'peer pressure' may involve informal dialogue or formal recommendations, public scrutiny, comparisons and/or rankings; and may be channelled through domestic public opinion, national administrations and policy-makers. Through this reciprocal evaluation process, peer review tends to create a system of mutual accountability.

The peer review process is closely associated with the OECD country reviews, but its practice is spreading widely to a variety of thematic issues. The process is also linked to the European Commission, whose initiatives include the review of National Statistical Institutes and Eurostat (2006–08) and the peer review on social inclusion undertaken by the Directorates-General Employment, Social Affairs and Inclusion. Recent examples of peer review processes being established include the OECD Global Forum on Transparency and Tax Exchange Information, the OECD Corporate Governance Peer Review, and peer reviews of FSB members on the implementation and effectiveness of international financial standards and policies in their countries.

Box 5.4: The G20 Mutual Assessment Process (MAP)

MAP was initiated by G20 leaders at the Pittsburgh Summit in 2009, as the global economy was starting to emerge from the global financial crisis. The G20 faced internal disagreements about how quickly to unwind the exceptional fiscal and monetary stimulus measures taken during the crisis, and there were real risks of a reversion to protectionism. MAP was intended to reduce those tensions. It also reflected dissatisfaction with the 'standard' instruments of IMF surveillance, which suffered from a perceived lack of even-handedness and independence. There were also questions about the IMF's model for policy advice and the IMF was seen as lacking in traction on countries' policies.

In the light of an unsuccessful attempt at international policy coordination to address global imbalances, the IMF's 'Multilateral Consultation', MAP was designed rather differently:

- By involving all G20 countries, MAP covers most major economies, accounting for over 80% of the global economy, and encompasses all aspects of policies – fiscal, monetary, structural and trade – to improve growth, address imbalances and avoid protectionism.
- As a mutual assessment process, MAP is designed to improve ownership of the process by the countries involved.
- The IMF's involvement is relatively limited, providing technical expertise and support, but not driving the process.

- The IMF inputs to MAP have been published in a very transparent manner; and while the G20 discussions are in private, the outputs from the process are also publicly available.
- MAP is a peer review process rather than surveillance.

It is too early to reach a definitive conclusion on the MAP process, but the early results are fairly encouraging, at least as measured against previous attempts at international policy coordination:

- MAP is not shying away from some of the most difficult issues currently facing the global economy – when and how to withdraw stimulus measures, how to address global current account imbalances, exchange rates and other forms of protectionism.
- It appears to be providing a forum in which countries can discuss each others' policies frankly. Brazil has been particularly willing to speak out publicly about exchange rate policies of other economies – another sign that the economic policy debate is opening up.
- The Seoul Summit produced some policy commitments by countries in the areas of monetary and exchange rate policies, trade and development, fiscal policies and financial and structural reforms (although at this stage they are rather general).
- Seoul also pledged to enhance the process, including through indicative guidelines against which to measure economic imbalances.

MAP is in its infancy, and it is still uncertain whether the process is capable of producing hard-edged policy prescriptions, and whether countries will implement their agreed commitments. The next round of MAP discussions will provide a clearer indication of how far countries are prepared to subordinate short-term national interests to international cooperation and coordination of policies. Also, as the global economy becomes even more diverse and multipolar but also more interdependent, it will show whether a system of country-led mutual peer review is more effective than current surveillance processes in encouraging countries to adopt policies that are in the global interest.

MAP is thus a deliberate attempt to overcome some of the issues that have hampered the effectiveness of IMF surveillance, namely clarity of objectives (although, by being linked to G20 objectives, MAP's clarity depends on whether the G20 itself is clear about what it wants) and the establishment of an integrated diagnosis (which pays more attention than before to interdependencies and their impact). Because MAP is clearly driven by the leaders themselves, it has the potential to better support an effective governance framework through greater impetus for the transparent sharing of information and through accountability resting at the highest level and sustained by the leaders' commitment to the G20 itself. Nevertheless, even as these represent hopeful developments, a breakthrough remains in doubt until the elements of a coherent and agreed framework for international cooperation are in place.

