

THE EVOLUTION OF THE G-7 AND ECONOMIC POLICY COORDINATION

OCCASIONAL PAPER NO. 3
JULY 2006



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Department of the Treasury
Office of International Affairs
Occasional Paper No. 3
July 2006

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The growth of global economic imbalances has generated much talk about how the situation can possibly be unwound gradually or in an orderly manner. Perceived currency misalignments appear to be increasing protectionist pressures. In the face of these challenges, some look back wistfully to the time of the Plaza Agreement. Some analysts are even calling for a Plaza-like "coordination" agreement to promote an orderly reduction in global imbalances.³

At the same time, the G-7 major economies that have traditionally participated in macroeconomic policy coordination and thereby took on such challenges for the global system no longer carry as much economic weight in the global economy as they once did. Indeed, as key emerging market economies play a larger and growing role on the global economic scene, they are now a more critical part of the global imbalance equation.

These debates have put vexing questions on the table. Can officials from G-7 and other key economies "coordinate" their policies effectively to strengthen global stability and growth? Is the G-7 still relevant, given that global economic weight – and more importantly relative contributions to recent global growth – is increasingly shifting to other countries?

Clearly, the potential for coordination has shifted over time. The Keynesian revolution and more recent moves toward independent central banks reinforced policy-makers' belief that they could manage their own economic objectives and destinies on their own to a greater degree than in the past. Policy-makers continue to debate who should adjust and by how much. Larger countries in particular are less inclined to subordinate domestic economic objectives to an external discipline or to allow domestic objectives to bear a disproportionate burden of external adjustment. Much research has been undertaken by econo-

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²The authors thank Ted Truman, Karen Johnson, Joe Gagnon, James Lister, Robert Kaproth, Michael Kaplan, Marvin Barth, John Weeks, and Jon Burks, among others, for their helpful and thoughtful comments.

³See, for instance, William R. Cline, "The Case for a New Plaza Agreement," *Policy Brief in International Economics* (No. B05-4), Institute for International Economics, December 2005.



mists to analyze the results of coordination, with varying conclusions about the value of the exercise.⁴

Yet countries do not have the luxury of operating independently. The exponential growth in global financial markets clearly has spillover effects, which affect the conduct of macroeconomic policy. On balance, the interactions among key economies are increasing, and globalization has raised a wide range of common and new economic and financial challenges for policy-makers. Thus, the international community needs processes to bring officials together to make them aware of developments in each other's economies and their effects on others – and to consider if and how they should act together in this light. It is in this context that new mechanisms for economic policy management among the major economies emerged after the demise of Bretton Woods and continue to evolve today.

This paper briefly examines macroeconomic policy coordination in the post-Bretton Woods era and assesses the potential for a Plaza-like agreement in the current climate. It also reviews the evolution of the G-7 over the last two decades in order to engage on the debate about the G-7's relevance. To be sure, there are many more detailed analyses of this history and scholarly assessments of the success of coordination. This paper aims to offer a brief historical review and to explore these questions from a perspective inside one government in the G-7 process.

THE ADVENT OF ECONOMIC POLICY COORDINATION AFTER BRETTON WOODS

Managing global economic adjustment and the interactions among countries is not a new ques-

tion. In principle, the gold standard provided clear rules for adjustment. But it had important weaknesses: it subjected countries to wide variations in output/inflation, and countries jumped ship from time to time (for instance, the United Kingdom following the first World War). Similarly, the Bretton Woods System provided for a high degree of policy automaticity in principle, but it too allowed the build up of huge systemic asymmetries and stress. Policy-makers could not agree on who should adjust and by how much, and the system met its demise.

Without an automatic policy adjustment mechanism in place, the need emerged for other means to address economic policy interactions across borders. All countries would benefit from a system that balanced the needs and interests of countries, constrained policies that undermined the economic objectives of others, and achieved a better outcome for all than could have been reached by single countries acting independently. In principle, economic policy coordination could entail individual countries formulating and implementing policies jointly with others, including trading off policies if need be, in order to secure a higher level of global economic welfare. On the other hand, no system can objectively balance the at times divergent self-interests and needs of countries.

It was after the first oil price shock in December 1973 that the five major industrial countries (G-5) made their first post-Bretton Woods attempt to coordinate policies. But they failed on this occasion to agree on specific macroeconomic policies. They tried again at the London Summit in 1977 when Leaders established growth targets, which were not achieved.⁵

The next effort came at the Bonn Summit in 1978, when Leaders agreed on a set of policies intend-

⁴See, for instance, Laurence H. Meyer, Brian M. Doyle, Joseph E. Gagnon and Dale W. Henderson, "International Coordination of Macroeconomic Policies: Still Alive in the New Millennium?" *International Finance Discussion Paper Number 723*, Board of Governors of the Federal Reserve System, April 2002, and Edwin M. Truman, "A Critical Review of Coordination Efforts in the Past," *Macroeconomic Policies in the World Economy*, ed. Horst Siebert. Heidelberg: Springer.

