John Murray: With a little help from your friends – the virtues of global economic coordination

Remarks by Mr John Murray, Deputy Governor of the Bank of Canada, at the State University of New York at Plattsburgh, Plattsburgh, New York, 29 November 2011.

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> "Uneven growth and widening imbalances are fuelling the temptation to diverge from global solutions into uncoordinated actions. However, uncoordinated policy actions will only lead to worse outcomes for all."
>
> G-20 Leaders Declaration, Seoul Summit
> 11–12 November 2010

> "We, the Finance Ministers and Central Bank Governors of the G-20, affirm our commitment to take all necessary initiatives in a coordinated way to support financial stability and to foster stronger economic growth in the spirit of cooperation and confidence."
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> Statement of G-20 Finance Ministers and Central Bank Governors
> 8 August 2011

Introduction

Thank you very much for the invitation to deliver the Distinguished Canadian Address on a contemporary public policy issue. I am honoured to be here and grateful for the opportunity to speak to you about one of the most important public policy issues that we are confronting in these extraordinarily difficult times.

Policy-makers around the world are facing two critical challenges of a truly systemic nature: restoring stability in Europe and rebuilding strong, sustainable and balanced growth in the global economy. The two quotes above are testament to the firm and shared belief of today's policy-makers that these challenges can be met only through timely and comprehensive policy coordination across countries. Yet a generation ago, both academics and policy-makers shared the equally firm belief that the prospective gains from global coordination were minimal, if not negative. They advocated a more independent approach to policy formulation and implementation, and advised authorities to simply "keep their own houses in order" and leave the rest to the insulating properties of flexible exchange rates.

This quote from Stanley Fischer is representative of the consensus view that prevailed in the late 1980s:

> "[M]ore consistent ongoing policy coordination in which countries, including the United States, significantly modify national policies "in recognition of international policy interdependence" is not on the near horizon. Fortunately, the evidence suggests that the potential gains from coordination are in any event small: the best that each country can do for other countries is to keep its own economy in shape."[1]

My remarks today are divided into three parts. First, I will outline the assumptions and research that supported the earlier, independent view of policy making. Second, I will trace

[1] S. Fischer, "International Macroeconomic Policy Coordination," International Economic Cooperation, edited by Martin Feldstein, NBER, (Chicago, University of Chicago Press, 1988) 11–43.

the evolution of thought since that time, and track the principal drivers behind the apparent change in attitude. Finally, I will present an example, drawn from the Bank of Canada's own modelling work, that highlights the prospective benefits of more effective policy coordination in the context of the current challenges.

Prevailing view in the 1970s and 1980s

Most academic economists and policy-makers in the period immediately following the collapse of Bretton Woods readily acknowledged the potential benefits of co-operative behaviour, but viewed these gains as small in practice.

In a world characterized by growing economic interdependence and cross-border spillovers, it stood to reason that something could be gained by operating in a more coordinated manner. Such actions, they believed, would minimize negative externalities and lead to Pareto-improving outcomes in which all parties would benefit and the losses inherent in non-co-operative Nash outcomes could be avoided. As a practical matter, however, these gains were believed to be very modest and perhaps even negative.

One of the principal reasons for this was a strong belief in the insulating effects of flexible exchange rates, which would not only give authorities the ability to conduct effective, independent monetary policies but would serve as an automatic buffer from both external and internal shocks.

A second reason for this independent approach to policy-making was the limited degree of economic interdependence that existed at the time. Although trade flows had been liberalized in successive GATT rounds through the 1960s, 1970s and 1980s, they remained a small, albeit rapidly growing, component of the GDPs of most countries. Moreover, this was the only metric by which interdependence was typically judged. International capital flows were still severely restricted in Europe and Japan, and financial linkages were still at a relatively vestigial stage – the Herstatt Bank incident notwithstanding.[2]

Persuasive theoretical and empirical arguments against coordination were also brought to bear during this period. Rogoff (1985) wrote an influential paper showing how greater co-operation among monetary authorities might lead to an undesirable equilibrium, characterized by increased instability and higher global inflation.[3] He argued that without the discipline provided by individual decision-making in a competitive setting and the risk of a sharply depreciating exchange rate in response to any suspected policy misbehaviour, authorities would feel free to collectively ease interest rates in the hopes of securing some short-term gain in output and employment.

