

ATTENTION: DEFICIT DISORDER THE G-20'S MODEST STEPS TOWARD A MORE COORDINATED FISCAL POLICY

EDWARD A. FOGARTY AND GENE PARK



In November 2008, governments representing over two-thirds of the world's population gathered hastily in Washington, D.C., to try and stop the global economy from unraveling. The emergency summit may have not have reshaped the financial system or produced a set of detailed fiscal measures, but with a historic five-page communiqué, world leaders proved to the market and each other that they agreed on strategy and that their stimulus plans would complement each other. A Brookings Institution policy brief hailed this Group of 20 (G-20) meeting as “a giant step forward.” But the contragulatory air was short lived. The onset of the sovereign debt crisis in the eurozone soon highlighted a major shortcoming of the common currency project: the lack of fiscal harmonization.

These turbulent years since 2008 have demonstrated how crucial coordinating fiscal policy can be. A country's tax rates and spending levels are the levers of last resort to steer economies, and politicians carefully guard this sovereign authority. But, in the short term, governments must confront this period of economic slowdown by working together to stimulate global demand, even as many of them struggle to rein in large public debts. In the long term, governments must address the persistent imbalance between countries with excessive savings, such as China and Germany, and those with excessive consumption like the U.S. This imbalance contributed to the 2008 global financial crisis by feeding excess savings into real estate bubbles across the world. Failure to work together may condemn the world to repeating this mistake.

The sort of international economic coordination we saw among the countries of the Group of 7 (Canada, France, Germany, Italy, Japan, the U.K., and the U.S.) during the last third of the 20th century may no longer be possible, thanks to the rise of China, India, and other large developing countries. Thus, the challenge facing the 21st century's leading economic forum, the G-20, is to manage the global economy at a time when the United States and a small group of advanced economies can no longer impose their preferred solutions.

What can we hope for from the G-20 when it comes to dealing with these challenges? Panglossians tell us we should relax, because the real lesson of the global financial crisis is that "the system worked." By coordinating fiscal policy to stimulate global demand and monetary policy to keep the financial system afloat, disaster was averted. Cassandras tell us that we're

in a "G-zero" world, where no country has the political and economic leverage to drive global policies, opening a power vacuum with no one able to decisively influence events. There is an element of truth to each of these claims: The G-20 performed sufficiently well in 2008-2009 as a forum for crisis management—and can be expected to do so in the future—but it has produced only modest progress since 2010 in tackling the coordination of fiscal policies needed to avoid the next crisis.

G-20 governments, which account for nearly 90 percent of the world's GDP, have struggled to synchronize fiscal policies in the aftermath of the crisis. While all countries want international economic stability, they would also prefer others bear the brunt of the painful economic changes necessary to redress imbalances. To some extent, overcoming this game of "pass the buck" has become harder with fundamental policy disagreements among leading states as well as a larger, more diverse group of economic powers with the clout to say "no." In this new world, the G-20 forum—and its essential partner, the IMF—must nudge its members toward greater consensus on the need to share the burden of ensuring systemic stability.

For those who bemoan a "G-zero" world, the key missing ingredient for international economic cooperation is leadership. While leadership is rarely benign in practice, there is something to the notion that assertive action by one or a few large economic powers is necessary for effective international coordination.

At the nadir of a global financial and economic crisis in 2008-2009, there was general agreement on what governments needed to do: They had to stimulate their economies through fiscal and monetary expansion. Still, stimulus

EDWARD A. FOGARTY is an associate professor of political science at Colgate University.

GENE PARK is an associate professor of political science at Loyola Marymount University and a WPI@LMU fellow.

projects, which make sense economically in the longer term, lead to short-term deficits and mounting debt. This creates a free-rider problem. While some governments boost global demand through their own deficit spending, free-riding countries can benefit from increased trade without contributing anything. For instance, Germany and South Korea, both with large trade surpluses, maintained positive budget balances from 2008 through 2009. Without a global hegemon, it's difficult to compel countries into assuming their share of the costs.