⁵Meyer, Doyle, Gagnon and Henderson, p. 18.



ed to fuel stronger global growth. Specific policy commitments were made by each Leader, including fiscal expansion in Japan and Germany and deregulation of oil prices in the United States, and together all committed to bring the Tokyo Round of trade negotiations to a successful conclusion.⁶ Many see this as the pinnacle of economic policy coordination. But these policies were just beginning to take effect when the second oil price shock hit in 1979, and many blamed the Bonn Summit for inflationary pressures that emerged thereafter. Following the Bonn Summit, meaningful coordination of economic policies languished for some years.⁷ Indeed, there was considerable discord in major countries in this period about how and to what extent to align their policies. The United States believed that countries should set policy independently and allow markets to determine exchange rates without any official guidance.⁸ Others saw more promise in coordination, with France advocating throughout the period a new international monetary conference to agree on a common approach.⁹

THE RISE OF G-7 ECONOMIC POLICY COORDINATION¹⁰

Despite differences in outlook among the major economies in the early 1980s, newly challenging economic circumstances in these countries and their consequences helped create the context for a new coordination push in the middle of the decade. The resulting period represents the most sustained effort among Finance Ministers to coordinate policy in the post-Bretton Woods era.

expansive fiscal policy (notably tax cuts and increased defense spending), and tight monetary policy to wring out inflation. Real interest rates rose. The dollar appreciated. The U.S. current account deficit expanded to a then-whopping 3-1/2 percent of GDP. Unemployment was high, peaking around 10 percent, the Midwest suffered, shifting from manufacturing to “rust belt”. Global competitive pressure built up on U.S. farmers and producers – and economic policymakers felt the heat.

By 1985, the new Secretary of the Treasury, James A. Baker, faced tremendous protectionist pressure. The dollar had already peaked and started to fall in February, but the political crescendo had built sufficiently to motivate a major effort to “coordinate” policy – announced in September 1985 at the Plaza Hotel in New York City. The communiqué detailed specific policy intentions to lay the basis for continuing strong growth and addressing imbalances, including tax cuts in Germany and fiscal expansion in Japan to help promote growth. The official document further asserted that exchange rates should more fully reflect fundamentals, calling for appreciation of non-dollar major currencies and indicating a willingness by Ministers to cooperate to achieve this end – which they did through extensive, coordinated intervention thereafter. The imperative of addressing global imbalances was further underscored by the Baker-Miyazawa agreement in October 1986, which made clear the commitment to further policy measures, rather than merely relying on exchange rates.¹¹

In the United States, the early 1980s featured an

Whether the Plaza Agreement was a success is

⁶ C. Fred Bergsten, “Should G7 Policy Coordination Be Revived?” *The International Economy*, Fall 2003.

⁷ Silvia Ostry, “Canada, Europe and the Economic Summits,” paper presented at All-European Canadian Studies Conference, The Hague, Netherlands, 24-27 October 1990.

⁸ Jeffrey A. Frankel, “International Nominal Targeting: A Proposal for Coordination in the 1990s,” expanded April 1990 version of a paper published in the *Kinyu Journal*, March 1990.

⁹ See discussion in *International Monetary Cooperation Since Bretton Woods*, Harold James, (Washington, D.C.: International Monetary Fund, 1996), pp. 409-435, highlighting the passion among some (particularly France) for a new international monetary conference and the skepticism and resistance by others (notably U.S. Treasury Secretary Donald Regan).

¹⁰ The role accorded macroeconomic discussions in the annual Economic Summits has varied substantially over time, but in general has lessened over time, especially in contrast with the 1970s. This paper focuses on macroeconomic discussions among Finance Ministers and Central Bank Governors and only references Summitry in several instances.

¹¹ Sam Y. Cross, “Notes for FOMC Meeting,” December 16, 1986.



still a matter of debate among analysts; the dollar had already started to fall, and it is not clear to what extent the Plaza Agreement furthered this trend.¹² In any case, the dollar remained in decline until February 1987. At that time, the major countries sought to halt the trend and announced a new more comprehensive agreement at the Louvre, based on an assessment of fundamentals. Privately, understandings were reached about appropriate ranges for exchange rates. Despite the Louvre Accord, the dollar continued to decline. Truman attributes this at least in part to the specification of clear policy actions that were not implemented,¹³ though it is not certain that even full implementation of commitments would have captured the attention of market participants and convinced them that the U.S. government truly wished to stop the dollar's slide. The stock market crash in October 1987 followed, and many analysts point to public debate between the United States and Germany about monetary policy as one contributing factor.

The G-7 tried once more to shore up market sentiment in December by issuing a communiqué based on telephone consultations (the "telephone communiqué"). Ministers reaffirmed their Louvre commitments, underscored the importance of fundamentals and announced new measures to help bring their economies into balance – in particular through additional fiscal measures in the United States and tax cuts in Germany. This was accompanied by a coordinated intervention that did indeed mark an upturn in the dollar,¹⁴ though not a lasting one.