Frankel and Rockett (1988) joined the debate and underscored the problems that might arise if policy-makers decided to coordinate using the wrong macro model of the economy.[4] The authors conducted a "horse race" with 11 of the most popular models of the time, and found dramatically different results depending on which model was chosen. Since only one of them could be right – but which one remained uncertain – putting all your policy eggs in a single basket was probably unwise. They showed that better results might be obtained through time

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[2] Bankhaus Herstatt was a mid-sized German bank that was active in foreign exchange markets and failed in 1974 during the first oil shock. It was shut down at the end of the business day, when many banks still had foreign exchange contracts for settlement. The international impact was substantial, even in the "less-connected" world of the 1970s. As the repercussions from failed transactions mounted, gross funds transferred in New York fell by 60 per cent over the next several days.

[3] K. Rogoff, "Can International Monetary Policy Cooperation be Counterproductive?" Journal of International Economics 18 (1985): 199–217.

[4] J. Frankel and K. E. Rockett, "International Macroeconomic Policy Coordination when Policymakers Do not agree on the True Model," American Economic Review 78, no.3(1988): 318–340.

by allowing policy-makers to choose their favourite model rather than forcing everyone to coordinate around a single model.

Oudiz and Sachs (1984) reinforced the case against coordination by simulating their state-of-the-art general equilibrium model and showing that, even if one picked the right model, the improvement, relative to proceeding independently, was very modest.[5]

It is important to note that all of these cautions came from the economics side. If one factored in the risk of political misdirection and the scope for the inept application of policy, the chances of success seemed even more remote. Doug Purvis, a well-known Canadian macroeconomist, referred to G-7 policy coordination as fine-tuning to the seventh power.

Certainly, real-world evidence did not seem to offer great hope. Mixed success at attempted coordination through the 1970s and 1980s, and the collapse of the Bretton Woods system itself – the most ambitious effort at international policy coordination – all appeared to point in the same direction.

So what changed?

Looking at the more recent policy statements from the G-20 leaders one can't help but be struck by the sea change that has occurred in received wisdom. Has the world changed, or were earlier views simply wrong? It is probably a little of both.

First and foremost, international linkages have risen dramatically over the past 20 years, increasing the significance of spillovers. This is clear in the trade numbers, which have typically increased at twice the rate of global GDP, but is even more evident in the escalating volume of gross financial flows (***Charts 1*** and ***2***). Recent evidence suggests that their effects can far outweigh those of trade flows.

Second, flexible exchange rates, which have a great deal to recommend them, have failed to live up to their initial optimistic billing. (Canada's positive experience with a flexible exchange rate through the 1950s and early 1960s might have contributed to this overly sanguine assessment.) Their stabilizing properties were shown to be more limited than previous enthusiasts had credited.

Adding to these complications is the limited scope that now exists for significant adjustment in policy-makers' standard fiscal and monetary instruments. The zero lower bound on interest rates and the elevated levels of government debt and deficits in most of the major advanced economies have left very little room for manoeuvre (***Charts 3*** and ***4***).

It is important to note that the earlier view had more of an ex ante orientation. "Tending to your knitting" or "keeping your own house in order" (with apologies for the mixed metaphors) was seen as a way of avoiding trouble for oneself and others. The fact that this prescription was not followed by everyone is, no doubt, one of the contributing factors in the present dilemma, if not the primary cause.

Second-best strategies for staying out of trouble, such as keeping your own house in order, may now have to give way to third-best coordination strategies, ex post, if one is trying to escape from a difficult situation with limited room for manoeuvre on the policy front. A little help from your friends might be all you have left.

In fairness to the proponents of the earlier independent approach, while they were skeptical of formal policy coordination, they typically assumed that a light-handed but important form of "soft" policy co-operation would nevertheless exist. More specifically, policy-makers were assumed to meet regularly – as they in fact do – in order to exchange views on the state of

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[5] G. Oudiz and J. Sachs, "Macroeconomic Policy Coordination among the Industrial Economies," Brookings Papers on Economic Activity 1 (1984): 1–65.

the global economy and get a sense of what they might do in alternative states of the world – if not fully revealing their near-term game plan. Proponents of the "less is more" view also expected countries to play by the rules of the game as implicitly understood at the time. Most importantly, advanced economies, which dominated the global scene by a wide margin during this period, were assumed to operate under a fully flexible exchange rate system. Even if some countries might choose to fix their currencies, this would not necessarily pose a problem. Unlike many of the present-day emerging market economies (EMEs), they were not expected to engage in persistent sterilized interventions in an effort to subvert the price adjustment process.

