Is International Economic Policy Cooperation Dead?
Summary

- The 2008 economic crisis gave a huge boost to international economic cooperation, as the world’s largest countries sought to avoid a global depression.

- The G20 initially responded to the crisis by agreeing to cooperate on liquidity support, fiscal stimulus, financial reform and trade. But some of these efforts tailed off quickly as the crisis abated.

- This experience shows that the costs of not cooperating can be very substantial if trust is lost across governments. This is a more important driver of cooperation than seeking small gains from more optimal policies.

- Modelling also shows that when economies face extreme circumstances – for example, when interest rates are close to zero or bank lending is constrained by insufficient capital – potential spillovers to other countries are amplified and the gains from international cooperation are substantial.

- A significant barrier to cooperation is when countries fail to agree on the size (or even the direction) of policy spillovers, for example on the effects of unconventional monetary policies. More work is needed to build a common understanding of these spillover effects.

- The experience of the last five years also shows that the institutional arrangements for cooperation are important in determining its effectiveness. The processes set up by the G20 can be important in delivering political support for international policy cooperation, but need to be refined and strengthened.
Introduction

The trend towards globalization has accelerated in recent decades, and regional integration has deepened (especially in Europe). These trends have led countries to take increasing interest in spillovers from one another’s performance and policies. But the 2008 economic and financial crisis gave this a huge fillip as the risks and vulnerabilities stemming from spillovers across national borders became only too clear.

The initial response to the crisis saw the most active move to international cooperation in living memory in a number of policy areas. The coordinated fiscal stimulus in the early stages of the crisis was seen as a good example of effective international efforts, where policy-makers feared that failure to act together could have turned recession into depression for the global economy as a whole, as well as for most countries individually. The action plan agreed at the November 2008 G20 summit in Washington addressed the failures in financial regulation exposed by the crisis (G20, 2008a). But this level of intense cooperation only lasted a short time.

Subsequently, international cooperation has become more complex. Monetary policy cooperation has become a hot topic again, but the focus has shifted from the potential benefits of coordinated policy action to the negative consequences of unconventional monetary policies (in particular quantitative easing (QE) in the United States and Abenomics in Japan), which have led some countries to argue that these are initiating currency wars. And the resurgence of interest in macro-prudential policies as stabilization tools raises further complexities (both between different domestic policy agencies and in terms of international cooperation).

Importantly, however, the instruments and processes for the unprecedentedly close international policy cooperation are still in place. In particular, the G20 process remains. This involves regular meetings at the leaders’ level focused on economic policies, and the linked creation of the G20 Framework for Strong, Sustainable and Balanced Growth at the Pittsburgh summit in 2009 and the associated Mutual Assessment Process (MAP) (G20, 2009b). This has been overlaid upon a post-crisis jump in regional policy integration in a number of policy areas, most notably within Europe.

But as the crisis has receded, so has the impetus for cooperation. There is a risk that the common purpose forged in the heat of economic chaos will wilt in more normal times. It is therefore particularly important to assess what the last five years tell us about why countries cooperate, what they should cooperate on, and how they should cooperate. This paper draws some preliminary conclusions based on the experience to date.

Cooperation or coordination?

There are a number of definitions of cooperation and coordination, though there is general agreement that cooperation is ‘softer’ and less binding than coordination. Both cooperation and

\[1\] The London Summit in 2009, for example, was seen as a major step forward in producing a coordinated response to the crisis (G20, 2009a).

\[2\] The Japanese Prime Minister, Shinzo Abe, launched a recovery plan in December 2012 consisting of three ‘arrows’ – monetary expansion, flexible fiscal policy, and structural reforms (Abe, 2012). The aggressive monetary policy easing has helped to boost inflation to around 1% and depreciate the yen by over 20% against the dollar year-on-year.
coordination imply that countries are prepared to adapt their own policy settings to take account of negative spillovers to other countries – and hence imply the need for active dialogue.

In addition to issues of cooperation across countries and jurisdictions, there are also big questions about cooperation between the various arms of economic policy (and the responsible institutions) within a country. This is particularly relevant given the increasing practice of making central banks independent of the fiscal authorities, and the growing importance of macro-prudential policies (which can have important interactions with monetary policy).