After 1987, current account deficits of the major industrial countries "gradually but surely fell to more sustainable levels."¹⁵ Indeed, the U.S. current account reached balance in 1991. A number of factors contributed to this adjustment,

including the effects of dollar decline over time (as the dollar lost 30 percent of its value in real trade-weighted terms between mid 1985 and mid 1991) and the slowdown in U.S. growth at the decade's end.¹⁶ Importantly for external adjustment, growth in Germany and Japan was particularly strong in the latter part of the 1980s and early 1990s, influenced by the initial impact of German reunification and expansive Japanese monetary policy, and outpaced U.S. growth for several years.

During this period, policy-makers' ability to deliver fundamental reforms and sound policies, which are the ultimate determinants of exchange rate relationships, was uneven. To be sure, policy-makers reached informal understandings about exchange rate levels and were prepared to take a public view as to when exchange rate changes were in line, or not, with fundamentals and to act on that view. Japan and Germany did look at budgetary priorities in light of international economic interactions. Interest rates were adjusted at concurrent times by major central banks on occasion. But many commitments were not new. Interest rate adjustments reflected economic needs and self-interest in the individual countries, and monetary policy was not geared solely to maintaining understandings about exchange rate ranges. Despite its commitments to the G-7 and the Gramm-Rudman-Hollings legislation aimed at controlling spending, the United States did not deliver in good time on the promise to reduce its deficit. Despite commitments to the G-7 about reducing interest rates, the German government could not deliver the Bundesbank, which slightly increased a key interest rate in September 1987 just before the G-7 meeting.¹⁷

Apart from the results of multilateral surveillance, the process of economic policy coordination it-

¹²Truman.

¹³Ibid.

¹⁴James, p. 457.

¹⁵Ibid.

¹⁶Sebastian Edwards, "The End of Large Current Account Deficits, 1970-2005: Are there Lessons for the United States?" *National Bureau of Economic Research Working Paper 11669* September 2005.

¹⁷James, p. 453.



self evolved substantially during this period. The Group of Five (G-5) continued secretive discussions that had begun in the mid-1970s, culminating in the announcement of the Plaza Agreement in 1985. Indeed, whereas the G-5 had been a secret group that did not issue communiqués, with the exception of the January 1985 meeting, the process set off by the Plaza Agreement then led to an expansion of the group into the G-7 and a pattern of public statements that has since become relatively consistent, with the exception of a brief period. The IMF developed a process for examining “objective indicators” and providing papers to the G-7, which offered a common set of data for the G-7’s multilateral surveillance discussions.¹⁸

The entire process was appealing and created a sense of order in other ways. The sequencing of communiqués, lists of policy commitments, and aura of cooperation created a sense of progress. In fact, however, commitments on the surveillance front were naturally limited, given the preeminence of domestic politics, such that agreement and action on concrete new policy actions was not the rule. Thus, communiqués often repeated policy objectives already achieved, announced domestically and/or not within direct control of Finance Ministers. And, as noted above, the actual results lagged behind the commitment to adjusting policies.

Also, during this period, senior G-7 officials often tasked their technical experts to work together on common problems in areas not related to multilateral surveillance, for example on IMF operational and policy issues. The international debt crisis provoked extensive discussion about the nature of the problem and potential solutions, eventually leading to the Brady Plan in 1989. These taskings promoted increased cohesion and deepened contacts at many levels among G-7 finance ministries and central banks.

In sum, the Plaza Agreement and its aftermath

demonstrated both the usefulness and limitations of multilateral engagement on economic policies. Policy-makers recognized the growing interactions among their economies and the reality that these inter-linkages must factor into their thinking about and formulation of domestic economic policy choices, although they were not willing to make the sacrifices necessary to maintain the discipline of a fixed exchange rate and more rules-based system. They all shared a strong interest in preserving stability, and were mindful of maintaining a sense of order in the system and working to resist protectionism. As creditors and key players in the system, they represented a like-minded grouping for setting forth perspectives on global economic issues beyond the G-7. Some good results were obtained. Thus, they clearly did not want to throw international economic policy to the wind. Yet the conviction behind macroeconomic policy “coordination” was less clear and the ensuing results at times fell short of the mark. In some cases, officials did not agree on announced coordinated actions or did not have a shared understanding of what they would mean. Further, the scope for changing domestic policies as a result of international considerations was often limited.

THE AGE OF GROWING PRAGMATISM

In the 1990s, two major dynamics shaped interactions within the G-7. First, on the macroeconomic policy front, policy-makers tended to be more inwardly focused as domestic policy challenges and political dynamics consumed much of their attention. Shaping concerted macroeconomic policies was not as prominent a theme as in the 1980s. Expectations about the ability to achieve macroeconomic results through multilateral surveillance were more tempered, and policy-makers emphasized that keeping one’s own house in order was perhaps the main contribution that could be made to a healthy global environment.

