Should G7 Policy Coordination Be Revived?

I. Absolutely! Now more than ever.

BY C. FRED BERGSTEN
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There are three reasons why the G7 should launch a major new effort to coordinate their economic policies, especially over the next year as the United States assumes the chair for next year's summit and associated meetings. First, the world economy stands at a crucial crossroads. There are strong positive signs of recovery in the United States and the beginnings of pickups in Europe and Japan. However, the outcome remains uncertain and needs policy reinforcement. Moreover, the sustainability of the U.S. expansion is unclear, in particular whether private investment will achieve the needed acceleration.

Second, global growth needs to proceed on a much more balanced geographical basis. The U.S. trade and current account deficits are ap-

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Melissa Ebbe, *St. Francis*, oil on fabric, 30 inches by 48 inches, diptych, 2002.

II. No way! Maybe a soft form of atmospheric cooperation. But no policy coordination.

BY HORST SIEBERT

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Do we need a coordinated demand package among the United States, Europe, and possibly Japan to get our economies going again? My answer is a clear no. Of course, the idea behind a demand stimulus for the world economy is motivated by the economic activity being at a low level, recovering from a recession, and by the expectation that additional demand would stimulate the upswing. And of course, it can be shown in a game theoretical context that cooperation between agents of economic policy improves the overall outcome. But while I accept a soft form of atmospheric cooperation, so that economic policymakers know what is on each other's minds, there are so many flaws in the ideas of macroeconomic internationally coordinated demand management that I have to warn against it.

The U.S. economy has left the bottom of the cycle's valley and is moving upward, and a recovery is forecasted for Europe for the next year. There definitely is no deflation in either economy. Therefore, there is little reason for a demand expansion now. It would even come too late, and it would represent a distortion of the upswing with the risk of overheating.

With respect to the policy instruments, monetary policy in all three major regions of the world has already produced extremely low nominal and real short-term interest rates. Monetary policy is expansive by all criteria, not only looking at the money aggregates but also at the most often used indicators such as the Taylor Rule.

The further expansion of fiscal policy can in no way be justified. In the United States, the budget deficit is already high anyhow, at 3.7 percent in 2003 and 4.4 percent of GDP in the fiscal years 2002–03 and 2003–04. In the euro area, Germany and France have surpassed the Maastricht criteria. Germany, producing one-third of the euro area's GDP, will violate the 3 percent norm for the third year with budget deficits of 3.5 percent in 2002, 3.8 percent in 2003 and a forecasted figure way above 3 percent in 2004. A similar story applies to France.

The stability of money always depends on the solidity of public finances. This is a specific issue in the euro area where the currency is Europeanized but budget decisions are subject to national political decision making. That is why the euro needs the stability pact and that is why the ECB has to be more cautious in its monetary policy than the Fed. What would happen if the international financial markets lost confidence in the euro because the budget deficits of the member states ran out of control? This would be a disturbing scenario for the world economy. The ECB has to always be aware of that risk.

Anyway, demand expansion is not the strategy that will solve the structural issues of the three major continental countries of Europe: Germany, France, and Italy. These structural issues lie in the high social welfare spending in these countries. Their systems of social security cannot be financed any more, not even considering the aging of the population. To finance these systems puts a tax on labor weakening the demand for labor; in addition the income floor they provide dries up the low segment of the labor market. All this, plus the institutional setup of wage-bargaining, is at the root of the high and persistent unemployment, the low capacity for shock absorption, and the low growth performance. Demand expansion would not solve these structural issues of the welfare state. Moreover, Europe would fall into a debt trap like Japan. It would be irresponsible to run into higher debt when debt already finances social welfare spending.

Besides, who still has confidence in the simple Keynesian approach of demand management? Politicians have proven un-

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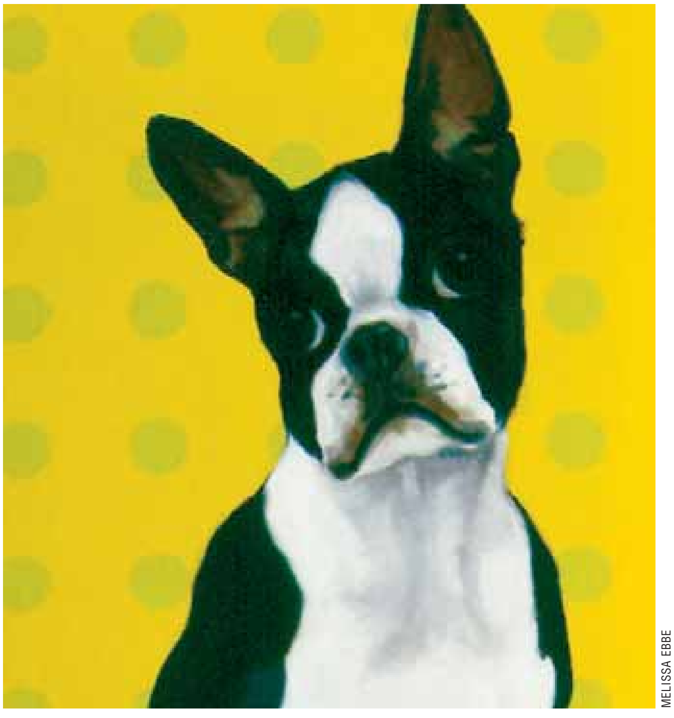
able to restrain themselves from spending money in boom times when tax revenues are high. They have been likened to a dog given the task of watching a mountain of sausages.