The step towards credibility that MAP offers is the collective call from the G20 for a 'candid assessment', or greater openness, in how countries exchange data, scenarios and views on how their individual policies interact in support of the health of the global economy. Moreover, it is the effectiveness of this information-sharing process that will be critical in engaging the leaders and, subsequently domestic constituents in meeting the objectives of the global economy. By providing a framework for identifying the benefits of cooperation, MAP provides G20 countries with an opportunity to sustain greater levels of cooperation.

of these earlier processes to monitor the progress on agreed objectives. Emphasizing common objectives and a more rigorous diagnosis, MAP is an effort to bring structure to the consultative process in a multipolar economic order. With MAP, the focus on cross-border linkages and evaluation of whether country policies are collectively consistent has now become sharper, and the G20 leaders' direct ownership of this process (see Box 5.4) is an attempt to make the process more outcome-oriented.

5.3 The need for a shared sense of purpose and focus for the G20

How leaders choose to present the endeavours of the G20 to their own constituents at home, particularly during this fragile stage when the analytical framework for cooperation is underdeveloped, is critically important for sustaining cooperation. It is also likely that if SICs within the group are unable or unwilling to exercise leadership and set a cooperative tone and example, cooperation will falter as they can always decide to retreat from cooperative commitments.

The G20 is already burdened by a very large backlog of commitments. The leaders should remove obstacles to meeting past commitments, but they cannot and should not be seen as being bogged down in technical details of meeting those commitments. Their role is to set priorities for the group, to accept and hone the diagnosis, but then to put the necessary political weight behind promised actions. Leaders therefore need to be mindful of keeping to the distinction between what is strategic and in need of political direction, and what is more technical and can be delegated. Clarifying the former, in turn, will help advance the latter.

The strategic focus of the leaders also needs to be expressed in the form of a clear message as to the G20's priorities. Attaining coherence of purpose and bridging the different institutions, groups and publics, in the pursuit of effective cooperation, require a firm statement of purpose emanating from the G20. Therefore, as the G20 seeks to set more detailed objectives, improve diagnosis and implement a governance agenda based on credibility and accountability, the importance of a clear and focused message to sustain the impetus for cooperation both at home and within the G20 should not be underestimated.

6. Strengthening the G20 Process

The G20 has shown us that ad hoc policy cooperation is possible in times of crisis. The G20 leaders acted swiftly to respond to the global financial crisis with an unprecedented fiscal outlay which almost certainly averted what could have been a precipitous collapse of the world economy. The establishment of the Financial Stability Board to advance regulatory reform and cooperation of the financial sector, the initiation of reforms of the international financial institutions and the maintenance of an open trade regime resisting protectionist sentiments are all much to G20's credit.

However, as India's Prime Minister, Manmohan Singh, observed in his speech at the G20 Summit in Seoul, 'the G20 was an apt response to an adverse situation that the world faced. A few years down the line, the world will ask … what else did G20 achieve other than averting a total breakdown due to the global financial crisis'.[34]

The G20 needs to make the transition from a crisis management committee to the forum that drives a framework for cooperation that is sustainable, flexible and allows countries to benefit from an interdependent world economy. Unless this happens, the lessons from the global financial crisis of 2008 will be lost.

6.1 Shifting up the cooperative spectrum

As discussed in Chapter 5, sustaining global economic stability and growth through policy cooperation has to rely on the recognition of the world's growing connectedness and its systemic implications. With more than one economy of global systemic significance, SICs cannot afford to consider their domestic policy in isolation from one another. The welfare implications of their policies are connected to the other SICs and the rest of the world through linkages, for example, stemming from US monetary policy and Chinese exchange rate policy. Thus, given a changing world economic order, a cooperative framework will require a much clearer understanding of the nature and scale of economic interdependencies and of the spillover effects from the policies of SICs.

Progress on MAP is the most promising opportunity for countries to develop greater recognition and deepen their understanding of international spillovers, and to identify the benefits of cooperation. In addition, MAP has the potential to provide a truly multilateral view of the impacts of national policies on shared global goals and on other countries. On the basis of a deeper understanding of global interdependencies provided by MAP, the G20 should be able to encourage cooperative behaviour that informs the very design of domestic policy. For each global issue for which a cooperative solution is beneficial, progress – defined as appropriate to each specific challenge – should be made to move up the cooperation spectrum from monitoring, to global benchmarking, to national benchmarking, to national policy, and finally to coordinated national policies. However, all cooperative behaviour will require the development of sound governance principles – clarity of objectives, transparency and accountability – and it must be flexible and adjustable in its applications to changing economic realities.

