# The Post-Summit Prospects for Policy Cooperation

An Address to the Economic Club of New York
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*As prepared for delivery*

It's a great pleasure to have the opportunity to participate in this Economic Club of New York-sponsored series. For many years I benefited from the chance to hear directly from global leaders and other distinguished speakers at Economic Club events. For several years before I left New York to take up my current position, I was honored to serve on the Club's Board. So I am particularly pleased to see that the Club is thriving under Jan Hopkins's leadership, promoting thoughtful debate on economic issues with innovative new formats, such as this one.

In the wake of the recent G-20 Seoul Leaders' Summit, I will focus my remarks today on the state of global policy cooperation. The consensus view—at least judging by the financial press reporting from Seoul—is that global policy cooperation is fracturing at best. At worst, it has become little more than a hollow slogan. In stark contrast to the concerted and coordinated actions taken by the G-20 in early 2009, observers now point to apparently divisive remarks from G-20 authorities over exchange rates, monetary policy, and capital flows. The phrase "beggar-thy-neighbor" is being heard with uncomfortable frequency.

The key message I wish to convey today is rather more positive than the headlines would suggest. It is my claim that the process of global policy cooperation remains both alive and relevant, even though the specific characteristics of the current global recovery is making the process more complex and in many ways more challenging than was the case when the global crisis was exploding in late 2008 and early 2009. Indeed, the period since the September 2009 Pittsburgh Leaders Summit has witnessed the creation of a new framework of international cooperation that holds out the prospect of delivering a collaborative, coherent and consistent approach to global policy formulation.

The underlying incentive for cooperation is clear: it is the claim that the outcome of successful collaboration will be stronger, more sustainable and better-balanced economic growth, together with reduced risks of negative surprises. Of course, the existence of this incentive won't by itself generate success. Moreover, the course of G-20 collaboration ultimately depends upon the G-20 members themselves.

Let's begin with a very brief review of the economic context. As you all know, the outlook remains challenging. While the global recovery continues to advance, it remains uneven across the world, and in most advanced economies, somewhat fragile. High unemployment in many countries not only is a major economic problem, but also is a source of social tension, heightening pressure on policy makers to produce rapid progress. The resulting uncertainty has helped to keep financial markets on edge, with high-profile sovereign and banking sector risks—especially in peripheral Europe—compounding the uncertainty. In contrast, the more appealing performance of many emerging market economies is attracting renewed strong investor interest.

While the central scenario of the IMF's latest World Economic Outlook forecast anticipates a sustained—albeit only moderate—global recovery, the outlook is clouded by several downside risks. I'll mention three:

• Renewed turbulence in European sovereign debt markets could spill over to the real economy and across regions through higher funding costs, tighter lending conditions, and a retrenchment in capital flows. New shortfalls in bank capital would create additional pressure on public finances and could trigger a new weakening in market confidence.

• Failure to reduce high unemployment rates could undermine consumer confidence in advanced economies, slowing consumer spending and weakening the global growth outlook.

• Several major emerging economies are enjoying rapid growth, but worries are emerging about accelerating inflation, asset price booms and strengthening currencies. As these developments in many cases have been associated with increasing capital inflows, they have given rise in some cases to new capital account restrictions, and in other cases such restrictions are being considered. This trend risks creating a more generalized slide towards financial protectionism.

Thus, we find ourselves today with the sense that the imminent and general danger has receded, but that it has been superseded by a situation where a recovery is underway, but it is uneven and accompanied by significant risks.

The IMF's Managing Director, Dominique Strauss-Kahn, has described the earlier crisis condition as "Phase One" of the G-20 Leaders process, and the current situation as "Phase Two". During Phase One, policy prescriptions generally were similar across nations, while the obvious, extreme danger spurred immediate action virtually across the board. In Phase Two, circumstances vary, as do policy priorities. Thus, the central tenants of successful policy collaboration are less certain, and the perceived need to act with alacrity and simultaneity are less acute than previously.

The thesis that I would like to discuss with you today is that under the current circumstances, it is inevitable that the process of policy collaboration will be, and will appear to be, less clear-cut than previously. In fact, there is a risk that the process could falter. My principal message, however, is that each meeting of the G20 Leaders to date has resulted in a strengthening of the analytical and organizational underpinnings of policy cooperation—even if the politics have became more challenging. Moreover, I will claim that Seoul was no exception. Contrary to the conventional wisdom, the chances are good that the G20 process is helping to create a new, more global, approach to economic and financial policymaking—and that the outcome will include better economic results.

Lest you think that this is just sophistry, I would like to describe the progress that is being made in three key areas—macroeconomic policymaking, global financial safety nets, and financial sector reform.