Challenges facing policy-makers today

As noted earlier, the two most pressing challenges facing policy-makers today are:

- finding a solution to the European debt crisis; and
- putting the global economy on a path to strong, sustainable growth.

The first of these is in some sense logically prior to the second. However, providing a credible prospect of long-term growth is also necessary for achieving the first objective. Fiscal and banking problems are not going to be solved by deleveraging alone. It will also be necessary to expand the size of the global pie in a more evenly distributed manner if long-run stability is to be achieved.

The remainder of my presentation will focus on the G-20 Framework for Strong, Sustainable and Balanced Growth. The world economy, in aggregate, is suffering from deficient demand (i.e., a deflationary gap). Beneath these aggregate numbers, however, is an obvious imbalance. Some countries, mostly EMEs, have been growing too quickly, leading to inflationary pressures and other serious market distortions. Others, mainly – but not exclusively – advanced countries, suffer from too little growth. Given these starting positions, there should be a way of making both groups better off by rotating demand from one to the other. Unfortunately, this has been much more difficult to achieve in practice than it would appear.

The uneven pattern of growth that we are presently experiencing is matched by unsustainable external imbalances, with many advanced countries running sizable current account deficits, despite their slow growth, while many EMEs are running sizable surpluses, despite their strong growth (***Chart 5***). In many cases, of course, the export-led development strategies that some EMEs pursue, and the resulting trade surpluses, are the reason for their phenomenal growth.

While exchange rate misalignment is an important external driver of the trade imbalances, a number of internal imbalances have also contributed to the problem, such as runaway government and household debt, and will have to be addressed before a sustainable solution can be achieved.

Major advanced economies with deficient demand cannot consolidate their fiscal positions and boost household savings without support from the external side in the form of increased foreign demand. Meanwhile, EMEs, seeing their growth decelerate because of sagging demand in advanced countries, are reluctant to abandon a strategy that has served them so well in the past, and have refused to let their exchange rates adjust in a material way. Sterilized intervention continued at an accelerating pace over most of the past four years, and new "macroprudential stabilization tools" (i.e., capital controls) have been introduced to further buttress their defences. Advanced countries, receiving limited assistance from some of their most important EME trading partners, have been forced either to use what little fiscal space remains to stimulate their economies or to resort increasingly to unconventional monetary policy remedies, such as the Fed's quantitative easing. The latter, in turn, tend to push capital flows toward EMEs in ever-larger amounts, exacerbating EME concerns about

the twin Hecubas of sudden stops and destabilizing credit growth, causing them to tighten their controls further (***Chart 6***). The vicious circle that is thereby created, as each waits for the other to do the right thing, threatens to destabilize the entire global economy.

How can we escape this "prisoner's dilemma"? The G-20 Framework for Strong, Sustainable and Balanced Growth offers just such an escape. It has four key components:

- fiscal consolidation in those countries that need it;
- a rotation of global demand (facilitated by greater exchange rate flexibility);
- sweeping financial sector reforms; and
- ambitious structural reforms to the real economy to foster higher long-run growth.

I will not have much to say about financial sector reform, except to note that it is probably proceeding at a faster pace than the other three components, despite the breadth of the reform agenda. While much has already been agreed upon, actions mean more than words and implementation is obviously critical.

Structural reform, in contrast, is moving exceptionally slowly, with few specific and concrete reforms being proposed by any of the G-20 countries. While it is difficult to garner the sort of political support necessary to drive significant change in the midst of a crisis, the reverse is also true. The momentum for reform seems to disappear once things appear to be getting better. Countries must break out of this paralyzing pattern and, instead, seize the opportunity to do the right thing now.

Fiscal consolidation is proceeding more rapidly, in some cases, than short-term macroeconomic conditions might warrant. However, countries are being forced to accelerate the pace of tightening by increasingly skeptical and impatient market "vigilantes," lest they fall into the ranks of those already deemed too far gone to save. Ideally, countries would be able to outline a credible longer-term plan for fiscal sustainability, and receive in return increased room for manoeuvre (i.e., easing, or less tightening) in the short term. This Augustinian approach to fiscal probity is clearly difficult, if not impossible, to effect in practice. As a result, many countries are finding themselves with less room for manoeuvre than they expected.

