# On Concerted Unilateralism : How can a higher global growth rate be achieved?

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# 1 Introduction

- During the Great Moderation the world economy grew rapidly, without inflation, and globalisation spread
  - it was thought that growth was self-sustaining
- We now know that more rapid global growth will require cooperation: I will present case for 'concerted unilateral reform'
  - "Cooperation between countries to ensure global economic growth: a role for the G20?", 13th Heinz Arndt Memorial Lecture, Australian National University, 17 September 2014
- We can also think abstractly about the kind of cooperation which is required (Anton Korinek). And there is much to be learned from history about the nature of cooperation required:
  - Martin Wolf : 'We are Doomed to Cooperate' ("Three Events which Shaped our World", *Financial Times*, 10 June,2014)
  - P Temin and D Vines *The Leaderless Economy: Why the World Economic System Fell Apart and How to Fix It* (Princeton, 2013)
  - P Temin and D Vines *Keynes: Useful Economics for the World Economy* (MIT, 2014)

# 2 History

*The Late 19th Century Global Economy*

- Described vividly by Keynes in 12 short pages: Chapter 2 of J. M. Keynes (1919) *The Economic Consequences of the Peace*
- A period similar to the Great Moderation. In the earlier period:
  - rapid growth: low wages, high savings, capital accumulation (Ramsey)
  - open trade managed within British empire and within Europe:
    - the UK and Germany specialised in advanced manufactures,
    - obtained food and raw materials in exchange, from the European periphery and from global periphery, much from empires
  - capital mobility made possible by gold standard:
    - much advanced-country savings invested abroad in building infrastructure, in both the European periphery & global periphery
  - macroeconomic stability ensured by gold standard
- Macroeconomic cooperation not needed: 0 targets / 0 instruments
- Outcome led to global convergence:
  - Germany, the US, and other global peripheries, converged towards UK
- Keynes observed that this policy ‘non-system’ was fragile

## *The Post World War I era*

- Even prior to the War
  - the UK was unable to sustain its technological leadership
  - lack of any institutional structure in which macroeconomic adjustment was possible (Germany chose to 'adjust' by going to war)
- Lack of Adjustment
  - deflation imposed on deficit countries - first Germany (reparations) then UK
  - no clear understanding of why the gold standard did not work. (At the Macmillan Committee, in 1930, Keynes focussed on nominal rigidities but he could neither clearly analyse what was wrong nor see a means of escape)
- Speculative Attack in 1931
  - A financial crisis in Germany became a currency crisis, spread to the UK, and then spread to the US
  - Further policy failure by the US in raising the interest rate to 'save' gold
- The global macroeconomic policy framework failed spectacularly.
  - Global spillovers turned a recession into the Great Depression
    - Note that this was *not* a 'policy decision'
    - And it led to a rise of protectionism
    - And it was followed by the Second World War
- In 1931 Keynes faced a twin task
  - First write the *General Theory* (closed economy) and then do Bretton Woods

*The Golden Age from 1945 to 1971 ('Trente Glorieuses')*

- Global Prosperity re-created in the period from 1945 to 1971
  - The 'Bretton Woods system':
    - the creation of the IMF
    - The creation of the World Bank
  - During this period global savings were again invested productively – initially managed by the Marshall Plan and by the World Bank, and then increasingly through FDI and private capital flows
  - The GATT – which became the WTO – promoted trade liberalisation
    - The GATT needed the IMF (to avoid protectionism) and the Fund needed the GATT (to ensure that the Marshall Lerner conditions held)
- Once again the global periphery converged with advanced countries
  - This time we saw Europe and Japan catching up with the US

- The global macroeconomic policy system under Bretton Woods
  - unwillingness to return to a gold standard system in which countries in external deficit were forced to adjust
  - replaced by a system of two targets / two instruments for each country
    - *internal balance*: demand to be managed by fiscal policy to ensure full employment (Keynes' *General Theory* now understood)
    - *external balance:* exchange rate to be adjusted to ensure that a country could export enough to pay for its imports at full employment
- *System for one country* written down by Meade in 1952 (Nobel Prize for 300 pages of difficult algebra) and explained by Swan in his diagram in 1956 (same idea in two dimensions)
  - International Monetary Fund the institution to manage adjustment processes for each individual country:
    - required international agreements about each country's exchange rate
    - required the IMF to provide liquidity during the adjustment process
    - allowed each country to use fiscal policy to pursue full employment