Once the worst dangers of a global financial crisis pass, the direction of policy incentives is less clear. Governments may differ on whether reducing debt is more important than economic growth. Those in the austerity camp believe reducing debt is a necessary condition for investor confidence and economic health, and thus leadership means setting an example of rectitude and encouraging others to follow. From this perspective, the biggest debtors must adjust the most. An official we spoke to in the German finance ministry, for example, dismissed short-term Keynesian solutions and instead emphasized the necessity of fiscal restraint and domestic reforms to restore competitiveness and, eventually, growth.

Those in the growth camp believe austerity is self-defeating and that using macroeconomic stimulus reduces the relative burden of debt. From this perspective, all governments should bear the costs of greater financial risk associated with higher public debt, at least until growth is on a firm footing. While several of Germany's eurozone partners have adopted this position over the last few years, a U.S. Treasury official put the growth position in an international perspective, lamenting a lack of "rotation in global demand"—implying that export-oriented economies such as Germany's needed to do more to stoke domestic demand.

A more nuanced perspective suggests that it matters which countries reduce debt and which continue to stimulate. Countries with smaller economies can pursue fiscal consolidation, because the global economy is less dependent on their demand. But large economic powers must bear the cost of continued fiscal (and perhaps trade) deficits, at least for the medium term, to keep the global recovery on track.

From this perspective, the role of leading powers remains an essential element of fiscal coordination, and, unfortunately, the world's largest economies haven't cooperated. Some countries—especially Germany and some of

DURING THE COLD WAR, THERE WAS LITTLE NEED FOR FORMAL TOP-DOWN INSTITUTIONS.

its European partners—have advocated for an austerity approach, and others—especially the United States and Japan—have advocated for a growth approach. The G-20 is hamstrung by this disagreement about who must shoulder the costs of fiscal adjustment.

MOVING FORWARD

Yet international fiscal cooperation isn't inherently doomed to failure. In other contexts, the European Union and the G-7 have achieved some level of agreement. These examples offer initial clues as to possible ways forward in the G-20, even if there's no solution to the fracturing of global political power.

The clearest example of international fiscal coordination today exists in the European Union. While early efforts to coordinate fiscal

policy occurred during the establishment of the euro, EU fiscal management has accelerated since 2010 as members have sought a way out of the current euro crisis and attempted to prevent the next ones.

In 2011 and 2012, EU members broadly agreed to a set of rules that dramatically tightened the existing fiscal regime. There are binding rules promoting fiscal discipline: National governments are expected to maintain budget deficits of no more than 3 percent of GDP and debt of no more than 60 percent of GDP. There is also close scrutiny of national budgets: Governments must submit their taxation and spending plans to the European Commission for review before national parliaments can adopt them. And there is potential punishment too: Governments face fines if they repeatedly exceed the deficit targets. This regime falls short of a fiscal union—national debts have not been mutualized, and there are no automatic international fiscal transfers—but it is a remarkably high level of coordination for a group of sovereign states.

Europe's vertical model of coordination, which gives substantial authority to supranational institutions like the European Central Bank, is possible only within a specific context. Most of its members participate in a currency union, and over the past six decades, the European Union has integrated across many policy areas. Yet intensive fiscal coordination only occurred when two conditions became manifest: deep financial interdependence (in the threat of contagion from a possible Greek government default) and deep dependence on German financial resources. In this context, Germany has used its dominant financial position to promote formal rules that enforce fiscal discipline and impose austerity on Greece and other debtor countries.

Perhaps a more appropriate example for understanding the prospects of G-20 fiscal coordination is the G-7, a forum that the U.S. has

used to push other countries to pursue policies that would help rebalance the global economy. Indeed, the G-7's Bonn Summit of 1978 is widely viewed as one of the most successful cases of economic coordination. At Bonn, U.S. officials persuaded their partners—particularly West Germany and Japan—to absorb some of the costs of stimulating global growth. Their agreement also addressed the growing current account imbalances among the leading economies, with the U.S. committing to fiscal consolidation (to reduce inflation) and other governments making concrete commitments to fiscal stimulus.