The pace and nature of progress on this spectrum will vary. When there is a well-recognized gain, for example in response to a common global shock, the move to coordinate national policies could occur quickly. When agreement on a common diagnosis is more difficult to reach, it may be more appropriate for countries to work through progressively more coordinated policy responses. Depending on the issue at stake, cooperative policy might start and end at different points along the cooperative

34 Speech by Dr Manmohan Singh at the Plenary Session of the G20 Summit in Seoul, 12 November 2010.

spectrum. Crucially, cooperative steps such as agreement on indicators or monitoring should not be seen as 'weak', but rather as 'initial' stages of cooperation.

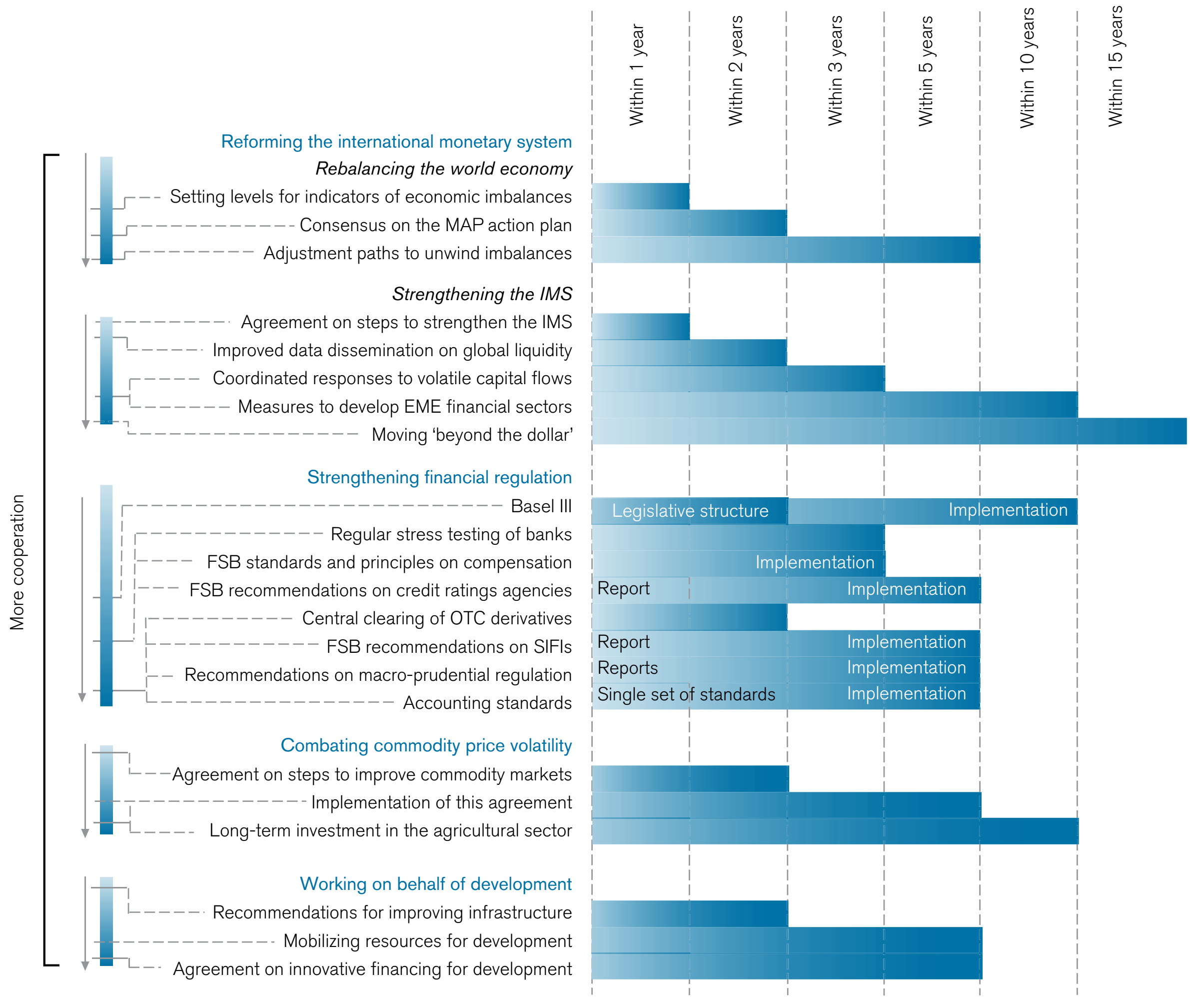
6.2 A schedule for cooperation

The French G20 Presidency has made its intention clear that in 2011 the G20 should press on with the existing agenda of financial regulatory reform, international monetary system reform and working on behalf of development. However, France has also expanded the agenda by calling for the strengthening of the G20's global development roadmap by including commodity price volatility and employment as well as social issues.

While progress on these long-term structural, institutional and regulatory issues is vital to the future shape of the global economy, the experience of past summits suggests that the G20 will continue to be confronted with tensions stemming from unresolved differences on the best way to sustain global economic cooperation.

A lack of progress along the cooperative spectrum risks becoming the source of disappointment, or even scepticism, with respect to the ability of the G20 to implement a common agenda. This could further incentivize individual nations to seek unilateral solutions. In this report, we map out a 'progress' schedule, tailored to achieving specific global challenges, for international policy cooperation (see Figure 6.1). The schedule is ambitious and demanding, as it should be.

Figure 6.1: A schedule for cooperation



Key

EME emerging-market economies
IMS international monetary system
OTC over-the-counter
SIFI systemically important financial institutions

Box 6.1: Explaining the schedule for cooperation

Our schedule for cooperation follows the main items on the French agenda:

Reforming the international monetary system: improving the system's stability, and forming a collective response to issues of destabilizing capital flows, persistent imbalances and the accumulation of FX reserves.

G20 Finance Ministers and Central Bank Governors agreed to a set of indicators to monitor imbalances. If there is agreement on the policies to be taken in line with the IMF's MAP, the actual implementation of policies to unwind current account imbalances could take a significant period of time (five years).