- A *Global System was* also established at Bretton Woods. This was also written down by Meade in 1952 (using a *two-country* model)
  - International Monetary Fund the institution in which to manage this internationally cooperative process:
    - required international agreements exchange rates (the N-1 problem)
    - required the IMF to provide sufficient liquidity during adjustment process (Keynes wanted the Bancor)
    - *Also* required appropriate fiscal policies in each country
- A need for global coordination of domestic fiscal polices
  - *John Maynard Keynes*: risk of dominant power (US) being unwilling to adjust exchange rate & imposing external balance on uncompetitive periphery, leading to a global Nash equilibrium in which there was global recession. (Became known as 'scarce currency problem', but this was a *macropolicy* problem not a *currency* problem.)
  - *Harry Dexter White*: risk of secondary countries (esp. the UK) refusing to discipline fiscal policy so that the necessary nominal exchange rate change in each such countries would not lead to adjustment but would simply lead to inflation: a Nash equilibrium with no adjustment in the periphery and inflation in those countries. (Therefore opposed Bancor)

- This was a global system, in which there was to be internnational surveillance of national fiscal policies
  - Keynes and White each believed that the respective risk which they had perceived required constraints on national fiscal policies
  - But they differed as to what these constraints should be!
- In Anton’s language:
  - In a two-country version of such a global system there should, in principle, be 3 objectives (full employment in each country and external balance between the countries) and three instruments (fiscal policy in each country and exchange rate between them)
  - In that case (if they agree on the external balance objective) the Nash equilibrium is the same as the cooperative equilibrium and ‘concerted unilateralism’ is ok
  - But the danger is that each country actually has an additional objective
    - Keynes: saw a risk of an unwillingness to adjust the exchange rate in US because the US would wish to protect its exporters
    - White; saw a risk of an unwillingness to cut fiscal expenditure in the UK because of a risk to protect public services
  - In that case cooperation is necessary

- Many now see a need for re-establishment of such a targets-and-instruments global system
  - In the face of global problems about the ending of a global policy regime (similar to the problems observed in 1914), we need workable constraints on national policies.
  - The G20MAP offers part of what is necessary
  - Making the G20MAP work remains a major agenda item for the reform of the International Monetary System

*The Crisis of Adjustment in the 1970s and early 1980s*

- Crisis of adjustment in 1971
  - Inflation not managed, leading to competitiveness problems
    - By late 1960s there was a lack of a nominal anchor
  - Growth of international capital mobility led to speculative attack
    - International Monetary Fund unable to enforce change of domestic policies and/or necessary exchange rate adjustment, in either deficit country (US) or surplus countries
- Speculative attack and breakdown: Lack of a clear macroeconomic policy framework led to systemic breakdown
  - Smithsonian 'agreement' in 1971 was not a policy choice
- Lack of macroeconomic policy framework remained true throughout the 1970s and for much of the 1980s
  - Discipline only re-established (gradually) in the 1980s

# 3 Intermission – the Great Moderation

- The Great Moderation followed the crisis of 70s and 80s
- Global Prosperity re-established
  - Bretton Woods regime replaced by a world of floating exchange rates and inflation targeting
    - The IMF became an institution to manage financial crises in Third World, rather than an institution to manage international macroeconomic interactions
  - the WTO promoted trade liberalisation
  - private capital markets managed international capital flows.
- The global periphery converged with advanced countries
  - This period saw - first - the Asian miracle of the 1990s and then the rise of China

- Inflation targeting becomes the central framework
  - One-target/one-instrument macroeconomics
    - Objective is inflation in each country, and subject to that being achieved, full employment of resources in each country
      - Note: How come ‘two for one’ - cf Blanchard, paper around 2003
    - Instrument is interest rate in each country
  - Floating exchange rates an essential part of this system
    - makes it possible for each country to separately use its interest rate as a policy instrument, even although UIP ties down the interest rates in each country to be equal to those in other
    - enables countries to insulate themselves from asymmetric shocks, including from policies in other countries (a Mundell-Fleming idea - see ‘impossible trinity’); see attack on this idea by Helene Rey
  - Fiscal discipline a longer term objective to be achieved by each country separately
  - External balance disappears as objective of policy
    - countries borrow to help with shock absorption and in light of longer term needs; ok provided both public and private sectors obey solvency constraints .

