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Instituting Economic Cooperation in a Noncooperative World

Can the G-20 Rebalance the Global Economy?

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Introduction and summary

In the words of Nobel Prize-winning economist Elinor Ostrom, a community is a group "with a common set of problems."[1] The Group of 20 nations, or G-20, is one such community.

Founded in 1999, the G-20 was convened in November 2008 to tackle the unfolding financial crises in the United States and the United Kingdom. Not least of the common problems the G-20 shares are the challenges of strengthening and stabilizing economic growth and making it more sustainable for long-term welfare. With G-20 member countries together comprising some 86 percent of the global economy, they are the *de facto* governors of the global economy.[2]

Beginning with this crisis summit, leaders of the G-20 nations instituted regular engagement on global economic-governance issues: coordination and cooperation on financial regulation and supervision, on macroeconomic policies, and on other initiatives designed to help steer the world economy toward a stronger, more stable and sustainable path. G-20 leaders directed their finance and central-bank officials and their representatives—along with the International Monetary Fund, or IMF, the World Bank, and a host of other international institutions—to work in concert toward common global economic goals.

At the September 2009 Pittsburgh Summit, G-20 leaders pledged, "We cannot rest until the global economy is restored to full health, and hard-working families the world over can find decent jobs."[3] Toward this goal, the G-20 made early progress in cooperating on macroeconomic stimulus and stabilization policies to stem the fallout caused by the global financial crisis. But the larger goal has yet to be achieved.

Today the global economy risks slipping back on its growth: Some 197 million people around the world remain unemployed—28 million more than in 2007, the last year before the crisis.[4] Amidst substantial fiscal contractions, the U.S. economy grew a mere 0.4 percent on an annual basis in the last quarter of 2012, while the European Union shrank 2.4 percent.[5] Japan's economy shrank 0.4 percent on an annual basis in the fourth quarter of 2012, after growing on average less than 1 percent annually for the past two decades.[6] China's growth slowed to 7.8 percent in 2012, and the IMF projects overall world economic growth to be 3.3 percent in 2013, compared to 5.4 percent in 2007 before the crisis.[7]

Large, destabilizing international economic imbalances clearly still exist, such as trade and financial imbalances between countries. Despite narrowing in part due to the crisis, structural factors in member-country economies point to international imbalances resuming, and growing, in the medium-term economic outlook. What's more, these economic imbalances are intertwined with an increasing social imbalance that is tipping ever more toward income and wealth inequality, and an increasing environmental imbalance that sees growth depleting the world's natural assets faster than nature can restore them.

As stewards of the global economic commons, G-20 leaders realized that deeper actions would be needed to tackle these persistent and growing global challenges. Leaders also realized that in order to sustain growth and achieve longer-term stability they needed to address the underlying contributors to the unfolding economic crisis. But is the G-20, an institution for global economic governance, up to the task?

The structure of the world economy is evolving, with the flow of goods, money, people, and ideas integrating at remarkable speed, and with growth and investment coming increasingly from large and lower-income countries. There is a new geo-economic reality that presents a wealth of opportunities for global growth, but also a wealth of risks to economic well-being now and for the long term. Global economic institutions must evolve as well. The G-20 is leading this charge, but the institution-building has some way to go.

One challenge to the institution is international rebalancing, which is the effective elimination of trade and current account surpluses and deficits between countries. Within the G-20 there is a fundamental tension over how to distribute the costs of adjustment for rebalancing. Should the deficit country adjust through austerity, constraining its living standards in order to pay off the financial assets sold abroad? Or should the surplus country, growing through exports in part at the expense of other economies, adjust to refocus its growth more intensively on domestic demand?

Unsurprisingly, one's answer depends a lot on where one stands in the world and how one views the history of these international economic institutions. Aside from different historical perceptions, leaders also face a complex web of competing domestic and transnational interest groups. For these groups, any policy adjustments can result in profound changes in how economic costs and benefits are distributed between and within countries.

As an institution, the G-20 draws its strength from the sense of community fostered among member countries' leaders and officials. Though all parties have "skin in the game," coordination to achieve well-known potential welfare gains for the world through stronger, more balanced growth is elusive in this noncooperative world.[8] The central question is: What does the G-20 need to do institutionally to be capable of sustaining cooperation among member countries over the long term?