¹⁸ James M. Boughton, *Silent Revolution - The International Monetary Fund 1979-1989*, (Washington, D.C.: International Monetary Fund, 2001), pp. 214-15.



Second, shared interests in broader global policy issues, such as the break-up of the Soviet Bloc, the Asian financial crisis and the operation of the international financial institutions, drew the attention of policymakers and consumed more of their discussions as they mapped out common approaches in these areas.

National economic developments posed considerable challenges for policymakers. In the United States, the imperative of restoring fiscal balance dominated the economic policy agenda in the 1990s. The U.S. fiscal deficit began to decline in the early 1990s and swung to surplus by the end of the decade, underpinned by good growth and a stream of “revenue surprises” as the stock market surged. For its part, the Federal Reserve “opportunistically” continued to bring inflation down and under control, building on the experience of the 1980s in the wake of the challenges of the late 1970s.¹⁹ Overall, after slowdown in the early 1990s, the U.S. economy gradually gained steam through the decade.

While the United States was building momentum, Japan was experiencing the aftermath of the bursting of the 1980s bubble economy. Despite serious signs of trouble and recession, banking sector reform was delayed. After substantially easing fiscal policy to spur growth, premature fiscal consolidation in 1997 stalled recovery, contributing to a contraction in the economy that year and the following. Monetary policy eventually became increasingly and highly accommodative. The challenges faced in Japan over this period were entrenched, and opinions differed internally and abroad about how to promote recovery.

In Europe, attention was heavily influenced by domestic agendas and intra-European affairs. German reunification in 1990 imposed high costs on the German economy, which contracted in

1992 and achieved only moderate growth in subsequent years, weighed down also by deep structural rigidities. The crisis in the Exchange Rate Mechanism of the European Monetary System in 1992-1993 also consumed the attention of financial officials.²⁰ Later on in the decade, the advent of European Monetary Union dominated the financial agenda, and European officials heavily focused on establishing the framework for the euro through the Maastricht Treaty and building the European Central Bank (ECB). Performance in some of the periphery countries of Europe improved markedly, as the lure of using the euro from the start facilitated improved policies and convergence of interest rates to German levels. But despite this progress, persistent unemployment and structural rigidities took a heavy toll, especially in the key continental countries. Overall, while the EU experienced some recovery in the mid to late 1990s, performance lagged significantly behind the United States.

Further, a shift in attitudes left policymakers even more doubtful about the feasibility and potential contribution of coordinating macroeconomic policy across borders.

- As monetary policy was able to bring inflation down, many central banks increasingly built up their credibility and felt increasingly accountable to get inflation down and keep it low. With monetary aggregates offering a less reliable policy anchor, inflation targeting regimes began to develop – in New Zealand, Sweden, Canada, Australia, and the United Kingdom. Obviously, exchange rates remained part of central banks’ monetary equation, but the emphasis was more squarely placed on keeping low inflation. In the United States, senior Fed officials maintained that external developments would be taken into account to the extent that they

¹⁹ Athanasios Orphanides and David Wilcox, “The Opportunistic Approach to Disinflation”; Federal Reserve Board Finance and Economics Discussion Series; May 1996.

²⁰ Edwin M. Truman, “Economic Policy and Exchange Rate Regimes: What Have We Learned in the Ten Years Since Black Wednesday?”; speech at the European Monetary Symposium, London School of Economics, September 16, 2002.



had feedback effects on the U.S. economy and that monetary policy responses should be aimed at the optimal performance of the U.S. economy.²¹

- Questions about fiscal policy as a flexible tool for macroeconomic management remained as acute as ever. As always, the conduct of fiscal policies required extensive compromises with legislatures and delved into fundamental domestic political choices. Lags between the announcement of fiscal intentions and implementation remained long. Policy-makers increasingly felt fiscal policy should follow a medium-term course and was not an appropriate instrument for macroeconomic fine-tuning.
- Attitudes toward foreign exchange market intervention grew increasingly skeptical in major countries. After frequent coordinated intervention during the Plaza and Louvre period and through the end of the 1980s and early 1990s, with the United States an active participant, officials—particularly in the United States—increasingly doubted the efficacy of intervention. In short, this growing skepticism reflected a return to that of the early 1980s, but it also took into account the realities of the modern global economy and markets.

Authorities increasingly felt that the amounts they could mobilize for intervention paled in comparison with huge and growing daily foreign exchange market turnover. They recognized that intervention operations would be sterilized, neutralizing the monetary policy impact of such operations. The exchange rate was increasingly thought of by most as an outcome of policies and not an object of policy. Current account targeting was eschewed, especially as current account positions were inextricably linked to global capital flows and the world of financial market participants. There was also concern that official actions

and statements to the market could themselves create volatility, distracting markets from intermediating forces of supply and demand.