Many of the same considerations apply to both national and international cooperation, such as whether institutions’ mandates allow them to take wider considerations into account. One conclusion we draw is that narrow and domestically oriented mandates make it much more difficult to talk about policy coordination – which generally implies some more binding commitments that are more difficult under narrowly defined mandates – and more fruitful to use the term policy cooperation. We therefore follow this practice in the rest of this paper.

While the question of domestic policy cooperation is now very much a live issue, the focus of this paper is on international cooperation. It looks first at some of the theoretical issues, and asks whether the circumstances leading up to and following the crisis have changed the incentives for international cooperation. It then examines how non-linearities in economic relationships, financial interconnectedness, unconventional monetary policies and fiscal stability issues may have altered the balance of arguments for cooperation. Finally it considers at the crucial, but often underrated, issues around the most appropriate processes and structures for cooperation.

Why cooperate?

Academic work on international economic policy cooperation has a long history. The theoretical literature suggests that cooperation can have benefits for all parties involved, under certain circumstances. But most empirical studies (which have focused mainly on monetary policy) estimate that the gains from cooperation are relatively small, and the appropriate forms of cooperation (and the level of gains) depend importantly on the policy regime in place, such as the exchange rate regime.

One strand of the literature suggests that under fixed exchange rates cooperation is not necessary to deliver optimal outcomes, provided that countries do not follow ‘beggar thy neighbour’ policies and that surplus countries are prepared to share the burden of adjustment in external imbalances. But the experience of recent years – both with de facto fixed exchange rate regimes, and within monetary unions – suggests that if these conditions are not met, policies focused on domestic objectives alone can be distinctly sub-optimal from an international perspective.

Nevertheless, during the ‘great moderation’ (Bean, 2009) there was a strong body of opinion that it was only necessary for each country to follow policies that were the best for itself (e.g. Obstfeld and Rogoff, 2002). This came from a belief that policy spillovers were relatively small and easily

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3 See Taylor (2013) for a recent summary of the early literature.
4 Hamada (1976) provides the intellectual foundation for this body of work.
accommodated by policy responses in recipient countries. But during the crisis as countries ran out of policy instruments – as interest rates reached the zero lower bound, as financial stability concerns loomed large, and as fiscal deficits and debt levels approached unsustainable levels – the benefits of cooperation were seen to rise. To a significant extent, however, this was less a reflection of the benefits of cooperation – which are still estimated to be small – than an attempt to avoid the losses from non-cooperation that can cascade. This was most obvious in the desire to avoid a new great depression following the crisis, but remains a powerful source of cooperation, particularly in areas such as trade and financial regulation.

**What is the record on post-crisis cooperation?**

The crisis of 2007–08 proved a watershed. Cooperation was stepped up significantly in a number of areas, especially short-term macroeconomic support and financial reforms. And the forums for cooperation shifted from relatively small groups of high-income countries with similar concerns and frameworks to broader groups with more diverse experiences and interests.

The first G20 summit in November 2008 stated that one of the reasons for the crisis was ‘inconsistent and insufficiently coordinated macroeconomic policies and inadequate structural reforms’. And it called for a broader policy response ‘based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging markets and developing countries’ (G20, 2008b).

The effort to better coordinate liquidity support, and monetary, fiscal and structural policies was initially quite successful, but tailed off quickly. Four examples illustrate the point.

- By October 2008 the US Federal Reserve had set up liquidity support internationally via swap lines with 14 other central banks, some of them unlimited. But these lines were subsequently restricted to the few central banks that the Fed regarded as key. Also, despite appearances that they provided two-way swap facilities, in practice they were unilateral – the Fed loaned dollars to other central banks, but never borrowed foreign currency from them. A better example of multi-country cooperation was the permanent increase in the resources of the International Monetary Fund, which was agreed as a liquidity firewall against sovereign contagion (IMF, 2011).