*Macroeconomic Policies*

In the basic area of setting macroeconomic policies, the most notable development is that the world's largest economies are creating a concrete mechanism to guide fundamental economic policies in the post-crisis era, underpinned by a serious, detailed and specific process of mutual assessment.

At the Pittsburgh Summit in September 2009, the G-20 Leaders introduced the Framework for Strong, Balanced and Sustainable Growth. The backbone of this Framework is a multilateral process through which G-20 countries identify objectives for the global economy and the policies needed to reach them. They also committed to a "mutual assessment" of their progress towards meeting these shared objectives—carried out through the Mutual Assessment Process, or MAP. The G-20 created a Framework Working Group for this purpose, with all G-20 members represented at a senior level. For its part, IMF staff has been asked to provide technical and analytical support, with inputs from other international organizations on issues such as labor and product markets, financial markets, and trade.

*What has the MAP achieved in practice?*

In the first stage—between the Pittsburgh and Toronto Summits—all G-20 members shared with each other—and with IMF staff—their policy plans and economic projections for the next 3–5 years. Taken at face value, these forecasts collectively would deliver the Framework's goals of strong, sustainable and balanced growth. However, given the underlying policy plans, the projections appeared to be relatively optimistic and were subject to notable downside risks. In addition, according to Fund staff analysis, they did not provide for sufficient fiscal adjustment, and implied limited progress towards external rebalancing.

This suggested that additional efforts would be needed among all G-20 members in order to achieve their shared objectives. The aspects central to judging prospective outcomes were highlighted by IMF staff through two alternative scenarios: First, a *downside scenario* quantified the implications of the key risks to the authorities' projections. At the same time, an *upside scenario* suggested actions that could improve the outlook and bring ***all*** countries closer to their objectives. This analysis was presented in a report to Leaders at their Toronto Summit, and subsequently was published.

A second stage of the MAP followed from the June 2010 Toronto Summit, where Leaders reaffirmed their commitment to the Framework process and agreed to extend the analysis in order to identify the policies each individual economy could undertake to achieve a more ambitious outcome—closer to that of the upside scenario. The result was a set of policy commitments from each member—available as a 49-page document forming part of the Seoul Leader's Summit results. The implications of these commitments were summarized in a new IMF staff analysis that also has been published as part of the Summit documentation, and is available on the Summit website.

Thus, the MAP represents the core of the policy coordination challenge—both analytically, and in terms of process. Notably, Leaders at Seoul endorsed the MAP as an ongoing G-20 feature. Moreover, they approved their Ministers' recommendation to enhance the MAP by agreeing to gauge the progress toward Framework goals through the use of "indicative guidelines". These guidelines are to be specified during the first half of next year. Fund staff will be working with other international organizations in support of the Framework Working Group in order to help develop these guidelines. Of course, this is a topic to which Fund staff already has given much thought over many years.

Based on these guidelines, the IMF has been asked – in the words of the G-20 Leaders Declaration—to "provide an assessment as part of the MAP on the progress toward external sustainability and the consistency of fiscal, monetary, financial sector, structural, exchange rate and other policies." This will constitute a most challenging assignment. The modernization of the Fund's surveillance mandate and instruments—including new, country-specific spillover reports on the wider impact of systemic economies' policies—will support this effort. The first such assessment is to take place during the coming year.

Thus, despite all the skepticism, the G-20 Leaders at Seoul clearly added new seriousness and substance to the MAP process. Of course, this doesn't guarantee success and we have already begun to see how challenging policy coordination can be without the motivating spirit of a crisis. But there are several elements that augur well for the potential results. The basic logic of the upside scenario is that there is a set of alternative policies that reflects a process of optimization in a global setting that—if implemented—would be expected to produce a superior outcome (relative to the baseline) for ***all*** G-20 economies.

In this sense, prospects for whether the MAP upside policies will be implemented depends principally on the answer to two questions. First, do the G-20 authorities accept that the superior alternative policy set is real and realistic? If so, it is in every G-20 economy's interest to implement the indicated policy adjustments. Second, does each G-20 member trust that the others will follow the policies indicated for each of them?

In Toronto and again in Seoul, the Leaders have affirmed and reaffirmed their intention to aim for the MAP's superior outcome. In Seoul, they endorsed new aspects that are designed to increase the likelihood that all G-20 members will implement the intended policies. Of course, the MAP lacks enforcement "teeth". And its development will take time, as all countries want to be assured that the process reflects their views and interests. But so long as each authority accepts that the upside potential exists, each will have a concrete incentive to seek it, in addition to the added discipline of the MAP process that was agreed in Seoul.

The prospect for fiscal consolidation is an important example of the potential benefit of the MAP. As explored in one of the analytical chapters of the Fund's recent World Economic Outlook publication, fiscal consolidation–when analyzed in isolation–tends to depress growth in the near term, but boost it in the long term. Because of worries about this short-term cost, governments may be reluctant to undertake fiscal consolidation. However, if trading partners adopt policies that support their own domestic demand, the resulting boost to their imports will help offset their partner's costs of fiscal consolidation, thus making it more likely to occur. In other words, collective policy action can help to deliver a solution that is better for all.