In the United States in particular, the prevailing view became that intervention should be used very sparingly and for signaling purposes when exchange rates were markedly out of line with perceived underlying fundamentals. That said, the G-7 cooperated closely to intervene on exchange rates when such action was perceived as warranted, for instance to address yen strength in 1995, yen weakness in 1998, and euro weakness in September 2000. These concerted operations demonstrated anew the ability of G-7 officials to work closely together, even against the background of greater constraints and limitations on their ability to “coordinate” policies. They also showed that even if officials were skeptical about foreign exchange market intervention, policy-makers did not preclude that serious misalignments might arise and that when it came to intervention, they had “never said never”.

While the limits of macroeconomic policy “coordination” increasingly became evident during the 1990s, the decade witnessed new and intense G-7 cooperation on other fronts. The first half of the 1990s saw the collapse of the Soviet Union, the emergence of many newly independent states, and the Mexican crisis of 1994, which was a harbinger of capital account crises to come.

The second half of the 1990s was also dominated by the Asian financial crisis, and crises in Brazil and Russia. The G-7 extensively discussed the challenges posed by these crises and their views on the appropriate international response. Intensive efforts were made to improve the “architecture” (some would say “plumbing”) of the international monetary system, particularly modernization of the IMF. Transparency and data dissemination were introduced into the Fund’s lexicon; the Fund delved into the world of strengthening financial sectors and supervision and regulation;

²¹ Alan Greenspan, The Federal Reserve’s Semi-Annual Monetary Policy Report; July 21, 1998.



standards and codes of good policy practice were promoted; national balance sheet analysis took root; and IMF facilities were revised, with some streamlined and the Supplemental Reserve Facility and the Contingent Credit Line added.

As they confronted the events of the 1990s, G-7 governments deepened their dialogue and cooperation, with more frequent interactions facilitated by improved communication technology. The emerging market crises of the mid and late 1990s led to extensive conference calls, consultations and actions together to help restore stability – further reinforcing the tight dynamics of the G-7 Finance Deputies in particular. Interestingly, the efforts to achieve shared goals in the international financial institutions (IFIs), where as major creditors they could carry sway, underscored the importance of the G-7 process even as the perceived utility of heavy engagement on multilateral surveillance waned.

On the whole, discussions within the G-7 involved good give and take on an increasing range of issues in the face of globalization. Multilateral surveillance exercises continued, but more as a means of keeping abreast of others' situation than an exercise in exerting peer pressure. To be sure, though, the United States often heavily engaged and exerted peer pressure, especially with Japan, in a bilateral context.

The G-7 process also evolved in other ways. With the advent of the euro, the question of participation in G-7 discussions needed reexamination. To adapt, the G-7 put in place new procedures, whereby the European Central Bank President and the Finance Minister from the country holding the EU Presidency (and a member of the Euro group) replaced national central banks during surveillance and exchange rate discussions, while Euro-area national central banks remained the interlocutors on broader policy issues. Driven by Summitry in the early 1990s, the G-7 also invited Russian officials to meet with the G-7 on Russian reform.

When emerging market country policies became

critical to broader stability, the United States sought to bring the G-7 together with key Asian and other emerging market countries to share information and discuss ways to change policy approaches. The “Group of 22” sprang from a discussion between President Clinton and Singaporean Prime Minister Goh in the height of the Asia crisis and produced three reports on issues central to the crisis reflecting the input and views of major industrial and emerging market countries alike. Thereafter, the G-7 launched the Group of Twenty (G-20) as a permanent forum. These groups helped change the dynamics of the international dialogue and began the more recent wave of modernization that continues today.

Also in the wake of the Asia crisis, the G-7 created the Financial Stability Forum (FSF), bringing together regulators, central bank and finance ministry officials from their countries, along with standard setters and officials from other key financial centers and institutions. Creating the FSF was a critical effort to make sure that financial officials stayed vigilant in working together on the promotion of financial stability in the face of ever-rapid changes in global financial markets.

CONTINUED ENGAGEMENT – THE CURRENT DECADE

Since the new millennium, G-7 engagement has been characterized by both continuity and change.

- Continuity in the sense that multilateral surveillance exercises remain a key part of G-7 deliberations – though with modest expectations regarding “coordination” given constraints on domestic macroeconomic policy formulation and skepticism among most about foreign exchange market intervention—and that engagement has focused on a wide range of issues.
- Change in the sense that the forces of globalization and the power of private financial markets have accelerated, global imbalances far larger than those in the 1980s have



emerged, there is a rising imperative to reach beyond the G-7 countries to tackle challenges in the world economy, and cooperation continues to expand into new policy areas.