Efforts to build institutions for international economic governance, such as the G-20, are a recent development in the history of international trade and finance. These efforts at institutionalization were formalized only in the post-World War II Bretton Woods system of fixed exchange rates and adjustments balanced between surplus and deficit countries. But as the international financial system began evolving and liberalizing after 1973—when power shifted more toward financial creditors—the onus of adjustment shifted in favor of austerity policies. Skepticism about these institutions has led many countries in effect to opt out of the present system. A number of countries—most notably across Asia and Latin America—have voted with their feet by pursuing policies of currency undervaluation and trade expansion to insure themselves against the real risks of international financial crises by amassing large holdings of official reserves.

Elinor Ostrom describes seven principles commonly observed in institutions that are successful at sustaining cooperative governance of the economic commons. (see box to the right) A generous assessment finds that while the G-20 is making significant progress toward these seven principles, it gets right only four out of the seven. The three it lacks—providing a credible system

Ostrom's Principles for Managing the Commons

1. Define clear group boundaries.
2. Match rules governing use of common goods to local needs and conditions.
3. Ensure that those affected by the rules can participate in modifying the rules.
4. Make sure the rule-making rights of community members are respected by outside authorities.
5. Develop a system, carried out by community members, for monitoring members' behavior.
6. Use graduated sanctions for rule violators.
7. Provide accessible, low-cost means for dispute resolution.

Sources: Elinor Ostrom, Governing the Commons: The Evolution of Institutions for Collective Action (New York: Cambridge University Press, 1990); Elinor Ostrom, "8 Keys to a Successful Commons," YES! Magazine, February 26, 2010, available at http://www.yesmagazine.org/issues/america-the-remix/8-keys-to-a-successful-commons.

for monitoring, sanctioning, and providing effective dispute resolution (numbers five, six, and seven)—unfortunately are essential to enabling enforcement of cooperative norms of successful global governance, and for avoiding the "tragedy of the commons," or the path back to yet more financial fragility and economic imbalances.[9]

The gains from coordinated rebalancing present the opportunity for a positive sum outcome that can substantially boost growth, incomes, and employment throughout the world. The default norm of contesting rebalancing, however, often characterizes international economic relations between countries, hence the large and sustained international imbalances persisting over such a long time. (see box on page 7) Achieving a stronger, more sustainable global economy requires cooperation among G-20 leaders; that cooperation hinges on whether leaders can build an institution capable of enforcing cooperative community norms.

The path toward cooperation and success in these areas should begin with recognition of the structural causes of international imbalances and its roots and inertia in rising inequality. G-20 leaders then should focus on employment- and income-targeted policies that grow their economies from the "middle-out"—recognizing that to sustain these policies, the global economy must grow by empowering those in or aspiring to be in the middle class with the financial security and economic opportunity to move up. Working together as a community of states to provide coordination in this way enables the world economy to grow more sustainably as a whole.

In the short term, progress toward G-20 cooperation will be seen in fits and starts, but there are steps President Barack Obama's administration can take today to seize the opportunity of the G-20: First, by strengthening the bilateral relationship with China, and second, by using this relationship to strengthen the G-20's effectiveness as a multilateral-governance institution. In this report we recommend the following steps.

Recommit community members to the Mutual Assessment Process

G-20 leaders delegated to the IMF a set of economic analyses called the Mutual Assessment Process, or MAP, to assist in a country-to-country peer-review process. (Technical details of the process and its results are described in Appendix 1.) The MAP established economic criteria for evaluating the extent and causes of international imbalances and to simulate the effects of economic rebalancing versus continuing on with business as usual. The IMF in turn delivered a stream of valuable and informative economic research on the G-20 nations.[10] In fact, in many instances IMF economists proffered fresh rethinking of principles and policies of international integration and liberalization of financial trading. But the MAP does not solve the G-20's institutional shortcomings; the technical analyses alone do nothing to spur action to change the noncooperative norm. Part of mutual assessment must be a follow-up process, where leaders discuss the analyses and possible reforms of the international economic architecture. The United States should therefore hold member countries to the expectation of full cooperation in the MAP, including supplying requisite forecasts and information on national economic policies needed for the analyses, as a step toward broadening the G-20 leaders' dialogue.

Housekeeping on outstanding commitments

To preserve credibility, the G-20 still has work to do on prior commitments. The United States should work to ensure that the G-20 makes good on these, including implementation of the 2010 International Financial Institution, or IFI, reforms, which shifted ownership and voting shares of the IMF and World Bank toward developing countries, including China.[11] The United States should also work to advance more governance and quota reforms of Bretton Woods institutions so that other member countries participate more broadly in the costs and governance of the IFIs.