An issue related to coordinated demand management is stable exchange rates. Of course, no one wants volatile exchange rates. But this would need such a tremendous amount of explicit coordination in monetary, fiscal, and other policy areas between the major regions of the world that it is simply unrealistic. Here are just two of the policy areas that influence the exchange rate and would have to be coordinated: The continental countries all have some type of wage policy undertaken not by the government but by the social partners, while in the United States, wages are determined in the markets. Or take the difference in social welfare spending of 20 percent of GDP for the public retirement, unemployment, and health systems in Germany, France, and Italy versus half that percentage for the United States. How can policies be coordinated under such divergent settings?

There are additional issues: The economies are in different cycles, their political decision mechanisms have different inside lags. But what is more important in an international context: Macroeconomic coordination blurs responsibilities; the other countries can be made the scapegoat for economic failures. Or, to put it differently, international coordination does not solve the assignment problem. Besides, one can observe in the euro area how difficult macroeconomic coordination is even in an economic and monetary union.

There is little reason for a demand expansion now.

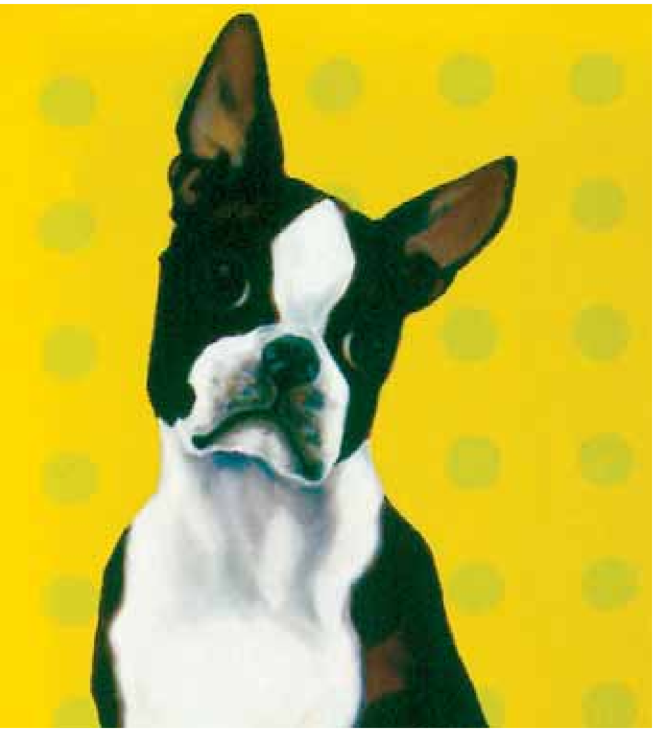


MELISSA EBBE

An example of severe failure of global coordination is how Japan was pressured in the second part of the 1980s by the United States to expand demand and to play the demand locomotive for the world economy. Among those playing that tune were Paul Krugman and my good friend Fred Bergsten. Japan expanded the money supply, the additional liquidity did not go into the consumer price index, but it produced the Japanese bubble in the stock and real estate market. When the bubble burst, Japan fell into disarray for a whole decade. Germany was pressured as well, but the Bundesbank did not follow.

Macroeconomic coordination blurs responsibilities.

But what about the basic idea from game theory that we can improve efficiency if we overcome the prisoners' dilemma in a cooperative approach? Do we have to forget this concept completely? No, it is relevant for another area of international politics, to agree on rules to reduce transaction costs, for instance in the area of the WTO, to reduce negative externalities such as systemic financial crises, for instance in a financial architecture for the world economy, or to deal with global public goods such as global warming. ◆



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Bergsten, *continued from page 18*

proaching $600 billion and have risen by almost one full percent of GDP in five of the last six years. The net foreign debt of the United States now approaches $3 trillion and is growing by 20–25 percent per year. The situation is clearly on an unsustainable trajectory. The dollar will have to fall considerably further to restore a sustainable equilibrium in the United States and world economies if it remains the primary tool of adjustment. The adverse impact on other countries' economies could be severe, especially in Europe, where the euro has already shouldered most of the counterpart appreciation.

Indeed, a continuation of the Louvre compact might well have prevented the Japanese bubble.