In 1985, the G-7's five leading members agreed to the Plaza Accord to address trade imbalances through exchange rate intervention. In this agreement, France, Japan, the U.K., and West Germany committed to appreciating their currencies relative to the U.S. dollar. Doing so would cause the U.S. to import less and also stimulate U.S. production by making U.S. exports cheaper. In both cases, the primary U.S. goal was to redistribute the burdens of stimulus and growth, targeting surplus countries, especially West Germany and Japan.

During the Cold War, there was little need for formal top-down institutions. Direct U.S. pressure on its allies usually sufficed. The U.S. provided vital security to Japan and Western Europe, and the U.S. economy was the largest export market for both. The German government understood that economic imbalances could be addressed by reducing U.S. government expenditures, such as drawing down U.S. troops in West Germany. This tacit threat made accommodation to U.S. economic interests an easy choice. Even more lopsided was the U.S.'s relationship with Japan, which relied totally on the U.S. for security given its pacifist constitution. Throughout the Cold War, U.S. coercion of Japan, or what the Japanese call *gaiatsu*, was used to make the Japanese fall into line on

economic policy. In this U.S.-dominated world, then, the functions we associate with formal international institutions—clear rules, a neutral umpire, and mechanisms of enforcement—weren't necessary to sustain macroeconomic coordination.

But U.S. hegemony isn't what it used to be. The end of the Cold War reduced allies' dependence on U.S. protection and thus diminished U.S. leverage. The "rise of the rest" has meant not only growing wealth in large developing countries such as China and India but also a decline in all countries' dependence on access to the U.S. market. Yet even as the U.S. capacity to exercise unchallenged leadership has fallen, economic integration has increased—making the need for coordination even more crucial as economic crises can spread faster and farther than ever before.

The end of U.S. hegemony implies a few things about the prospects for international fiscal coordination. First, more countries will need a seat at the table; China, for example, will not accept a subordinate relationship to the U.S. While countries such as Germany, Japan, and South Korea remain U.S. allies, perceptions of security threats vary depending on their geographic location and economic interests. Europeans do not perceive China as particularly threatening, and while China poses a strategic challenge for Japan and South Korea, both countries must balance these security concerns with the reality that China—not the U.S.—is their largest export market.

Second, no one country can impose either the growth model or the austerity model on others. More horizontal modes of cooperation require consensus building and voluntary acceptance of fiscal norms. And third, the role of institutions is changing. The G-20 can be a location to discuss various accords, but other institutions must encourage G-20 members to reach agreements and oversee progress toward fiscal

goals. These lessons help us understand why the G-20's track record is mixed.

PESSIMISM OF THE INTELLECT

Looking at the history of G-20 action since the 2008 financial crisis, one can understand the G-zero pessimism. Most G-20 countries focused on fiscal stimulus, but some governments, like Germany and South Korea, tried to rely on the spending of other countries to spark global growth and avoided policies that would run up their own debt. Instead of setting clear targets for individual country's responsibilities, G-20 agreements largely repackaged existing domestic commitments. The London Summit in April 2009, for instance, called for an aggregate G-20 stimulus of \$5 trillion, but

A LACK OF AGREEMENT HAS CAUSED G-20 SUMMITS SINCE 2010 TO VACILLATE BETWEEN AUSTERITY AND GROWTH MODELS.

the headline figure reflected the pre-summit fiscal commitments of individual countries—not actual policy coordination. The declaration that came out of the Pittsburgh Summit in September 2009 did not contain concrete numerical targets, but rather called for maintaining short-term stimulus while preparing a shift toward fiscal consolidation. Still, the role of the G-20 in the crisis was less to induce formal commitments than it was to bring leading states together to reassure the world and one another that they were working together. And by and large, it worked.

But since 2010, the world has needed the G-20 to guide the global economy between the threats of a post-stimulus collapse in demand and destabilizing trade imbalances. Specifically, the world needed G-20 members to reach consensus on a plan that prescribed appropriate fiscal actions—stimulus as the economy slowed, consolidation over the longer term, and differentiated responsibilities for current account creditor and debtors.