Define the community

To strengthen the effectiveness of the G-20, the United States should urge G-20 members to revisit and clearly establish membership criteria. Current membership of the G-20 is not ideal in terms of it comprising the world's actual largest economies or in equitable geographic distribution of representation in the multilateral process.[12] Since under current rules, the annual G-20 host country has the authority to invite guest-country representatives, the United States should express support for the informal convention of a "permanent" guest status for representatives of the African Union, the Association of Southeast Asian Nations, and others as appropriate.

China's emergent voice and responsibility

To further draw China into the system of multilateral governance, the United States should support China serving as host country at the earliest opportunity. At present, the agreed-upon schedule of rotating G-20 leadership will transition from Russia in 2013 to Australia in 2014 to Turkey in 2015. The next opening for China to serve as host would be in 2016, and the United States should encourage such an assignment.

Finish the work on financial regulation reform

From the get-go, G-20 members established a core mandate for national implementation of internationally coordinated financial reforms.[13] These are needed to secure volatile, speculative capital markets around the world. As literally thousands of rules prescribed by the 2010 Dodd-Frank Act—the United States's most significant financial regulatory reform in more than a decade—are yet to be written, let alone implemented, by U.S. supervisory authorities, the United States first should lead by example and finish the work of getting its own financial house in order.[14] The United States must finish erecting a robust system of financial supervision before the next financial crisis hits.

As a further step, G-20 leaders should examine the benefits of creating other missing international institutions that can help facilitate stable, sustained growth and rebalancing. The steps for these entities to take should include a sovereign bankruptcy mechanism that provides rules for the orderly restructuring of debts that preserve the public investments in equitable growth, and an international clearing union such as that proposed by John Maynard Keynes. This would provide a central clearing mechanism, much like on a stock or commodity exchange, by automatically adjusting respective international trade and financial surpluses and deficits among imbalanced countries. Such a mechanism would allow for orderly adjustment of accumulated reserve surpluses in order to maintain appropriate exchange rates.[15]

Revisit governance issues

The United States should use the opportunity of the G-20 to encourage community members to revisit governance issues in the World Trade Organization, or WTO, and other international economic institutions. In particular, the United States should encourage members to revisit the effectiveness of the WTO dispute-settlement mechanism for adjudicating the rules of the trading system. A transparent, balanced, and efficient dispute-settlement process would benefit all member nations, smoothing frictions in international economic relations.

This report explores the structural factors of the G-20 in detail, with specific focus on the role of imbalances within and between the United States and China. These two countries reside at the core of international imbalance issues and warrant specific attention. As the world's two largest economies and primary contributors to these key imbalances, China and the United States share a special responsibility for marshaling member countries to strengthen the G-20 community and the coordination it engenders. Both countries hold responsibility for 38 percent of the total G-20 current account imbalances.[16] In both countries, the economies that are developing from rising income and wealth inequalities create a foundation for persistent imbalances. This disequalizing growth lies at the root of the U.S. trade and financial deficits, as well as China's and others' surpluses.

Global benefits of G-20 collective action

In 2012 IMF staff developed forecasts of the economic effects from continued lack of cooperation on international rebalancing relative to the status quo, as well as the potential general welfare benefits of rebalancing. The staff report titled, "Group of Twenty: Towards Lasting Stability And Growth," describes the potential benefits of broad international collaboration. In the upside scenario of cooperation and policy coherence, the IMF forecasts an additional 2.5 percent growth of world gross domestic product in 2017 relative to the "World Economic Outlook" baseline.[17]

Furthermore, the report estimates that if the proposed policy recommendations are enacted there could be almost 36 million additional jobs across the G-20 nations than would have otherwise been possible. These policies would reduce global imbalances by three-quarters of 1 percent of world GDP by 2017, a relatively important amount, especially for advanced deficit and emerging surplus economies.

The report also assessed potential gains relative to a downside baseline scenario where international cooperation degrades and fiscal-contraction policies undermine the recovery of worldwide economic growth. The report concludes, "The gains in the upside compared against the downside (relative to baseline) amount to 4 percent of GDP and 58 million jobs in 2017. Cumulative output gains over five years between 2012 and 2017 would be 3.5 times larger."[18]