The efforts to address the economic imbalances should be paralleled by the initiatives to strengthen the IMS. Looking at the issue of capital flows, countries should be able to improve their data collection. However, the framework for coordinated responses would be likely to take longer to establish.

The final step to strengthening the IMS comes from moving 'beyond the dollar' as the key reserve currency, but this should be expected to be a very slow and gradual process.

Strengthening financial regulation: maintaining and strengthening the financial framework and ensuring that rules agreed upon at the G20 are applied.

Significant agreements have already been reached and steps forward have been taken on financial regulation. At the Seoul G20 Summit, an agreement was reached on implementing the Basel III banking standards. The targets are to have the legislative framework in place by 2013 and for the requirements to be fully phased in by 2019.

A host of reports with recommendations for further financial regulation are set to be published during 2011.[a] Actual agreement and implementation of these forthcoming recommendations should not be expected to come about quickly. Nevertheless, progress in this field has started at a brisk pace and thus may be expected to occur within a quicker time frame than other issues such as reform of the IMS.

Combating commodity price volatility: improving the transparency and regulation of commodity trading markets as well as expanding food supplies and enhancing responses to food crises.

So far, there has been little agreement on how to tackle commodity price volatility. Current proposals focus on improving the transparency and regulation of commodity trading markets. The speed in securing an agreement on commodity markets is likely to be linked to the pace of progress elsewhere in financial regulatory reform. Agreement on principles may come about within two years, but implementation is longer-term. On an even longer time-horizon, policies to expand the supply of commodities – particularly agricultural goods – could help stabilize prices.

Working on behalf of development: a priority area often seen as part of the G20 strategy to reach out to the non-G20 members as well as to seek legitimacy for managing the global economy.

The Seoul G20 Summit brought development onto the agenda. One aspect of this on the French agenda is improving infrastructure. The G20 has already commissioned a panel for infrastructure investment whose recommendations are due to be published in September 2011. However, mobilizing resources to finance investment is likely to prove challenging, in particular with the pressure on public spending in advanced economies.

