CONFERENCE REPORT

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MACROECONOMIC COOPERATION AND THE INTERNATIONAL MONETARY SYSTEM

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While the International Financial Institutions came together in Washington for their annual meetings in early October the Foundation of European Progressive Studies (FEPS) in cooperation with the Initiative for Policy Dialogue (IPD) and with the support of the Ford Foundation and the Center for American Progress (CAP) brought world-leading economists together to discuss 'Macroeconomic Cooperation and the International Monetary System'.

The timing could have not been better and the issues not more pressing. Five years after the Global Financial Crisis the world economy is still struggling to return to sustainable growth. This latest crisis has renewed interest on the need and the importance to reform the global financial and monetary architecture. International policy coordination, debt crisis management, participation in global economic governance, and the choice of means of payments in cross-border transactions are increasingly seen as crucial issues to create a global economic environment where global stability and growth take centre stage.

To this end, **macroeconomic cooperation on fiscal and monetary issues should be sought internationally to support global economic activity and to address concerns about unsustainable payment imbalances in the global economy**. Simultaneously, advanced economies have to accept that the global economic world order has changed fundamentally. Emerging and developing countries are catching up fast and increasingly driving global output expansion. The rise in their economic importance has to be acknowledged in the global institutional landscape if the strength of international organisations is to be ensured.

With this in mind, leading economists gathered together in Washington to discuss the questions of (1) macroeconomic cooperation in a world of independent monetary and fiscal policies, (2) alternative global reserve currency and exchange rate arrangements as well as (3) European macroeconomic governance.

1. Macroeconomic Cooperation in a World of Independent Monetary and Fiscal Policies

Macroeconomic cooperation is not only desirable in the world economy but given the integration of international markets at least **some degree of coordination is necessary to ensure the effectiveness of international and even domestic policy action**.

Monetary policy is symbolic for this need of cooperation. This can be illustrated with a simple theoretical model, assuming that the US economy had not one but in fact two independent central banks: one looking after the economic affairs of the East coast and another one responsible for the West coast. If the East coast finds itself in the midst of a prolonged economic slowdown its lender of last resort will implement unconventional monetary policy measures (such as quantitative easing) to lift economic activity. This move would make money more cheaply available for East-coast firms than before. The hope of the East-coast central bank is that regional firms will borrow relatively cheap funds to invest them in the local economy, generating jobs and fostering growth.

However, if the West coast is simultaneously going through a boom the cheaply obtained funds are more likely to end up in thriving West-coast businesses. The fear of economic overheating will prompt the West-coast central bank to tighten monetary policy, counteracting the initial East-cost easing. As consequence, economic externalities and spill-over effects between the two coasts will change the impact of both central banks' actions, reducing the effectiveness of their policies.

Now substitute US and Brazil for East and West coasts and you have a good representation of the consequences of quantitative easing for emerging markets and more broadly of uncoordinated macroeconomic policies. While advanced countries – and particularly the US – have been trying to stimulate their stagnant economies with cheap money, some emerging markets have been struggling to avert this flood of money and its undesirable consequences. The US credit channel – which theoretically transmits funds from banks to businesses – seems blocked. In general private lending responded to QE only feebly in the US while credit volumes to small and medium enterprises remain significantly below pre-crisis levels. Simultaneously, emerging markets had to pursue aggressive capital controls and reserve accumulation for some time to fend off exchange rate volatility due to the surge in incoming portfolio investment.

What the real world has taught us is that many economic models, based on the idea that decisions of rational agents acting independently in their own interest will lead to the best possible economic outcome, do not describe global macroeconomic activity very well. If self-interested countries do not take into account the potential consequences of their actions for other countries – so-called economic externalities and spill-over effects – the effectiveness of these policies might be reduced or even completely offset by counteracting measures elsewhere in the world. Indeed, the interconnectedness of the global economy has been often significantly underestimated, and with it the urgent need for macroeconomic cooperation.

Furthermore, it is increasingly evident that economic size matters. Economic policies of large economies such as the US or the Eurozone are likely to have global repercussions. As such, these economies have to assume their economic responsibility to contribute to global growth and financial stability.