- In the early stages of the crisis a number of key central banks coordinated their interest rate cuts. But as they approached the zero interest rate (ZIR) lower bound, unconventional monetary policies were increasingly used, though only by some banks, and not in a coordinated fashion. These unconventional policies (especially QE) have also generated complaints from some emerging markets about the negative spillover effects on exchange rates and international capital flows.

- There was also a measure of cooperation on fiscal policy in the early days, with most G20 countries rallying round the call in late 2008 for a coordinated fiscal stimulus of 2 per cent of world GDP (Strauss-Kahn, 2008). But by mid-2010 the consensus was waning, partly as countries’ economic circumstances diverged, but also as the intellectual consensus weakened.
At the Pittsburgh summit the G20 launched the Mutual Assessment Process (MAP) to achieve greater consistency of policies, and to support ‘strong, sustainable and balanced growth’. This was an ambitious plan to generate policy cooperation, backed up by G20 leaders, in order to internalize interactions between countries and to bring peer pressure to bear on countries to follow more optimal policies. While it is too early to reach a definitive conclusion on the impact of the MAP, it is fair to say that it has not lived up to the ambitious objectives set for it.

The record is significantly better for some structural reforms. In particular:

- From the outset G20 leaders set out an action plan for financial-sector reform, and called for ‘intensified international cooperation among regulators’. The Financial Stability Forum was also strengthened and its membership broadened to include all G20 countries.

- At successive summits, mindful of the experience of the 1930s, the G20 committed not to introduce new trade restrictions. Backed up by the strong institutional processes of the WTO, these pledges have been largely successful – and much more successful than models would have suggested in the circumstances.

**International policy spillovers**

One of the conclusions from experience with the MAP is that there is still little or no consensus on the impact of international spillovers. In part this goes back to the intellectual debate about whether good domestic policies are globally optimal.

Monetary policy is a case in point. In the standard literature (such as the two-country Mundell-Fleming model) the impact of conventional monetary policy action on the home country is clear, but the impact on output of the foreign country is ambiguous. And if there are differences in how firms’ prices respond to exchange rate changes, the impact is even more uncertain.

With many countries at the ZIR lower bound, attention has switched to the impact of unconventional monetary policies – QE in the United States and United Kingdom, outright monetary transactions (OMT) in the euro area, and most recently qualitative and quantitative easing (QQE) in Japan (one of the three ‘arrows’ of Abenomics). Since these actions typically operate on the shape of the yield curve, rather than the overall level of interest rates, the impact even on the home country is harder to be sure about.

However, these policies have led smaller and less systemic countries to complain that the actions of the ‘home’ country are having negative impacts on them. It is argued that US QE, for example, has generated large capital flows from the United States and towards emerging markets, as well as pushing down the dollar. And the same argument is being advanced in Asia about the Bank of Japan’s actions. Event studies do suggest that the announcement of QE, and the more recent statements on tapering, have had significant impacts on capital flows, at least in the short term.

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5 The Financial Stability Forum was strengthened and upgraded in 2010 into the Financial Stability Board (FSB, 2013).
6 See section 1 of Taylor (2013) for a simple model to illustrate this intuition.
(Fratzscher, Lo Duca and Straub, 2013; IMF, 2013a). But it does show very clearly that we are far from having a consensus on the spillover effects of these policy actions.

Uncertainties about the analysis of spillovers abound in all policy areas, not just monetary policy. For example, there is a deep intellectual divide between policy-makers who see rapid fiscal consolidation as largely self-defeating through its impact on growth and those who regard significant progress on fiscal consolidation as key to regaining market confidence in sovereign borrowers. At the very least, reducing the uncertainties about policy effects is needed to make a persuasive case for international cooperation – for example through the IMF’s regular Spillover Reports (IMF, 2013b).

Even if there is agreement about the spillover effects of policies, it is not obvious that countries can (or should) adjust their policies in all cases to minimize harmful international spillovers. But if it can be demonstrated that there is clear mutual benefit from cooperation – where one country is following protectionist policies, or where there are significant leakages across borders so that domestic policies are less effective, for example – clear analysis is important to make the political case for cooperation. In times of crisis, when the costs of not cooperating are often much larger, that case is therefore more evident.