Regrettably, it is movement on the exchange rate front and the correction of external imbalances that are proceeding at the most glacial pace (***Chart 7***). A way must be found to break this log-jam to everyone's advantage. The Mutual Assessment Process (MAP) that the G-20 has initiated and the use of indicative guidelines are expected to help push the process forward, but meaningful action, as opposed to agreement on the mechanics of the MAP, appears to be lacking.

Model simulations

The final section of my presentation contains some model results highlighting how much could be gained globally from timely and simultaneous action on many of these fronts – and by the converse – how much could be lost if it is done poorly or not done at all. I'd like to stress at the outset that these simulations are not merely illustrative. They are based on an estimated global model that the Bank of Canada uses internally for its forecast exercises and analysis of alternative policy scenarios. By the same token, I won't try to suggest that the model does more than it can, despite being the best of breed. A healthy degree of caution has to be applied to all such exercises.

Still, I think you'll find the results interesting. We begin with a base case and use our model to identify a set of conditions that are sufficient for the resolution of global imbalances. These include:

- increasing U.S. private savings rates and maintaining them through time at 6 per cent of GDP;

- engineering a gradual, timely and credible fiscal consolidation in the United States, Europe and Japan;
- allowing the real effective exchange rate for China to appreciate by 20 per cent, while the U.S. dollar depreciates by 15 per cent;
- implementing policies to stimulate domestic demand in China and emerging Asia; and
- pursuing a program of gradual but meaningful structural reform in Europe and Japan to raise potential growth.

This should not be interpreted as a Goldilocks scenario. It might be possible to do much better with more ambitious and concerted action; however, it is sufficient to stabilize government debt and deficits, together with current account balances, at sustainable levels. We might call it a "good," as opposed to "great," outcome.

In an alternative scenario, we ask what would happen if the implementation of these corrective measures were delayed by five years (i.e., over our projection horizon), after which time they are allowed to kick in. In other words, this alternative scenario eventually course corrects and is by no means as bad as it can be. The results for the good and (somewhat) bad scenarios are shown in the graph below.

Postponing the required policy measures in emerging Asia, including China, and in the advanced countries produces a cumulative 8 per cent decline in world and U.S. GDP relative to the baseline, while the difference in China's GDP is roughly 12 per cent. In 2017, world GDP is lower by over US$7 trillion, and it could well be much worse (***Chart 8***).

A third, and separate, scenario that we conducted on an earlier occasion is in many ways even more interesting. It asks what would happen if fiscal consolidation and household balance-sheet repair were actively pursued in the advanced countries – whether voluntarily or driven by impatient financial markets – but without the support of rising external demand in those countries that needed it (i.e., absent exchange rate adjustment and stimulative policies in emerging Asia).

The resulting loss in global GDP is greater than under the bad solution, at least over the five-year horizon. Doing half the job, in other words, is worse over the short- to medium run than doing nothing. Fiscal consolidation and the repair of household balance sheets are necessary and inevitable, but doing them quickly, unassisted by growth from elsewhere, deepens global deflation.

EMEs will not be able to decouple in these scenarios. Although many of them face inflationary pressures at the moment, and serious distortions to their domestic economies, they will be quickly caught up in a vortex of imploding demand from the advanced economies and follow them down. Rotating global demand through the timely adjustment of exchange rates and structural reform could prevent this.

Sounds good. Everybody wins. So why hasn't it happened? Fear, narrow self-interest and political inertia are the reasons. This is why adopting an "After you, Alphonse strategy" is bound to fail. The hope is that, by everyone agreeing to move together, these impediments can be overcome. Everyone should hold hands and take a leap of faith – but not blind faith, mind you. There is good reason to think it will work. It certainly looks better than the alternatives.

Thank you for your attention.