*Global Financial Safety Net*

International cooperation also has been critical for strengthening the global financial safety net. Improvements in the safety net will help to prevent future financial crises, while mitigating their effects in case they do occur.

Action taken since September 2008, are a case in point. As the crisis unfolded, the IMF's membership agreed to triple the financial resources at the Fund's disposal. This provided the firepower needed to help contain the rapidly spreading financial contagion. Our members also endorsed important innovations in the IMF's lending framework, including the creation of a new financing instrument—the Flexible Credit Line (FCL)—which can be used to provide contingent financing to economies with strong macroeconomic fundamentals and excellent policy frameworks. The FCL is an insurance-like instrument designed as a crisis-prevention tool. It represents the Fund's first financing format that is adopted for a world of securitized cross-border finance.

The combination of increased financial firepower and more appropriate instruments is potentially much more likely to succeed in crisis prevention than was possible previously. Moreover, enhancements to the IMF's insurance-like facilities recently have been approved by the Fund's Executive Board. For countries with strong policies and sound economic fundamentals, the FCL has been made more adaptable. For countries with moderate vulnerabilities, the Fund now offers a form of contingent protection through the newly-authorized Precautionary Credit Line.

Finally, our members recently agreed to double the total amount of IMF quotas—which in effect will double the Fund's *permanent* resource base. This measure will enhance confidence in the IMF's ability to respond effectively to global financial crises.

Looking ahead, we are continuing to explore ways to refine our techniques for coping with shocks of a systemic nature. Building on our recent experience in Europe, this might include greater cooperation with regional financing arrangements. We're also examining how the synchronized use of FCLs could support multiple countries affected by a common shock.

*Financial Sector Reform*

In the wake of the financial crisis, the G-20 has placed great emphasis on global cooperation in repairing and strengthening the financial sector. The relatively new Financial Stability Board—or FSB—is playing a lead role in coordinating international regulatory reform efforts -- along with the standard-setting bodies -- as well as cooperating with the IMF and other institutions.

More broadly, the G-20 has endorsed reform efforts that are aimed at fortifying the four pillars of a sound financial system: (i) stronger regulation; (ii) more effective supervision; (iii) development of a resolution mechanism for systemically important financial institutions (SIFIs); and (iv) improving the process for assessing the implementation of new standards. A fifth element is the creation of a level regulatory playing field among countries, and resolving other critical cross-border issues.

Already there has been significant progress in delivering the core elements of a stronger, more resilient financial regulatory framework. The Basel III accord announced this fall by the Basel Committee on Banking Supervision—that calls for increasing the quality and quantity of bank capital—was achieved in record time: only a year and a half was required, compared to the twelve years it took to agree on Basel II. Important progress also has been made on elaborating a policy framework for reducing the moral hazard created by systemically important financial institutions, and identifying principles for reducing the reliance on a small set of credit agency ratings.

Nonetheless, much work remains to implement these measures and to ensure that the new financial regulatory improvements will be complemented by more effective supervision and resolution frameworks. The Seoul Summit strongly endorsed achieving new progress in these areas. Moreover, the recent agreement to make the IMF/World Bank Financial Sector Assessment Programs mandatory for countries with systemically important financial sectors represents an important concrete step in ensuring that the new standards are implemented and adhered to. Further work on macro-prudential policy frameworks is another key area that was endorsed at Seoul

*Global Governance*

The broad-based commitment to global cooperation also has manifested itself in historic changes in governance at the international financial institutions. Just last month, the IMF's membership agreed an important reform package, including a shift of over 6 percent in quotas—essentially in relative voting shares—to dynamic emerging and developing economies. As a result, the ten largest members of the IMF will include the four BRICs, along with the United States, Japan and the four largest European countries. It will be difficult to claim that this lineup lacks legitimacy.

These are not just cosmetic changes. They will have a real impact on how the IMF is run, and create an institution where global economic realities are reflected in countries' voting power. They will enhance the Fund's credibility and effectiveness—making it a stronger institution for promoting global financial stability and growth for all its members. In fact, the reforms already are impacting the way our members view the IMF: Leaders of several emerging economies noted at the Seoul Summit that they now consider the IMF as representing their interests effectively.

*Concluding remarks*

In sum, much has changed in the past year. This includes the specific challenges in achieving effective global policy cooperation. The stakes are high, as the positive potential payoff is significant. Looking behind the headlines, the G-20 Leaders in Seoul confirmed the importance of collaboration. The coming year will be pivotal in determining if the crucial new initiatives I have described today will continue to make progress.