The French G20 agenda also focuses on innovative financing mechanisms for development, such as taxes on transport, trade and finance. However, progress on this front should not be expected too quickly.

The French agenda also includes the objectives of:

Fighting corruption: this priority area forms part of the G20's long-term overall strategy to clean up the business environment, to fight tax avoidance and to strengthen the rule of law.

Supporting employment and strengthening the social dimension of globalization: to be discussed by the G20 labour and employment ministers at a meeting in late September, the four priority objectives in this area include promoting employment, particularly for young people and disadvantaged individuals; stronger social protection; respect for social and labour rights; and improved coordination of strategies among international organizations.

a The FSB is to produce reports on credit ratings agencies and systemically important financial institutions. In the case of the latter, this involves recommendations for methods of identifying these institutions, setting a stronger regulatory framework and discussing cross-border resolution mechanisms. Meanwhile, the BIS, FSB and IMF (working together) will produce recommendations for macro-prudential policy frameworks by the second half of 2011. The G20 delegated to the Financial Accounting Standards Board and International Accounting Standards Board the responsibility for convergence in international accounting standards and they are expected to produce a common set of standards at the end of 2011.

6.3 The French opportunity for a robust framework of cooperation

The central task of the French G20 presidency is thus to ensure that promises to cooperate are turned into concrete policy action, beyond the need to respond to crises as they arise, through the development of a robust framework for cooperation. The G20 needs to look beyond its roots as a crisis steering committee and build a new framework for cooperation that can help it transcend the zero-sum mentality that sank earlier international cooperation efforts, and that still underlies much of the discourse about global imbalances and the recriminations heard in each country about others' economic policies.

Thus, the G20 framework for cooperation should be founded in:

- An understanding of interdependencies, including an agreement on common economic objectives and a common diagnosis and agreement on the policies to deliver objectives; and
- Moving up the spectrum of cooperation, sequencing the policies to deliver objectives, monitoring progress against objectives and ensuring accountability through openness and transparency.

Achieving this will enable the G20 to provide the strategic direction needed to manage a changing world economy in times of recovery and growth, as well as in times of 'stress'. Therefore, as detailed in the Executive Summary and in the individual chapters of this report, we recommend the following:

1. ***Support and develop the G20 Mutual Assessment Process and the study of interdependencies.***
2. ***Publish ex ante international impact assessments for domestic policy.***
3. ***Set the tone for cooperation from the top.***
4. ***Reinforce a single statement of purpose for the G20.***
5. ***Maintain strategic momentum and accountability for commitments.***
6. ***Publish national road maps for delivering international commitments.***
7. ***Increase the transparency of the rotation of the G20 presidency.***
8. ***Develop regular 'Summit Reports' on G20 work to highlight progress against commitments and improve transparency and accountability.***

In these ways, the G20 can make the transition from a crisis committee to the forum which drives a framework for cooperation that is sustainable, flexible and allows countries to reap the benefits of international economic policy cooperation – greater economic and financial stability, and greater prosperity for all through sustained global economic growth.

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Appendix

Chatham House–CIGI Workshop Agenda

This workshop forms part of a project funded by the ESRC

To be held under the Chatham House Rule

Rebalancing the World Economy with Emerging Powers: the Search for Post-Crisis Growth Models and Policy Tools for Macro-Coordination

24–25 September 2010, Beijing

Peking University, School of International Studies (SIS)

09.00-09.10	**Opening Remarks**
	Wang Yong, Professor, Peking University
	Paola Subacchi, Research Director, International Economics, Chatham House
	Tom Bernes, Acting Executive Director, CIGI
09.10-11.20	**Session 1.1: Coordination in Different Policy Areas**
	This session will examine the interrelationship across different issue areas such as monetary, fiscal and trade policies. It will evaluate some of the previous efforts to achieve policy coordination across various issue-areas at the international level. The authors are encouraged to also reflect on the differential spillover impacts these policies will have on the smaller poorer economies and larger economies.
Chair:	*Ma Zhengang*, Former Chinese Ambassador to the UK
Presenters:	*Wang Xin*, Deputy Director General, Financial Research Institute, People's Bank of China
	'The Rise of BRICs' International Financial Power and Its Implications'
	Charles Adams, Visiting Professor, Lee Kuan Yew School of Public Policy, Singapore
	'Global Imbalances: Asian Perspectives and Issues'
	Fabrizio Pagani, Special Political Counsellor to the Secretary General, OECD
	'Within the Global Governance Toolbox: Policy Coordination and Peer Reviews'
Discussants:	*Tom Bernes*, Acting Executive Director, CIGI
	Paola Subacchi, Research Director, International Economics, Chatham House
11.30-12.30	**Session 1.2: Coordination in Different Policy Areas**
Chair:	*Daniel Schwanen*, Special Advisor, CIGI
Presenters:	*Huang Yiping*, Professor of Economics, China Center for Economic Research