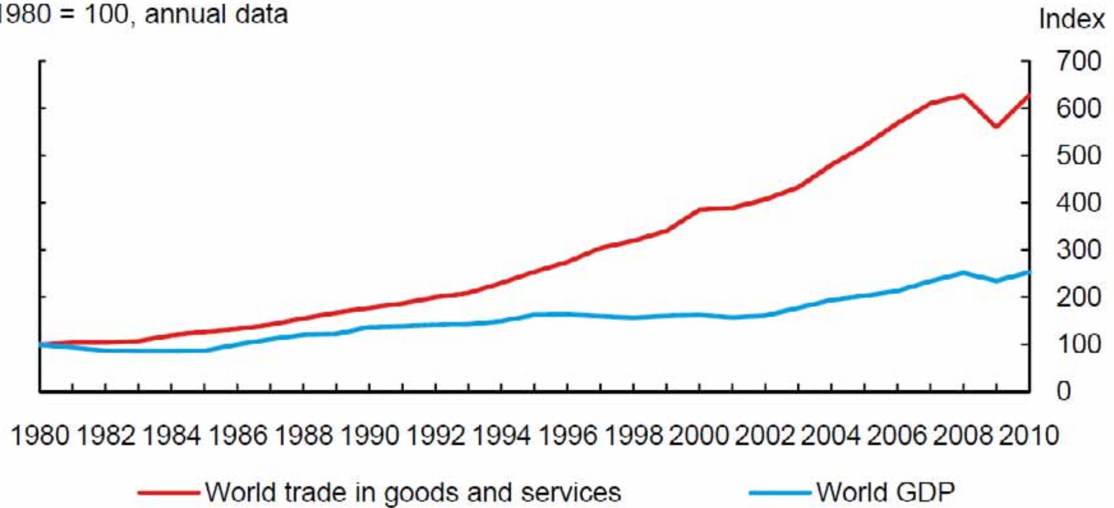


Chart 1: Trade flows have grown faster than global GDP
World trade volume of goods and services in 2005 dollars and real GDP
1980 = 100, annual data
Index
700
600
500
400
300
200
100
0
1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010
World trade in goods and services
World GDP
Sources: International Monetary Fund World Economic Outlook
and Organization for Economic Cooperation and Development
Last observation: 2010

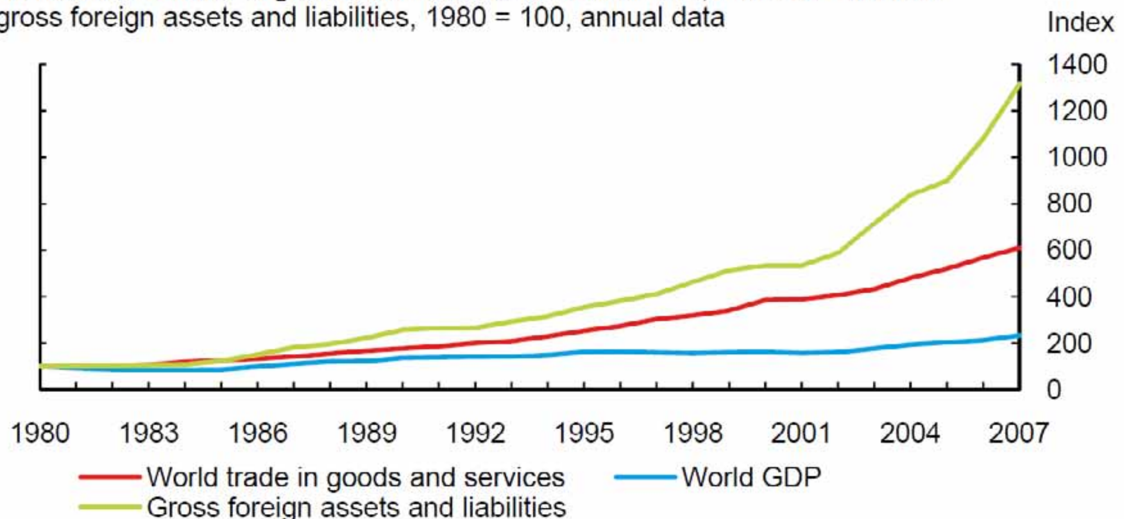
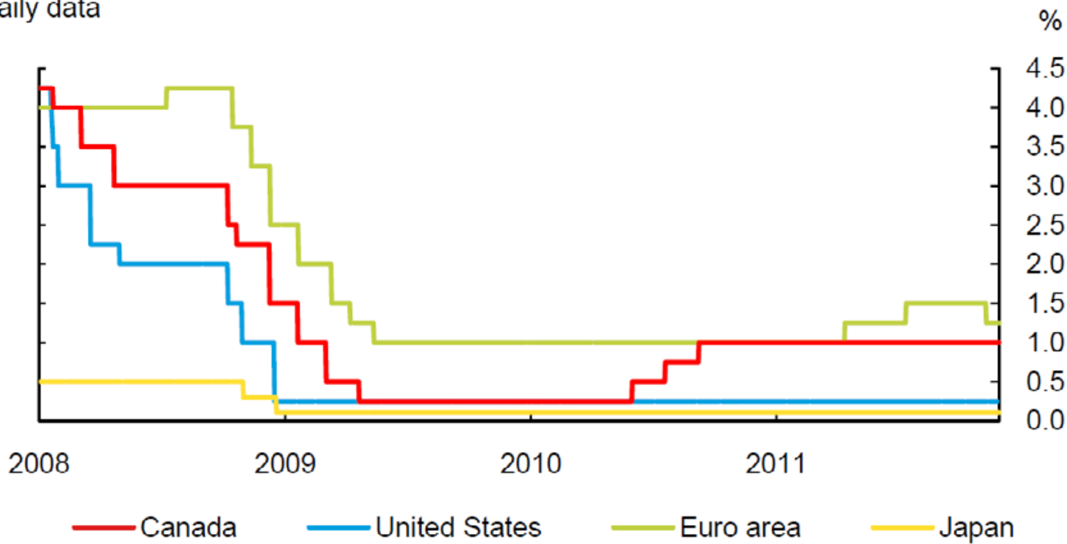