The better solution by far would be a coordinated global growth strategy in which Europe and Japan adopted both the structural reforms and macroeconomic policy changes needed to achieve the much faster growth of which they are capable. The United States' external deficit could then fall as a result of increased exports to more rapidly growing trading partners, rather than through a further, perhaps precipitous, decline of the dollar.

The third reason for pursuing G7 policy coordination now is to help restore overall harmony in trans-Atlantic relations. Deep scars remain from the debate over Iraq earlier this year and could flare again at almost any time. Such an agreed G7 strategy could thus strengthen the international security as well as economic outlook.

The record of the past thirty years shows that there are four strong reasons for the main industrial countries to pursue active coordination of their economic policies, all of which obtain now. First, successful coordination improves the economic results for each individual country. Second, coordination at high political levels can facilitate tradeoffs across issue areas that would otherwise be impossible. Third, both the process and substantive results of policy coordination strengthen overall relations between the participating countries.

Fourth, and most importantly, international coordination bargains can help political leaders in individual countries win domestic support for their economic policy initiatives. National leaders often launch constructive reform programs that encounter strong domestic opposition. But embedding those reform efforts in an international agreement, where each country undertakes an obligation to do its part in a global deal and demonstrably benefits from the overall package, can overcome that resistance and convert stalemate into consensus.

There have been numerous examples of effective policy coordination. The most dramatic have taken place in Europe throughout the evolution of the European Union, especially in the run-up to the creation of the euro and its subsequent implementation. Those successes have obviously not come without controversy but they have clearly achieved the four purposes enumerated above: enhancing policy impact, facilitating cross-area tradeoffs, strengthening political relations, and especially overcoming resistance to domestic reform.

Coordination has occurred less frequently at the global level but there have been two noteworthy episodes of success. In 1978, the Bonn summit adopt-

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ed a comprehensive global growth package in which several countries committed to implement specific expansionary measures. These measures were faithfully adopted and the desired results were beginning to be realized when the Iranian revolution in early 1979 led to the second oil shock, disrupting the entire world economy and derailing the macroeconomic side of the summit effort.

The Bonn package nevertheless had two profound and lasting effects, both of which made major contributions to global growth and stability. The United States, as part of its G7 commitment, agreed to decontrol domestic energy prices and thus reduce world demand for oil. President Carter (and President Ford before him) had already attempted to achieve decontrol but had been thwarted by the U.S. Congress. Carter was able to convince Congress that the total Bonn package was in the national interest of the United States, however, and that the United States thus had to fulfill its part of the bargain.

In addition, the G7 leaders at Bonn pledged to bring a successful conclusion to the Tokyo Round of global trade negotiations in the GATT, which were floundering at the time. The Round concluded shortly thereafter and U.S. Trade Representative Robert Strauss testified subsequently that it would never have succeeded in the absence of the political commitment at Bonn.

The second major episode of successful G5/G7 coordination came via the Plaza Accord of 1985. Through direct cooperation in the currency markets, the countries managed an amazingly orderly adjustment of the massive disequilibrium in exchange rates that had developed during the first half of the 1980s. They steered the dollar down by a trade-weighted average of more than 30 percent, with corrections of more than 50 percent against the individual key currencies (deutschemark and yen), with very little adverse effect on global growth or any of the national economies. In so doing, they also averted the outbreak of massive trade protectionism in the United States that was threatened by the surge in its trade deficit to then unprecedented levels.

When the decline of the dollar threatened to become disruptive, in early 1987, the G7 shifted from Plaza correction to Louvre stabilization to avoid the risk of a "hard landing." Some observers of that arrangement, especially in Japan, have blamed the subsequent asset bubble in that country on the Louvre accord. In fact, the currency "reference ranges" adopted at the Louvre were retained for only a few months and could hardly be blamed (or credited) for anything that occurred over the next few years. (Japan's bubble developed in 1988–89 and burst in 1990–91.) Indeed, a continuation of the Louvre compact might well have prevented the Japanese bubble: an effective agreement to avoid renewed dollar appreciation and yen decline, as occurred in the late 1980s, would have pushed Japan to stimulate domestic demand through fiscal rather than monetary policy and thus obviated the direct cause of its subsequent travail.

It is thus clear that policy coordination among the major countries can be achieved and can deliver positive results. The strategy now should be to devise a package which the individual leaders could use, as they did in 1978 and again in 1985–87, to overcome domestic resistance to reforms they have already proposed. Prime Minister Koizumi could use such a program to win comprehensive reform of the Japanese banking system. Chancellor Schröder could use the package to galvanize support, both from his own party and the opposition-controlled Bundesrat, for his efforts to modernize the German welfare system and labor practices. Similar gains could be achieved in each of the G7 countries. The results would include a stronger world economy, a more balanced recovery, and a significant restoration of political and security harmony between the United States and several of its traditional allies. With leadership from the United States, the G7 should devise and implement such a package in the coming months. ◆

Global growth needs to proceed on a much more balanced geographical basis.