- One-one framework means that, *even although there are significant spillovers* there is no need for international cooperation
  - Each country can (costlessly) defend itself from consequences of outcomes in other countries, including from consequences of other countries' policies (c.f remarks by Anton).
- Footnote 1
  - Anton's paper shows that this statement is not formally correct, but I believe that his objection is, *in this case,* of second order importance (Cf. Dornbusch joke of 1986: 'Would you set up cooperation machinery, and constraints on policy, when benefits are so small?'
- Footnote 2
  - A brief period in early 1980s of 2 target (output, inflation) one instrument (interest rate) macroeconomics in which cooperation appeared to be desirable. Attackable by two-for-one reasoning. (Cf Dornbusch joke of 1986 again.
- Footnote 3
  - East Asian countries brought down by speculative attack. But no need for global macroeconomic cooperation after the crisis. (cf. Stiglitz)
- Footnote 4
  - This view has significance – or not - for the Mohan-Rajan complaints about US policymaking

## 4 The GFC and slow global growth

- The Great Moderation came to an abrupt end in 2008
  - Financial collapse and subsequent deleveraging
    - most rapid decline in economic activity since the Great Depression (Eichengreen and O'Rourke, 2010).
  - Remarkable cooperation at G20 Meeting in London in April 2009
    - Interest rates lowered – to nearly zero in US and UK and later Euope
    - Huge fiscal expansion – deliberate and accommodating
      - 'Concerted unilateral expansion'
  - Subsequently quantitative easing (QE) adopted in US UK and now EU
    - But this has been only partially effective.
    - And low interest rates and QE very risky: search for yield, vulnerability
  - In 2009 many thought of both fiscal policy and QE as augmenting monetary policy when the zero bound was reached.
    - Position seemed hopeful
  - There was a pledge of cooperation in process of promoting growth at Pittsburgh summit in September 2009
    - G20 Mutual Assessment Process or "G20MAP" appeared useful

# 5 Fiscal austerity

- The decision to withdraw fiscal support for recovery was taken at the G20 summit in Toronto in June 2010
- ‘Concerted unilateral expansion’ no longer possible when debt-reduction becomes an additional objective
- Enter world of ‘constrained 2 – 2’ macroeconomic policy making
  - Objectives: economic activity and public debt
  - Instruments: fiscal policy and QE
  - But the Nash equilibrium is one in which there is both a shortage of global demand and exchange rate warfare
- The Nash equilibrium is one in which there is both a shortage of global demand and exchange rate warfare

- Austerity in one country imposes burdens abroad
  - In normal world this is not so
    - Fiscal tightening accompanied by monetary easing (demand creation) and currency depreciation (leading to demand diversion). But other countries can defend themselves
    - But if all countries do this, there is *no demand diversion*, and global interest rate falls leading to *world-wide demand creation*
  - When there is a zero bound to interest rates:
    - the diversion of demand comes at the expense of other countries
    - This imposes burdens if they cannot do QE: they cannot compensate for the demand lost abroad
    - And there is *very little world-wide demand creation*

*How to understand this failure to cooperate fiscally?*

- View that too much debt is costly to growth
  - Reinhart and Rogoff……???
- View that cooperation is costly to domestic objective of debt reduction
  - In US, impossible to obtain bipartisan support for eventual debt reduction.
  - In UK, view that delaying debt reduction is time inconsistent
- These views were mistaken
  - Higher public debt may be a consequence not a cause of low growth
  - Fiscal austerity may be counterproductive
    - Size of fiscal multipliers
    - Fall in revenues
  - Especially the argument reviewed above: austerity in one country imposes demand diversion on other countries and leads to very little demand creation globally
    - Countries imposing austerity did not understand the global climate

*Nevertheless in what follows I am going to take austerity in advanced countries as given*

- I am *not* going to discuss its effects in Europe: likely speculative attack
- I am also *not* going to discuss the implications for emerging markets

# 6 Cooperation to Ensure Global Growth

*The Construction of a Global Growth Strategy*

- Australia assumed the G20 Presidency at an inauspicious time
- Background
  - *Macroeconomic and Reform Priorities,* document prepared by IMF Staff for meetings of G-20 Finance Ministers and Central Bank Governors, February 22–23, 2014, Sydney, Australia
  - This document – without being specific - identified a range of plausible reforms which together could lead to world output being 2¼ percent higher by 2018 (about 0.5 percentage point higher growth per year relative the 2013 WEO baseline)
- Between February and June 2014 countries considered what actual reform polices each might separately offer as part of a global growth strategy
  - These were subject to peer review in June-July and outcomes were agreed in Cairns in September
- External evaluation has recently validated additionality of 2% of global GDP by 2018