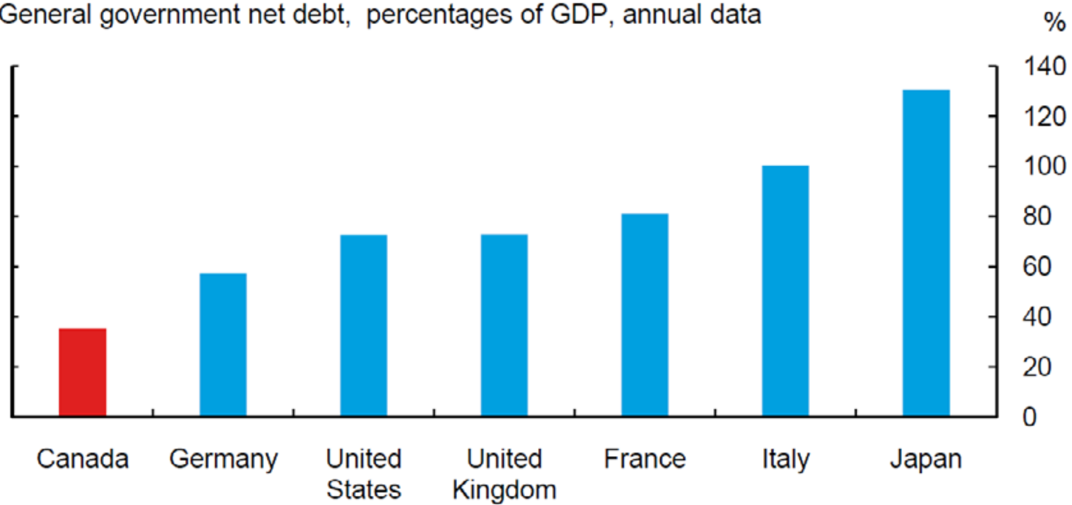
Chart 2: Capital flows have increased dramatically
World trade volume of goods and services in 2005 dollars, real GDP and real
gross foreign assets and liabilities, 1980 = 100, annual data
Index
1400
1200
1000
800
600
400
200
0
1980 1983 1986 1989 1992 1995 1998 2001 2004 2007
World trade in goods and services
World GDP
Gross foreign assets and liabilities
Sources: International Monetary Fund World Economic Outlook, Lane, Milesi-Ferretti (2007)
and Organization for Economic Cooperation and Development
Last observation: 2007