	'What is the Role of Exchange Rate Policy in Promoting Strong, Sustainable and Balanced Growth?'
	Geng Xiao, Director, Columbia Global Centers, East Asia
	'China's Search for Macro Stability and its Global Implications'
Discussants:	*Ding Yifan*, Deputy Director, The World Development Institute, Development Research Center, State Council
	Paul Jenkins, Distinguished Fellow, CIGI
13.30-15.30	**Session 2.1: Rebalancing the Global Economy to Achieve 'Strong, Sustained and Balanced Growth'**
	This session will focus on the requirements for rebalancing the global economy, in particular in the areas of global governance and development. Which policies are needed to rebalance the global economy in order to achieve 'strong, sustained and balanced growth'? It will also examine how burden sharing could be effected at a systemic level. While most governments would agree that policy coordination is an answer to prevent zero-sum games at the international level, there is a lack of agreement over what kind of tools should be used to promote coordination. This session will begin with the areas and kinds of macroeconomic policies that need to be coordinated before considering two of the main tools commonly mooted at the multilateral level – peer review and surveillance – to promote policy coordination. If they are 'the' solutions, why are current attempts at promoting peer review and surveillance running into roadblocks, gridlock, deadlocks? Are there preconditions for successful peer review and surveillance for providing international order that need to be reconsidered, especially if/when the balance of international power is undergoing a shift toward a more diverse and fragmented and multi-polar international system?
Chair:	*Paola Subacchi*, Research Director, International Economics, Chatham House
Presenters:	*Wang Yong*, Professor, Peking University
	'Rebalancing Global Economy: What does it mean for global governance?'
	Edward K.Y. Chen, Distinguished Fellow, Centre of Asian Studies, University of Hong Kong
	'Rebalancing the Global Economy for Long-Term Growth: What does it Mean for Coordinated Policies'
Discussants:	*Paolo Guerrieri*, Vice President, Instituto Affari Internazionali
	Daniel Schwanen, Special Advisor, CIGI
15.45-17.45	**Session 2.2: Rebalancing the Global Economy to Achieve 'Strong, Sustained and Balanced Growth'**
Chair:	*Wang Yong*, Professor, Peking University
Presenters:	*Paolo Guerrieri*, Vice President, Instituto Affari Internazionali
	'The Difficulties of Macroeconomic Coordination: a Risk of a Long Period of Sub-Par Global Growth?'
	Gregory Chin, Senior Fellow, CIGI
	'Preconditions to Collective Action: Lessons from a Previous Age, Not That Long Ago'
Discussants:	*Huang Ping*, Director-General, Chinese Academy of Social Sciences
	Mark Thirlwell, Programme Director, International Economics, Lowy Institute
17.45-18.00	**Closing Remarks**
	Wang Yong, Professor, Peking University
	Paola Subacchi, Research Director, International Economics, Chatham House
	Tom Bernes, Acting Executive Director, CIGI

Chatham House–CIGI Workshop Agenda

This workshop forms part of a project funded by the ESRC

Workshop to be held under the Chatham House Rule

Search for Post-Crisis Growth Models and Policy Tools for Macro-Coordination

2–3 December 2010, London

Chatham House, 10 St James's Square, London, SW1Y 4LE

Thursday 2 December 2010

16.15-16.25 **Opening Remarks**

Paola Subacchi, Research Director, International Economics, Chatham House

Tom Bernes, Executive Director, CIGI

16.25-18.00 **Session 1 (Panel Discussion): Review of Lessons from the Bretton Woods Arrangement**

The Bretton Woods Agreement remains one of the most ambitious, comprehensive and deliberately constructed set of rules for the international economy even though it collapsed three decades ago. Notwithstanding its flaws, its operation, particularly on how it facilitated policy cooperation and coordination, may provide some lessons on the pitfalls to avoid and opportunities to be seized when contemplating the reconstruction of the international economy.