*The Strategy: A wider range of Policy Instruments than macro*

The core idea:

- The promotion of additional investment in infrastructure
- This is a supply-side as well as a demand-side reform
- A reform in which assets are created as collateral to debt
- This appears to be acceptable, even to countries committed to austerity targets i.e. balance-sheet 'offsets' have enabled policy-makers to get around their austerity constraint
  - Work on public-private risk sharing will lower public sector cost per dollar of investment
    - But note that many PPP projects have ended up with private sector gaining upside and state bearing risk
- This strategy requires addressing obstacles to investment:
  - including regulatory obstacles and a lack of depth in financial markets

## *Strengthening Investment in Emerging Market Economies is a crucial part of this strategy*

- This is where there are huge potential returns
  - Requires reduction in policy risk
  - Requires global financial reform
  - BRICS Bank –at best – may become part of this strategy The promotion of additional investment in infrastructure
- Requires international macroeconomic adjustment
  - Depreciation of real exchange rates, and current account surpluses, in advanced countries, to support increased imports of emerging market economies where investment is taking place
- This strategy contains a longer term potential to help moderate secular stagnation in advanced countries .

*In addition*

- Further micro reforms:
  - promoting competition, particularly in the services sector, as well as reforms to training programs to address skill mismatches.
  - In addition: taxation reform; reform of labour-market institutions including reforms promoting job creation and participation; policies to support technological catch-up.
  - Success in these domestic reforms will enable countries to better support the development of global value chains.
- Supply-side reforms in emerging market economies are likely to reduce national risk premiums and external difficulties, which would in turn enable other countries to implement more accommodating policie
- Doing only the reforms on this page, without the infrastructural investment, risks going in wrong direction, like the Lisbon 'reforms' in the EU

*This is not a search for a short term, instant outcome.*

- Ambition is to to institute a continuing process, over a number of years, in which microeconomic reforms help to stimulate aggregate demand.

*Will these proposed reforms actually be implemented?*

- Reforms are driven by domestic political agendas.
  - The outstanding example of concerted unilateral reform is the liberalisation in East Asia in the 1980s and 1990s
- International environment can feed into this domestic agenda.
  - clear from this era that the sense of opportunities throughout Asia fed into the ability to galvanize domestic reforms.
  - Especially true in the early days of APEC
  - The prospect—and the reality—of liberalisation by others abroad, especially when they were important regional trading partners, was used persuasively by trade policy officials and politicians as they embarked on the contest with protectionists at home over liberalisation.
    - Such leverage was useful during the period, from the mid-1980s to the eve of the Asian financial crisis in 1997, when virtually all Western Pacific economies embarked on far-reaching unilateral liberalisation in the high tide of internationally oriented growth in East Asia.
  - It became easier to liberalise in a climate in which many other countries were doing the same thing.

## *'Concerted Unilateral Reform'*

- What is proposed here can also be described as a process of 'concerted unilateral reform'.
- In effect, each country is able to be 'mindful' of the *opportunities* created by the actions of other countries.
  - These opportunities will influence the extent to which way each country can pursue its own domestic mandate.
  - The existence of a global growth strategy may well act as an inducement to national reform strategies.
- Countries' reforms will, in effect, lead to increased demand abroad
  - what each does may induce reform efforts by others – in the way which happened with trade liberalisation in East Asia in the 1980s and 1990s.
- Such an approach may support a process of global cooperation
  - A cumulative process could be stimulated over a number of years, as happened in East Asia in the 1990s

## 6 Conclusion

- Austerity has made the global growth much more difficult
- ‘Concerted unilateral reform’ is a method of cooperation which can help promote global growth
  - Actions will take place within the G20Mutual Assessment Process
  - Previously, the focus on austerity within the G20MAP has conflicted with objective of growth set out by the G20
  - This strategy offers the opportunity of reviving growth
- This new strategy may enable the G20MAP to be become properly established as part of a global policy process.
  - The aim of Australian policymakers this coming weekend is to hand over an institutional framework which makes possible a continuing enhancement of infrastructure investment, and of other supply-side reforms, which together stimulate stimulate global growth
  - The ambition is to pass on this framework to Turkey, and then to China, as a continuing G20 activity
- Of course Turkey,as G20 President, will have other objectives, including the provision of enhanced international liquidity at times of global macroeconomic stress. But that is another story.