Chart 3: Policy rates remain at or near historic lows in most advanced countries



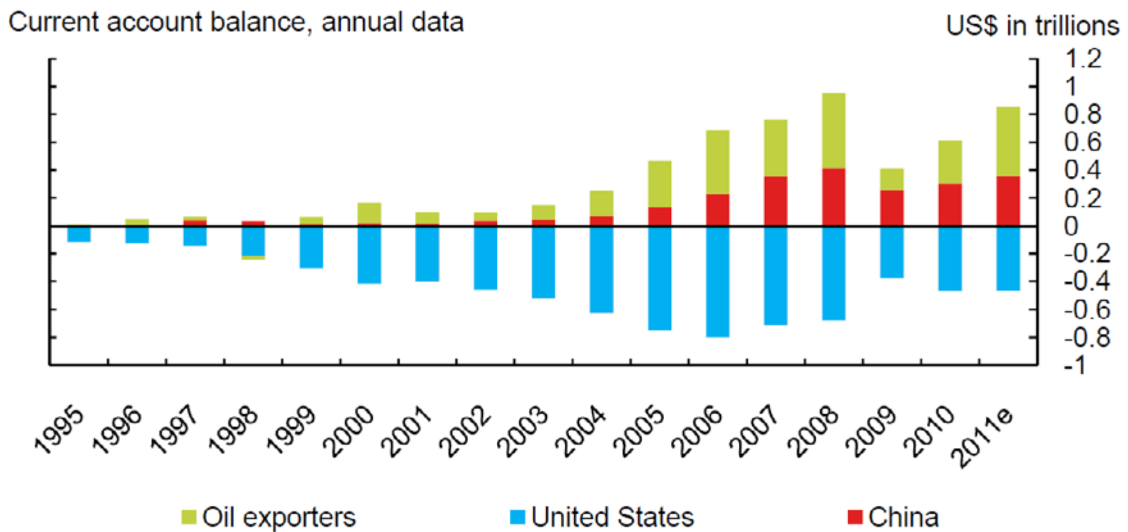
Sources: Bank of Canada, U.S. Federal Reserve, European Central Bank, and Bank of Japan Last observation: 25 and 28 November, 2011

Chart 4: Debt levels in many countries leave little room for manoeuvre



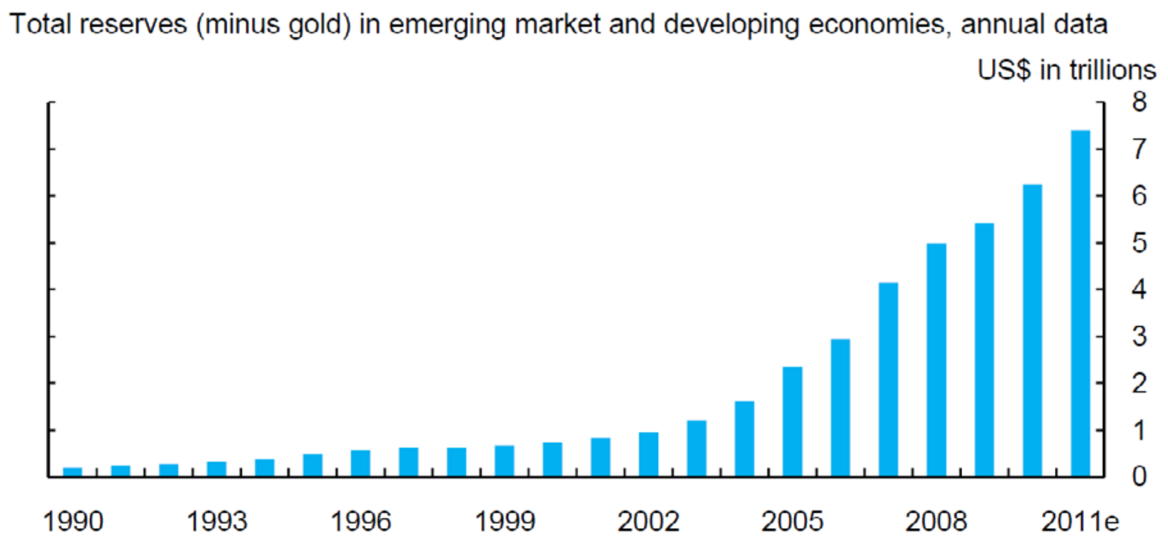
Source: International Monetary Fund World Economic Outlook Last observation: 2011 estimate