On the multilateral surveillance front, discussions were initially influenced by the U.S. downturn in the wake of the perfect storm of the bursting of the tech bubble, the 9/11 terrorist attacks, and the aftermath of corporate scandals. Japan began to clean up its financial sector, put itself on a recovery track and end deflation. Europe most recently shows signs of somewhat stronger growth, though there has been only limited progress on structural reforms and unemployment remains high.

Subsequently, as conditions strengthened, two dominant issues have taken center stage in G-7 surveillance discussions.

First, the emergence of large global imbalances appropriately features prominently on the agenda. The G-7 relatively quickly came to a consensus that that adjustment of global imbalances was a shared responsibility and that a three-part strategy for orderly adjustment was needed in the context of sustained and strong global growth. The three components widely agreed were: fiscal consolidation and raising private saving in the United States, structural reforms to raise potential growth in Europe and Japan, and greater flexibility in exchange rates, especially where such flexibility is lacking – with a particular focus on emerging Asia and China.

The G-7 effort to tackle the challenges of global imbalances also yielded the Agenda for Growth, launched by Ministers and Governors in September 2003 and aimed to address supply-side issues to increase flexibility and raise productivity growth. Each country committed to pursue additional pro-growth policies, and together they agreed to engage in regular “supply-side surveillance,” which would include assessing (or “bench-

marking”) proposed reforms and reviewing their results. The ability of G-7 members to deliver on promises was limited, however, and many of the needed structural reforms were outside the control of Finance Ministers and Central Bank Governors.

Despite agreement on the three-part strategy and the launch of the Agenda for Growth, basic questions about who should adjust, how, and by how much have remained.

- U.S. fiscal consolidation is clearly in the U.S. national interest. Some foreign voices seemingly suggest, though, that if only the United States would rein in its fiscal deficit, U.S. external deficits would be quickly reduced with the global economy benignly more balanced. At the very same time, many foreign officials—and often the same officials—also stress how important solid U.S. growth and demand for imports are to their economies. Criticisms of the U.S. “twin deficits” continue, notwithstanding the lack of a good correlation between U.S. fiscal and current account deficits in past decades.
- The Euro-area’s current account position is near balance. Thus, some European officials argue that the Euro-zone is not really part of the global adjustment equation, though it surely needs to improve economic performance for its own good. Others, including U.S. officials, do not support this view. They believe there are important gains to be made in the European non-tradeable services sector and investment climate, which could boost European potential growth, stimulate demand for imports, attract greater flows of global capital, and lead to a sustainable current account deficit. From this perspective, Europe is part of the global adjustment picture and part of the solution.²²
- Japan has clearly felt that external demand

²²Treasury Department, “Report to Congress on International Economic and Exchange Rate Policies”; May 2006; pp. 6-7.



is an important support for Japanese growth in overcoming deflation and getting back on a solid recovery track in the wake of its dol-drums. Some Japanese officials psychologically may be less inclined than their U.S. or European counterparts to view the exchange rate as a simple by-product of other policies. Others outside of Japan emphasize that it is critical for Japan to wean itself from export-led growth.

- The G-7 has called for countries beyond its confines to increase currency flexibility, particularly China, to assist in the global adjustment process; in turn, greater currency flexibility in China is seen as a means of facilitating greater flexibility throughout Asia, given other Asian countries' concerns about maintaining competitiveness vis-à-vis China. Asian officials recognize the need for greater currency flexibility. But they have also pointed to underlying saving-investment relationships in their countries as key to understanding their current account positions and argued that currency flexibility will not contribute significantly to solving global imbalances.

On balance, then, while there is agreement about the broad strategy, beneath the surface there are some key, nuanced differences about relative contributions to global adjustment.

The IMF's latest proposals on a process for multilateral consultations may represent an important effort to reinforce the role of shared responsibility, understanding, and peer pressure in the international monetary system. These proposals underscore the multilateral dimension of global imbalances and the need for a broader discussion of imbalances than can be afforded within the confines of the G-7. The process should also help promote exchange rate policies that are con-

sistent not only with domestic policies, but global adjustment with the international monetary system.

A second key issue framing G-7 surveillance discussions this decade has been the declining collective weight of G-7 economies in the world economy – and the resulting limits on their ability to influence the world economy through their own policy actions. The world economy is now in its fourth consecutive year of growth exceeding four percent annually (on a purchasing power parity basis). This is a phenomenal and welcome development. But growth performance is quite disparate. The United States continues to outpace other G-7 countries and has been the main engine of global growth for some time. Meanwhile, fast-growing emerging market countries, particularly in emerging Asia, are imparting a source of dynamism to the global economy. In 1985, the G-7 countries accounted for 48.9 percent of global GDP (using PPP weights); in 2005, they only constituted 41.9 percent.²³ As G-7 growth is lagging behind that in emerging markets, the weight of the G-7 in the global economy is declining, and the G-7 is no longer providing the same degree of marginal impetus to global growth.

The challenges posed by global imbalances, world financial markets, and shifting weight in the global economy have affected the G-7 process itself.