For instance, the Eurozone crisis has been an important drag on the global recovery since the austerity medicine dispensed – especially to the Eurozone periphery – resulted in stagnation and high unemployment. The trade surpluses amassed within the EU as outcome of weak purchasing power reflects in trade deficits amongst some emerging markets. From the perspective of developing countries the current slowdown in their development is a direct outcome of European inability to coordinate and generate growth policies.

International cooperation on monetary and fiscal issues is crucial in order to support global economic activity. After the Global Financial Crisis there was a period of successful global cooperation. Every government leader turned suddenly into a Keynesian, stimulating economic activity through additional expenditure at home and benefitting from positive demand externalities internationally. Equally, there was international consensus that trade protectionism could only deepen the global crisis, averting the implementation of beggar-thy-neighbour policies that appeared to be in the self-interest of individual economies. Recent efforts to clamp down on tax havens are also a successful example of international cooperation.

Nevertheless, these are very few examples. Given the global economic turbulences in recent years a higher degree of macroeconomic cooperation could be expected. Cooperation seems to work well if the gains or losses at stake are particularly high. During the financial crisis the non-cooperative outcome (the so-called Nash equilibrium) for each country was significantly less attractive than the global coordinated stimulus. This helped to bring about consensus amongst government leaders in the G20 in 2009. Furthermore, the fact that all countries were required to implement the same type of policy and that this could be written down as a simple numerical goal – taking the form of a stimulus equal to 2% of GDP – further facilitated agreement.

Thus, one of the crucial issues that emerged at the conference is how to create the conditions for an economic environment where sustainable macroeconomic coordination takes centre stage so that ad hoc harmful policies can be avoided. Related to this issue, conference participants also highlighted the importance to discuss how to create incentives for international cooperation and how to create an international financial and monetary system working in a desirable and sustainable way in the future.

2. Alternative Global Reserve Currency and Exchange Rate Arrangements

The need to reform the international monetary system – especially with respect to reserve currency and exchange rate arrangements – has been evident before the Global Financial Crisis. The large global imbalances and the related amassing of foreign exchange reserves were symptomatic of ailing monetary structures. **The crisis of 2008/09 brought additionally issues of international liquidity generation and the necessity of countercyclical prudential policies to the fore**. All these concerns originate from the deep-seated problem that the current monetary system is structurally prone to boom-bust cycles. Furthermore, years of financial liberalisation have neglected economic and financial stability as important pre-requisites for sustainable global growth.

Boom-bust cycles are typically set off by surging credit extension, translating into increases in aggregate demand. As a consequence assets experience price inflation,

feeding back into the cycle as collateral for further credit growth. Busts quickly follow such booms as ever-rising asset prices prove to be unsustainable. In the long term avoiding recurring crises leads to higher growth levels. However, since boom-bust cycles are able to produce dynamic short-term growth during the booms – and therefore significant short term financial profits – individual lenders are willing to take on risk disregarding the costs of a potential bust. The latter is often inflicted on society rather than the risk-taking individual, anyway. This lack of internalisation of costs during boom times at the expense of social welfare can be interpreted as a negative externality – and market imperfection – upon society similar to the social cost of pollution. Therefore, just like pollution boom-bust cycles are a natural target for government regulation. Macro prudential financial regulation should also be countercyclical, encouraging credit extension during economic slowdowns and tightening in times of booms. Such regulation could arguably also reduce income inequality since during boom periods risk taking increases on the back of credit extension in the financial sector, profiting from asset price inflation. Financial regulations can also be complemented by financial taxation, of which the financial transaction tax is a good example as it would discourage excessive volatility.

Increased cross-border capital mobility has also raised financial fragility on the global level – and especially in emerging and developing economies – since negative externalities tend to be larger in open economies. At present, there are three fundamental flaws in the international mechanisms coping with fragility:

(1) The asymmetries in the international payment system load the whole burden of adjustment on deficit countries, overlooking the close connection between trade surpluses and deficits.
(2) Effectively, national currencies are used for reserve accumulation, generating a contradiction between national and global policy objectives.
(3) Economic and financial volatility induced by periodically recurring crises prompts emerging economies to amass international reserves in the search for self-insurance. Furthermore, this immense volume of reserves also weakens global aggregate demand.