**Cooperation in extreme circumstances**

Recent work at the IMF has looked again at the effect of fiscal and macro-prudential policies, trying to model the impact of cooperation in times of financial stress (Benes et al., 2013). In particular, it looks at the potential gains from coordination of these policies when there are non-linearities in the system (i.e., the impact rises compared with the shock). The effect of these non-linearities is especially potent in extreme circumstances – for example, when policy interest rates are at the zero lower bound, when banks are close to minimum capital adequacy levels, and when borrowing rates rise sharply as loan-to-value (LTV) ratios increase.

In these circumstances conventional monetary policy is not available as an instrument of stimulus, and with credit constraints imposed by (or on) banks and reluctance on the part of the private sector to borrow there would be little support for economic activity from private demand – a reasonable description of circumstances in 2008 and 2009. In those circumstances, model simulations find that the effects on growth of fiscal stimulus and easing of macro-prudential constraints in one country are large, and there are positive spillovers to other countries.

Equally importantly, macro-prudential failures in one country seem to create much larger negative spillovers than perfectly aligned policies create positive ones, because a financial crisis is highly disruptive to the global financial system.

This suggests that fiscal stimulus (with neutral monetary policy settings that do not seek to offset the impact) and supportive macro-prudential measures can provide substantial support to output during periods of acute stress. Furthermore, international cooperation of these policy measures increases their potency considerably for all countries.

For example, if banks are close to their regulatory limits, additional lending will become much more costly.
Additional policy tools?

Following the crisis the increased focus on macro-prudential tools for financial stability purposes raises further cooperation issues, at both the national and international levels (Kohn, 2013). Given the interconnectedness of international financial markets, and the potential for financial institutions to move between jurisdictions in order to avoid tighter regulation, there is a *prima facie* case for cooperation on these policies.

National authorities necessarily have to take into account inward externalities from financial flows. And branches of foreign financial institutions (as opposed to subsidiaries) that are supervised and regulated by the home authority can undermine the host authority’s macro-prudential efforts. More generally, the possibility of disintermediation and regulatory arbitrage (in the absence of effective capital controls) is likely to reduce the effectiveness of macro-prudential (and micro-prudential) instruments. And with national incentives to promote domestic financial institutions, there are incentives for a ‘race to the bottom’ if there is a lack of cooperation.

This again suggests that there may be relatively large gains from international cooperation on macro-prudential policies to avoid negative outcomes, given the interconnectedness of financial institutions and markets across national borders. The long experience of cooperation on banking regulation suggests this is the case, as does the more recent but intense cooperation on wider financial regulation and supervision since the crisis, in particular through the Financial Stability Board.

The role of surveillance

Given disagreements and uncertainties about the spillover effects of domestic policies, there is a premium on effective and influential surveillance at national, regional and global levels.

There have been moves recently to strengthen surveillance at all levels – at the IMF, at the regional level (within the EU and Chiang Mai Initiative), and at national level through the establishment of financial stability committees, for example – following the general failure to anticipate the crisis. The most comprehensive new initiatives have been the G20 MAP and the strengthening of financial surveillance (through a whole range of agencies).

The post-crisis experience with surveillance is mixed. On fiscal policy there has been no shortage of agencies warning about a sub-optimal national policy stance (e.g. IMF, 2012), but also no consensus about the appropriate settings and speed of consolidation efforts. In the absence of agreement about the ‘right’ fiscal policy stance domestically, and about the spillover effects internationally, the early consensus on fiscal action following the crisis has given way to essentially national decision-making.

The experience with financial surveillance has been rather better, with deeper and more intense analysis of financial systems and institutions. Also, the multiplicity of agencies involved in surveillance, at national, regional and international levels, does not appear to have caused problems, with the various agencies cooperating reasonably well. There have been differences of
view on some important issues, for example the size of impaired assets; but that is inevitable – and arguably provides a healthy level of peer review and challenge.

But no surveillance is fully effective unless it is acted on. One of the reasons why the G20 MAP was set up as a *mutual* assessment process was in order to increase countries’ commitment to acting on its conclusions.

