Executive Summary

Preventing Crises and Promoting Economic Growth
A Framework for International Policy Cooperation

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A Joint Chatham House and CIGI Report

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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 macro-economic, 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 global 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.