Therefore, the current international monetary system carries a significant equity bias favouring those advanced countries that enjoy seigniorage. These economies possess currencies that serve as international reserve currencies. Hence, their decisions on domestic monetary policy have global repercussions. Simultaneously, they benefit from emerging markets' wish for self-insurance against exchange rate volatility. Since developing countries are forced by design of the international monetary system to hold advanced-economy currencies the current system in fact imposes a net transfer of resources from poorer to rich countries.

Ascribing a central role to IMF special drawing rights (SDRs) and subsequently moving towards an entirely SDR-based IMF would be a sound solution for the described flaws. In the late 1970s, SDRs were created as international reserve asset during the fixed exchange rate regime of the Bretton Woods system. Subsequently, SDRs lost in importance as major currencies moved towards the floating exchange rate regime and the growth in international capital markets facilitated borrowing for creditworthy governments. Today only 0.5% of global non-gold reserves are held in SDRs. Nevertheless, strengthening the role of SDRs would be in line with the IMFs Articles of Agreement, calling for SDRs as the principle global reserve asset. In order to create truly global reserves the IMF would have to move to an entirely SDR-based system. This would necessitate giving the Fund the authority to issue unlimited SDRs in times of crises. Historically, SDRs have always been created during such episodes but in a rather ad-hoc fashion. The challenge is to institutionalise the IMF's right to do so, allowing the international organisation to act as global lender of last resort. In this way SDRs would be used where they are needed – namely in emerging and developing countries. Currently, due to the link between allocation of SDRs and IMF quotas, which also determine political influence in the Fund, the majority of

SDRs are at the disposal of advanced economies, which hardly ever use them.

Given the recent disarray in major advanced economies – think of the US government shutdown and the persisting Eurozone troubles – there seem to be a stronger case than ever for a truly global reserve asset, devoid of these countries' political dominance.

3. European macroeconomic governance

European austerity policies are an example of international cooperation with a harmful policy outcome. Hence, the challenge of cooperation does not only address questions of how to bring about policy coordination but also **how to ensure this coordination has a growth-enhancing character**.

In the EU the outcomes of three years of austerity are devastating. Debt levels, as proportion of GDP, have worsened, unemployment is extremely high, and the economic rift between the struggling South and the relatively prosperous North is widening. Recent reports of positive but meagre economic growth and expectations of a modest recovery of growth (between 0.5 and 0.7%) for 2014 will not change this severe economic deterioration. Above all, unemployment (especially amongst the young) remains a major problem.

Since exchange rate devaluations are impossible for Eurozone countries the only way used to bring down trade deficits was an international devaluation brought about by the compression of domestic demand. On paper so-called structural reforms have brought down trade imbalances, bringing a return to economic stability. In fact, reduced trade deficits came at the cost of a deflationary spiral of waning domestic demand and rising unemployment in troubled European countries. There was little effort to pursue expansionary policies in surplus countries, like increasing their wages; on the contrary, surplus countries are also engaging in large, and particularly unnecessary, fiscal consolidation.

European austerity policy and more fundamentally the policy foundations of the Euro, especially the Stability and Growth Pact, appear systemically irrational and suicidal. They are unlikely to return growth to the Eurozone while – economically – they invite prolonged economic stagnation à la Japanese and – politically – they sow destructive right-wing populism. But there is an alternative. Since financial markets have calmed down after the European Central Bank's courageous backing of the Euro – no matter what! – excuses that austerity policies must be implemented to keep financial markets from panicking have diminished. The perceived link between market confidence and budget deficits has been broken. Space for less contractionary fiscal consolidation has clearly increased.

Longer maturity periods and lower interest rate payments for highly indebted European economies should be negotiated, to give space for such less contractionary policies in the periphery countries.