The constraints on macroeconomic policy coordination that prevailed in the 1990s – notably the simple realities of the domestic political conduct of fiscal policy, the increasing focus of central banks on inflation and to a lesser degree exchange rates, skepticism about the wisdom of current account targeting, and doubts regarding the efficacy of intervention – remain well-entrenched. The role of peer pressure has further softened. In addition, the United States in particular has in general fur-

²³ International Monetary Fund, World Economic Outlook Database, September 2005. The changes in PPP weights for developing countries and emerging markets reflect both countries gaining and losing weight. Fast-growing emerging markets have seen their PPP weight in the world economy increase far more than the decline in G-7 weight. China, India, and South Korea saw their combined PPP share of the global economy rise over 13 percentage points in this period.



ther stepped back from efforts to promote specific policy change in G-7 partner countries, preferring a more collegial approach.

As stated by then-Assistant Secretary for International Affairs Randal Quarles: “A continual process of informal discussion and contact provides the best means for understanding the interaction of national policies around the globe and greater sensitivity to each country’s concerns....I think our current informal processes are working as well as they can in a world of diverse perspectives. The most important contribution any country can make is to improve its own economy’s performance. The better an economy functions individually, the more positive a contribution it can make to the global economy.”²⁴

Thus, while G-7 policy-makers have valued interactions with each other, G-7 multilateral surveillance discussions have focused more on reviewing developments than a back and forth examination of prospects and policy changes.

At the same time, G-7 cooperation on issues beyond the macroeconomic realm has continued and deepened. There was close and continuing engagement in addressing country cases such as Brazil, Argentina, Uruguay and Turkey. The initial HIPC debt reduction initiative and the more recent Multilateral Debt Relief Initiative were clear products of G-7 cooperation. The G-7 as always has continued its work on IFI reform, for instance achieving greater harmony on the balance between flexibility and limits on exceptional access to IMF financing. And G-7 cooperation also helped achieve incorporation of Collective Action Clauses in sovereign external bond contracts.

Cooperation also entered new terrain – the G-7’s unity in tackling the challenge of combating terrorist financing was a new and resolute chapter in cooperation, symbolized so strikingly by the joint press conference of G-7 Finance Ministers at

their special meeting in early October 2001. That cooperation launched strenuous day-to-day G-7 efforts at collectively designating terrorists, freezing their assets, incorporating FATF standards into the daily activities of the Fund and Bank, and cleaning up unsafe financial practices. These efforts built on and were facilitated by earlier work within the G-7 and other international groupings on offshore financial centers and the abuse of the international financial system.

Further, while G-7 debates on IMF reform could be seen as a hardy perennial, the Medium Term Strategic Review – against the background of the recent decline in IMF credit outstanding and the desire to tackle the governance structure of the Fund – in some respects is a qualitatively different and more sweeping exercise than witnessed in the past few years.

Just as the substantive discussions have changed, the process of G-7 engagement has also evolved. G-7 Finance Deputies remain at the heart of the process, meeting often, holding conference calls, and frequently speaking or emailing daily. They organize Ministerial sessions and engage intensively if an emerging market begins to face problems. The members of this group get to know each other well, and the group is sufficiently small to get business done.

G-7 Ministers and Governors continue to meet three times a year, and the Finance Ministers meet alone with their Russian counterpart (as the G-8) to discuss finance issues ahead of the Leaders’ annual summits. The “choreography” of the G-7 meetings has grown complicated, and debates swirl about who has domain for a given issue and who should be at the table. In recent meetings, the ECB President and the President of the European Economic and Finance Council have attended the G-7’s multilateral surveillance session; European national central bankers then join the discussions; then Russian and

²⁴ Randal Quarles, remarks in *The Euro at Five: Ready for a Global Role*, (Washington, D.C., Institute for International Economics, Adam Posen, editor; April 2005), p. 42.



European Commission officials attend a portion of the meeting. The heads of the IMF and World Bank also attend parts of the meeting. As a result, many people are in the room, which tends to lead to more scripting and less candor among top officials. European efforts to coordinate positions in the G-7 with other EU states can further complicate informal exchanges.

More pronounced and likely significant for the long term are the shifts in G-7 interactions with those outside its membership and an existential soul-searching now underway about how the G-7 fits into today's global architecture. This dynamic is linked to the changing pattern of global economic weight discussed above and is also mirrored in the current intense debates about changing IFI governance, particularly at the IMF.

The issue of who should be included in exclusive, heavyweight discussions on the world economy and international financial system is a thorny one.

- The G-7 still accounts for over 40% of global GDP on a PPP basis and far more than half using market prices, plus nearly half the voting power of the IFIs. The G-7 countries tend to be like-minded creditors of the system. But many others are becoming creditors too.
- The G-20 has taken root as a key forum for broader dialogue on key international economic and financial policy issues. It has usefully brought emerging market officials together with those of the G-7, providing an opportunity for mutual education and increasing buy-in from emerging markets for many of the initiatives pursued in the IFIs and elsewhere such as the broader adoption and implementation of standards and codes. The G-20 has helped G-7 officials deepen contacts with emerging market colleagues and this has facilitated interaction, particularly at urgent times. The G-20 is a highly valuable and new piece of the global architecture. Yet, the G-20 is large, and some participate far

more actively than others.