Chart 5: Current account imbalances are unsustainable



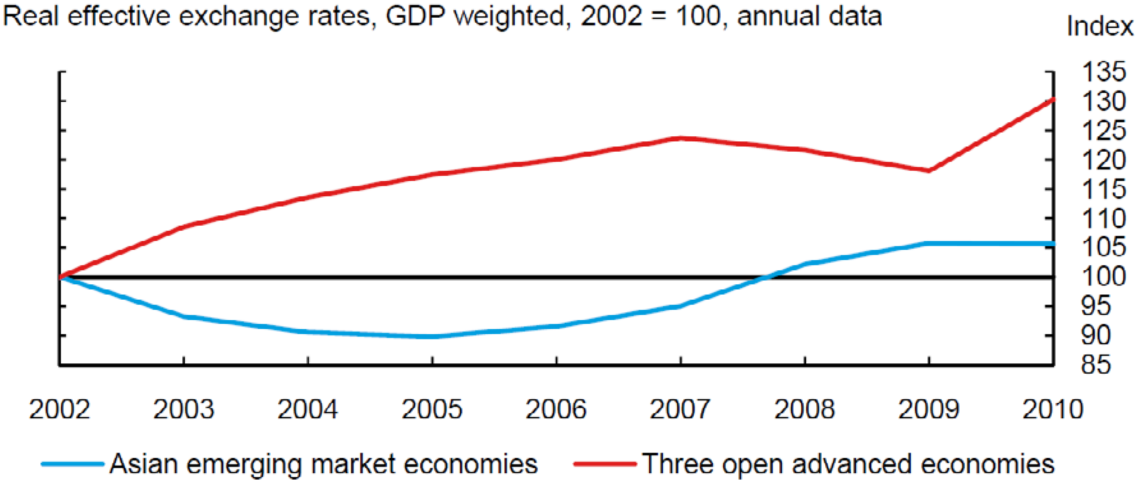
Note: The Oil exporters comprises OPEC members and Russia.
Source: International Monetary Fund World Economic Outlook

Chart 6: Reserve accumulation in EMEs has been soaring



Note: 2011 estimate is calculated by annualizing reserve accumulation from January to August 2011
Source: International Monetary Fund International Financial Statistics

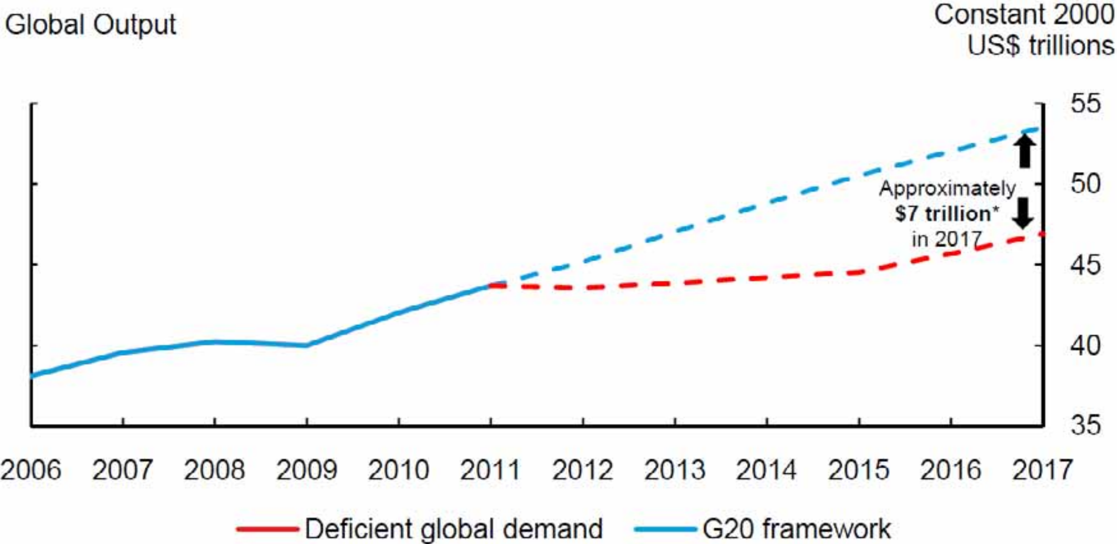
Chart 7: Limited exchange rate adjustment in Asian economies



Note: Emerging Asia: China, Thailand and Malaysia; Three open advanced Economies:Australia, Canada and Switzerland
Sources: Bank for International Settlements, International Monetary Fund World Economic Outlook, national statistics agencies, Bank of Canada calculations

Last observation: 2010

Chart 8: Postponing action opens a $7 trillion global GDP gap



*This estimate is a rough approximation. Depending on the assumptions, it could range from $6 to $9 trillion
Sources: Bank of Canada and World Bank