The balance sheets of European banks still harbour problems. For this undertaking a banking union would be needed in the EU.
In the long term, some form of fiscal union may need to be established, in order to finance a major European investment programme, addressing the productivity gap between Southern and Northern Europe. In the meantime, existing institutions such as the European Investment Bank should be strengthened even more and utilised more intensively, for example by a further expansion of its capital to facilitate increased lending. Fiscal policy coordination could also consider a common social security system across Europe. This would allow for transfers of resources from low to high-unemployment member countries. And finally, the EU has to return to the spirit of European solidarity in order to overcome the severe economic and political crisis that it is facing. Stronger EU members with trade surpluses have scope to push for higher domestic wages in order to stimulate intra-European demand, contributing to level trade imbalances.
Finally, looking even further into the future of Europe we will need to enhance productivity of individual EU member countries as well as the region as a whole to ensure growth and prosperity. Investment in education and innovation will play a key role. However, the paradox of Europe has to be overcome: the European Union has a similar population to the US, their GDPs are comparable and so are their portions of international trade. The EU possesses a single market and a common currency but there is a very small, and insufficient, EU budget. Given the challenges to the EU in the future this should be changed to ensure democracy and economic prosperity for all European citizens.

CONFERENCE BACKGROUND

On October 8th 2013 FEPS in collaboration with the Initiative for Policy Dialogue (IPD) at Columbia University, and with the support of the Ford Foundation and the Center for American Progress (CAP) organised a conference on Macroeconomic Cooperation and the International Monetary System. The conference addressed three fundamental issues:

1. Global macro-economic cooperation;
2. How to reform the international monetary systems to contribute to world economic growth;
3. European macro-economic governance.

The objective of the conference was to discuss the role and challenges of macro-economic cooperation in a world of independent monetary and fiscal policies.

The conference started with a welcome dinner discussing the role of macro-economic cooperation in restoring growth – a US perspective**. Joseph Stiglitz**, Co-President of the Initiative for Policy Dialogue, **Jason Furman**, Chair Council of Economic Advisers in the US, and **Massimo D'Alema**, President of FEPS and former Prime Minister of Italy provided food for thought.

The conference had three high-level panels and a public debate. The first panel focused on **Global macro-economic cooperation**. This panel was introduced by **Homi Kharas**, Senior Fellow of Brookings Institution. Speakers included: **Joseph Stiglitz**, Co-President of the Initiative for Policy Dialogue, **Olivier Blanchard**, Chief Economist, International Monetary Fund, **Amar Bhattacharya**, Director, G24 Secretariat, and **Adam Posen**, President, Peterson Institute of International Economics

The second panel concentrated on **how to reform the international monetary system to contribute to world economic growth**. The panel was introduced by **John Williamson,** Senior Fellow at Peterson Institute for International Economics. Speakers included: **Anton Korinek**, Assistant Professor of Economics, Johns Hopkins University, **Jose Antonio Ocampo**, Co-President, Initiative for Policy Dialogue, **Eswar Prasad**, Senior Professor of Trade Policy, Cornell University, **Heidemarie Wieczorek-Zeul**, member of the Bundestag and former Minister for Economic Cooperation and Development of Germany.

The third panel discussed **European macro-economic governance**. The panel was chaired by **Ernst Stetter**, Secretary General of FEPS. Speakers included **Malcolm Sawyer**, Emeritus Professor of Economics, Leeds University Business School, **Paolo Guerrieri**, Professor of Economics, University of Rome, **Stephany Griffith-Jones**, Financial Markets Programme Director, Initiative for Policy Dialogue, and **Marcus Miller**, Professor of Economics, University of Warwick, UK.

The day was closed by a public panel chaired by Professor **Stephany Griffith-Jones.** Guest speakers included: **Joseph Stiglitz**, Co-President of the Initiative for Policy Dialogue, **Adam Posen**, President, Peterson Institute of International Economics, **Jose Antonio Ocampo**, Co-President of the Initiative for Policy Dialogue, and **Massimo D'Alema**, President of FEPS and former Prime Minister of Italy

Full video of the public panel can be found online:
http://www.americanprogress.org/events/2013/09/30/75631/macroeconomic-cooperation-and-the-international-monetary-system/