- And then there are the changing dynamics and evolving roles of countries within the system (“variable geometry”). China's impact on the global economic system is huge, undeniable, and must be taken into account. India and Brazil as well, large countries in their own right, are beginning to show the fruits of reforms as liberalization and sound policies take hold, growth is quickening, and their impact on the world economy is evident. Amid sustained high petroleum prices, oil producers are accumulating sizeable reserves and petro-dollar recycling is back on the international agenda. Even if the G-7 accounts for a large part of global GDP, outside the G-7, and the United States in particular, other key emerging markets are providing significant impulse to global growth and are having a pronounced and growing impact on the global economy. Addressing global imbalances requires engaging heavily with new actors outside the G-7.

Against this background, the G-7 countries have been conducting “outreach” – often inviting others to meet with the group on the sidelines of meetings. For instance, G-7 Deputies met with their Chinese counterparts in 2003 and have repeated this practice several times since. Ministers and Governors first invited the Chinese in September 2004 to discuss China's current economic situation and outlook and its importance for the global economy. More broadly, China, India, Brazil, and South Africa have joined G-7 meetings on an ad hoc basis, as have others, to discuss global economic developments. At their most recent meeting, G-7 Ministers heard a presentation from the Chairman of the G20 Deputies and held an informal dinner with officials from China, Russia, Saudi Arabia, and UAE to discuss issues concerning petrodollars and their recycling.

Through these sessions, a table that is already quite large is potentially becoming even bigger. This raises the question about how big the table should be and who should be there in order to fa-



cilitate useful discussions and to allow the group to achieve something meaningful. Outreach to important economies beyond the G-7 is here to stay and one can easily foresee a future in which outreach moves beyond ad hoc arrangements toward greater institutionalization. How that is done is another question, one that increasingly and more urgently needs to shape the agenda of G-7 and other policy-makers.

CONCLUSIONS

Large global imbalances and the growing weight of emerging market economies have spawned debates – why not a Plaza 2? Why not declare the G-7 dead?

The Plaza Agreement and Louvre Accord demonstrated the strong level of cooperation and political will among financial officials in the major countries at the time. Still, the limits and constraints on sovereign actors in coordinating policies were evident in the 1980s, and the extent of “coordination” that prevailed even then is at times overstated. Economic policy thinking in the 1990s reinforced these limits and constraints. Fiscal fine-tuning was increasingly eschewed. Monetary policy focussed more forcefully on achieving low inflation and promoting central bank independence and credibility. Exchange rates played less of a role as a policy target in most major countries, and there was far less conviction about the efficacy of foreign exchange market intervention, except in limited circumstances. These trends from the 1990s have generally been reinforced since 2000, especially as the power of private markets has grown.

Against this background, economic policy discussions in the G-7 have evolved over time to focus to a greater extent on informal exchanges of views. The role of peer pressure has softened. Policy-makers focus for all intents and purposes on keeping their own economic houses in order. But even if the potential for explicit macroeconomic coordination has diminished, policy-makers are acutely aware of the interactions among their economies. Multilateral surveillance re-

mains a useful process, and policy-makers benefit from discussing economic performance and sharing and debating policy approaches. Further, one should not underestimate the strong ties that exist among participants in the G-7 process, nor discount their ability to muster a collective political will to take action to address challenges, macroeconomic, exchange market, or otherwise, especially in response to a clear common threat.

In addition, cooperation has been extended to other critical areas. The G-7 process built up in the 1980s, 1990s and this decade, and the fluid interactions facilitated thereby have allowed the G-7 to tackle international economic and financial challenges of key geo-strategic significance – the transformation of the ex-Soviet states, the Asian financial crisis and its wake, and debt relief for the poorest. The world economy has strongly benefited as a result. And the creation of the G-20 and other mechanisms for broader consultation, policy debate, and mutual education have helped deepen discussions, build consensus, and enhance policy-making well beyond the G-7.

The ongoing value of extensive informal consultations among key policymakers points not to preservation of the status quo, but to the need for evolution in this process in order to increase the potential for cooperation to strengthen the global economy going forward. The changes achieved thus far to extend consultations to those playing a greater role in the world economy are critical and beginning steps forward. But the world is changing faster than the existing process for consultation and cooperation. Evolution thus needs to accelerate in order to reflect shifting global economic weight, impetus, and financial power, as well as globalization and the dominance of private capital markets. Change simply must be faced soon by the G-7 and IFI Boards in particular, for the international community to retain tools for cooperation that remain central and relevant in the modern global economy.