A lack of agreement has caused G-20 summits since 2010 to vacillate between austerity and growth models. The Toronto Summit in 2010 produced a proposal for winding down stimulus and promoting fiscal consolidation, but over the next couple of years, this austerity-oriented approach gave way to a more complicated formula that addressed a variety of imbalances (including large current account surpluses) and reinforced the importance of prevailing economic conditions in determining fiscal choices.

By the 2013 and 2014 summits in St. Petersburg and Brisbane, the G-20 shifted toward a growth-oriented focus, aiming to lift members' GDP growth at least 2 percent above their existing trajectories by 2018. Yet summit communiqués could only paper over the fact that specific country responsibilities were not clear and that there were few mechanisms to enforce commitments anyway. The St. Petersburg leaders' declaration vaguely prescribed highly indebted advanced economies to implement "country-specific, medium-term fiscal strategies" that "take account of near-term economic conditions." The Brisbane declaration, for its part, essentially ignored fiscal issues (other than tax-base erosion) and instead emphasized uncontroversial goals such as reducing youth unemployment and promoting infrastructure investment.

Underlying these weak G-20 prescriptions are discordant positions among the big three

countries. The United States and China sustained global demand by pursuing domestic growth. With its quantitative easing program, the U.S. government pursued monetary rather than fiscal stimulus, injecting money into the economy with Federal Reserve bond purchases rather than tax cuts or public spending. Meanwhile, in 2012, the Chinese government launched a second round of fiscal stimulus of roughly \$150 billion, targeting infrastructure and manufacturing. Such was the significance of these growth-oriented policies that, according to the *Economist*, these two countries and India have since late 2011 accounted for between 70 and 80 percent of the world's GDP growth.

Meanwhile, the German government's insistence on fiscal consolidation, both at home and throughout Europe, not only ensured Europe contributed little to global growth but also reflected exactly the sort of fiscal free riding the U.S. had hoped to prevent. Fiscal suppression of domestic demand since 2010 helped take the euro area's trade from broad balance in 2000-2010 to a large surplus by the end of 2015. In this way, euro area economies used government-supported external demand in China, the U.S., and elsewhere to soften the blow of their own austerity.

Yet both the U.S. and China lost credibility in other ways. Governance failures in Washington—partisan gridlock that produced fiscal cliffs, unintended sequestration, and partial government shutdowns—have injected uncertainty into world markets. Plus, the unpredictable 2016 presidential election process has hardly been reassuring. Meanwhile, the Chinese government's questionable policy responses to softening growth have raised questions about its ability to competently manage the economy. Moreover, the government's refusal to maintain transparency in its budgeting process or accept international monitoring of its fiscal policies tends to reaffirm the idea that its government

selects policies oriented more toward regime survival than global leadership. Indeed, this Chinese position is particularly unfortunate because promoting transparency and peer review in fiscal policy is one area in which the G-20 has made significant strides.

OPTIMISM OF THE WILL

Despite its inability to set clear targets or develop methods to enforce compliance, the G-20 has created a foundation for possible convergence by empowering a neutral third party, the International Monetary Fund. The G-20 has delegated a growing list of monitoring functions to the IMF, including determining if a member country's fiscal policies will contribute to "strong, sustainable, and balanced growth." In doing so, the G-20 selected a favored mechanism of horizontal coordination—peer review and "naming and shaming."

At the Pittsburgh Summit in September 2009, G-20 leaders called for the creation of the Mutual Assessment Process (MAP) to help countries share ideas on policies to ensure sustainable growth. The IMF's role in this process is to assess the policies and macroeconomic framework of members and verify information provided by member countries used consistent assumptions. After the Toronto Summit, an "enhanced MAP" directed IMF monitoring toward more specific indicators, including external balances as well as fiscal balances, which it would publish prior to the next G-20 summit. (Also starting in 2009, the IMF began to publish a biannual report called the Fiscal Monitor, which provides data and analysis on global and country-specific fiscal trends.) Thus, in 2009-10, the G-20 strengthened the IMF's role as the watchdog of all countries' macroeconomic policies—with the biggest and most powerful receiving extra scrutiny.