Chair: *Paul Jenkins*, Distinguished Fellow, CIGI

Panellists: *Andrew Walter*, Reader in International Political Economy, LSE

Pierre Siklos, Wilfrid Laurier University (WLU) and CIGI Senior Fellow

'An Economic Perspective on the Constraints of the Bretton Woods System'

Domenico Lombardi, President, The Oxford Institute for Economic Policy and Senior Fellow, Brookings Institution

Friday 3 December 2010

10.15-10.25 **Opening Remarks**

Paola Subacchi, Research Director, International Economics, Chatham House

Tom Bernes, Executive Director, CIGI

10.25-12.00 **Session 2: Analytical Framework for Cooperation in a World of Interdependencies**

At the heart of the issue of policy cooperation is the existence of global interdependencies. An understanding of these interdependencies is fundamental to knowing what form cooperation should take, and what would facilitate or pose an obstacle to cooperation. Leaders need to be informed by this understanding as they reflect on cooperation within and across policy areas, and on the past and future use of policy tools and their disposal.

Chair: *Tom Bernes*, Executive Director, CIGI

Presenters: *Michael B. Devereux*, University of British Columbia (UBC)

'The Evolution of Global Interdependencies' [via teleconferencing]

	Paola Subacchi, Research Director, International Economics, Chatham House
	'Cooperative Behaviour vs Unilateral Intervention: Why Should We Cooperate, and Where?'
	Ralph C. Bryant, Senior Fellow, Economic Studies, Global Economy and Development, The Brookings Institution
	'Structure and Analytical Requirements for a Successful Promotion of Cross-Border Economic Cooperation'
Discussants:	*Paul Jenkins*, Distinguished Fellow, CIGI
	Uri Dadush, Director, International Economics Programme, Carnegie Endowment for International Peace
14.00-15.30	**Session 3 (Panel Discussion): Policy Tools to Sustain a Cooperative Agenda**
	Most governments would agree that cooperation potentially implies policy coordination in order to prevent zero-sum games at the international level. But there is a lack of agreement over which policies should be coordinated, what kind of tools should be used to promote coordination, and who bears the costs. Two of the main tools commonly mooted at the multilateral level to promote cooperation and inform potential macroeconomic coordination choices are peer review and surveillance. If they are 'the' solutions, why are current attempts at promoting peer review and surveillance running into roadblocks, gridlock and deadlocks? Are there preconditions for successful peer review and surveillance that need to be reconsidered, especially if/when the balance of international power is undergoing a shift toward a more diverse and fragmented and multipolar international system?
Chair:	*Paola Subacchi*, Research Director, International Economics, Chatham House
Panellists:	*Paul Van Den Noord*, Economic Counsellor to the Chief Economist, OECD
	Daniel Schwanen, Special Advisor, Programs, CIGI
	Stephen Pickford, Former G20 Finance Deputy
15.45-17.15	**Session 4: Cooperation and Development: Developing Countries and the Trade Agenda**
	This session will examine how cooperation can work across different policy areas, linking macro-economic and financial issues to more structural issues underlying growth. It will reflect on previous efforts to cooperate across various policy-areas. The authors are also encouraged to reflect on the differential impact that coordinated policies flowing from a cooperative framework can have on the smaller, poorer economies and larger economies.
Chair:	*Stephen Pickford*, Former G20 Finance Deputy
Presenters:	*Peter Draper*, Project Head of the Development through Trade Programme, South African Institute of International Affairs
	Helmut Reisen, Head of Research, OECD Development Centre; Associate Fellow, Chatham House
Discussant:	*Shuaihua Cheng*, Programme Officer, Strategic Analysis and China, International Centre for Trade and Sustainable Development (ICTSD)
17.15-17.30	**Concluding Remarks**
	Paola Subacchi, Research Director, International Economics, Chatham House
	Tom Bernes, Executive Director, CIGI

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