**How to cooperate?**

Making international cooperation work, including achieving greater consensus on surveillance – especially, but not exclusively, on spillover effects – has important implications for the processes of international dialogue, and for the international institutions that support it. Despite its neglect in much theoretical work, the institutional structure matters for the overall effectiveness of policy cooperation.

There are many dimensions to this, including the following questions.

- How far should cooperation (or coordination) be based on rules and backed up by sanctions?

- Should the group of countries involved be small (since a smaller group is likely to be easier to coordinate, and potentially with more homogeneous viewpoints) or large (and therefore more comprehensive, and bringing in a wider range of interests)?

- Should cooperation be carried out by the players themselves (which potentially gives greater ownership, familiarity with the issues, and domestic legitimacy) or by external agencies (which are more independent and objective, and have greater *international* legitimacy), or a combination of the two?

The answers are likely to vary depending on the issue involved, and the structure of the global economy. However, experience shows that well-designed institutions and processes can significantly enhance cooperation, and help realize the benefits – or at least avoid the costs of non-cooperation.

One way of thinking about the trade-offs is that forms of cooperation should be tailored according to how homogeneous the participants are, and how ‘technical’ the issue is. For technical issues between relatively homogeneous countries – such as trade – a rules-based approach to cooperation may be most efficient; but for issues which are more ‘political’ and where the group of countries involved is relatively diverse – such as the G20 MAP -- a more ad hoc and discretionary form of cooperation may be more appropriate.

But there is a wide range of views on the value of ‘rules-based’ structures – such as the WTO -- versus looser ones such as IMF surveillance. Some view ‘softer’ cooperation as largely useless, while others point out that WTO-like structures are often excessively legalistic and adversarial. Two tentative conclusions we draw are that cooperation tends to become more formalized over time, and that rules may be better at preserving a given level of cooperation (e.g. limiting the rise in trade protectionism following the crisis) than at moving cooperation forward (for example, the Doha
trade round has been sidelined by smaller and more informal initiatives such as the proposed transpacific and transatlantic agreements).

**The road ahead**

Policy cooperation is an age-old issue. But the crisis five years ago may have led to a fundamental change in the balance of arguments. A number of tentative lessons can be drawn.

- Effective cooperation across the different arms of *domestic* policy -- especially fiscal, monetary, macro-financial and structural – is important.

- The costs imposed by a lack of *international* cooperation and subsequent loss of trust can be very substantial, especially in times of crisis. The benefits from cooperation can also be larger in extreme circumstances if there are non-linearities in economic relationships (especially as interest rates reach the zero lower bound), and in areas where cross-country interconnections are large (e.g. macro-prudential issues).

- Institutional arrangements for cooperation matter, since political agreement is needed to make cooperation work. Moreover the role (and design) of international institutions can help – or hinder – cooperation.

- Spillovers between countries are an important component of the case for cooperation. But effective cooperation requires a common understanding of the size and direction of these spillovers. And reaching that common understanding is even harder when more than one policy (and the mix between policies) is being considered. A further practical problem is that the effects are likely to be asymmetric: systemically important countries generate relatively large outward spillovers, but are relatively less affected by inward spillovers than smaller and less systemic countries.

- If the main motivation is to identify risks and mitigate their effects, there are benefits from a diversity of views across countries, institutions, and analytical frameworks.

Overall, the experience of the crisis shows that countries cooperate mainly to avoid very bad policy outcomes rather than to achieve (generally rather smaller) gains from internationally optimal policies. This helps explain why cooperation has advanced farthest at times when the costs are most obvious (such as the crisis) and in areas where the costs of non-cooperation are most obvious and are widely agreed, such as trade (where the memory of the 1930s remains strong), and financial regulation (where international interconnections are great).

The implication is that economists should focus more on possible downward spirals from non-cooperation – not least because failure to cooperate in one policy area can transmit across to other areas – and less on the benefits from perfect international alignment of policies. A potential corollary is that in the first instance cooperation may be easiest to achieve and most effective in areas such as macro-prudential rules, rather than in monetary and fiscal policies. Another fruitful way to improve cooperation is to develop and strengthen analysis in order to reduce the scope for fundamental disagreements between countries over the impact of cross-country policy spillovers.
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