Carrying out its expanded mandate, for the Cannes Summit of November 2011, the IMF delivered three sets of reports. The IMF's Account-

ability Report assesses whether countries have made progress in meeting their policy commitments from earlier summits. The Sustainability Report analyzes fiscal and current account balances across key economies, suggesting causes as well as steps for addressing them. The MAP Report assesses medium-term macroeconomic frameworks of countries to ensure consistency with G-20 goals, which the IMF updates every several years.

The IMF's growing role has the potential to enhance cooperation. Through its technical role, the IMF can create common ground for discussion, for instance, by shaping the debate through what it chooses to analyze. In the early

INSTITUTIONS ARE FILLING SOME OF THE GAPS LEFT BEHIND BY RETREATING U.S. HEGEMONY.

stages of G-20 negotiations over fiscal stimulus, officials in the German finance ministry and the IMF confirmed that the IMF drove the conversation around a target minimum fiscal stimulus of 1.5-2.0 percent—meaning a collective G-20 stimulus well in excess of \$1 trillion.

Perhaps most importantly, the IMF has overcome internal debates and taken a firm position in the austerity versus growth debate, shifting toward the latter. While the IMF had been a proponent of budgetary consolidation around the 2010 Toronto Summit, by 2012 its chief economist, Olivier Blanchard, called the impact of austerity "large, negative, and significant." An internal audit in 2014 said the IMF's earlier pro-austerity position "turned out to be a mistake and its timing unfortunate" due to

the fragility of the post-crisis economic recovery. Most dramatically, in 2015, the IMF chided euro area members—implicitly, Germany—for imposing severe austerity on Greece in a third bailout, declaring it inconsistent not only with economic growth, but a threat to the sustainability of Greece’s public debt.

Still one must not overstate the capacity of the IMF to move the needle of fiscal coordination in the G-20. Many developing country members of the G-20 remain wary of the IMF due to its imperiousness during past financial crises, and it only retains real leverage over countries that borrow from it. Nevertheless, the IMF’s stewardship of the MAP process is introducing real, albeit uneven, transparency and peer review into budgeting, and its comparatively independent and objective assessments in the austerity versus growth debate offer some hope for consensus on the direction of G-20-led fiscal coordination.

Some might interpret this turn of events as evidence for the G-zero argument—that we are drifting, leaderless, toward the next global financial calamity. Comparing actual levels of international economic cooperation with what might be considered ideal or even necessary leads to disappointment and pessimism. Instances of successful cooperation, such as in the Bonn Summit or Plaza Agreement, were ad hoc arrangements that responded to prevailing conditions as much as they shaped them. To expect more from the G-20 is unrealistic.

Indeed, our relative optimism stems from the fact that—even with a larger group of players and in the absence of a consensus regarding the distribution of fiscal adjustments—institutions are filling some of the gaps left behind by retreating U.S. hegemony. A resurgent IMF and new norms of fiscal transparency and peer

review in the G-20 offer hope of continued dialogue regarding best practices and greater constraints against go-it-alone policies. Even if such forms of coordination lack mechanisms for establishing and enforcing commitments, convening policymakers from leading economic powers offers something more than photo ops. As a U.S. Treasury official told us, G-20 meetings offer the chance for countries to understand one another’s interests, preferences, and, crucially, domestic constraints. This can reduce mutual suspicions that the other side is intent on pursuing the sort of beggar-thy-neighbor policies that marked the breakdown of international economic cooperation during the early years of the Great Depression.

But if effective institutions are a necessary condition for preventing the next global financial crisis, they are not sufficient. We’ll always have less coordination of fiscal policy than is desirable for economic and financial stability. Governments want to preserve their sovereignty, be responsive to domestic political constraints, and sometimes free ride on the fiscal actions of others. So we must be realistic about what the G-20 can accomplish.

Policymakers recognize that economic interdependence necessitates ongoing policy cooperation. Political leaders, whether on the left or the right, who declare an intent to break with the system quickly find how little room to maneuver they actually have. Yet translating this recognition into practice is a challenge. Based on the 2008 economic crisis, we can have some confidence that, when the next crisis hits, members of the G-20 will unite and act appropriately. And outside of this, the G-20 can take baby steps toward greater coordination and fiscal transparency, but anything more is likely out of reach. ●