# The 1938 Problem and Global Rebalancing


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# 1 Two Problems, Not One

- The papers in Session 3 consider *global rebalancing.*
  - As is well known, *two* things are necessary for this:
    - Changes in *relative* absorption between deficit and surplus countries
    - Changes in *relative* prices
- But the world also needs *satisfactory global growth*
  - At the London summit in April 2009 the world's leaders promised not to repeat the mistakes of the 1930s.
    - But the policy has involved very large increases in public debt
  - Unemployment in the US, Europe, and elsewhere remains disastrously high. To solve this requires a sustained recovery.
  - Yet the financial markets, and policymakers, are now focused on reducing public deficits and debt. The temporary stimulus packages are unwinding, and fiscal consolidation is setting in.
- Will attempts to rebalance damage global growth?
  - In particular, will fiscal consolidation put growth at risk, as in 1938?

- Paul Krugman set out a clear version of his double-dip worries in the *New York Times* 2 on 5 September. See his *“1938 in 2010”*
  - These worries have been echoed by Roubini
- Nevertheless projections of the recovery – eg by the National Institute in London - are for global growth of 4.8% in 2010 rather than for double-dip
  - fuelled by East Asia with Chinese growth at 10.6 percent
  - although growth in the US will be only 3.1 percent
  - and that in the Europe area of 1.8 percent
- It is true that world output regained pre-crisis levels in 2009 Q4
  - But in the US this was only reached in 2010Q2
  - In the UK and Germany it will not reached until 2012
  - In Japan and Italy it will not be reached until 2013
- Thus, on this forecast, even if no double dip, demand for labour in OECD countries will remain way below trend
  - unemployment in OECD countries is now a massive social issue
    - cf interview with Blanchard on IMF’s projections on September 9
- And there are risks to even this modest recovery – see overleaf
  - Fiscal consolidation compounds these risks – a ‘global 1938 problem’

# 2 Risks to Growth: The Global ‘Adding Up’ problem

- Within the OECD
  - Private sector continues to repair balance sheets & private demand in ‘short supply’
    - True for US, Japan and for some of Europe (ex Germany)
    - In Germany low private sector demand arises for other reasons
  - Financial sector acts to restrain private sector demand
    - Continues to deleverage by means of large markup on loans
    - Balance Sheet risks to German and French banks
    - Additional effects on growth of Basel III
  - In Europe there is a particular adjustment risk – see below
  - All of these regions therefore relying on export-led growth
- Within emerging markets
  - Caution about Chinese rebalancing expressed by Yiping Huang and Bijan Wang
    - This caution echoes concerns expressed by YuYong Ding
    - Simulations by Milesi-Ferretti suggest Chinese net exports will subtract nearly 1% of world GDP from the level of demand facing other countries
- There is a risk that recovery in global trade growth will slow
  - Up till now there has been a significant inventory rebuilding
  - Continued rapid growth will now depend on rapid growth in demand for imports coming from overall growth in private sector demand
- There is thus a significant risk of a global ‘adding up problem’

# 3 Risks coming from Europe

- Within EMU, the GIPS are in difficulty but at the same time Germany is excessively competitive – it has an expected current account surplus of $187b. The way forward requires:
  - cuts of absorption in Greece, and elsewhere in the GIPS, coupled with expansion of absorption in Germany, and
  - below average inflation in Greece, and elsewhere, for a long time, coupled with above average inflation in Germany.
- The trouble is that
  - Adjustment in Greece – and Spain Ireland and Portugal – is extremely difficult.
    - Will the ESF be robust enough to assist with and manage these processes?
  - Germany will resist the second, 'coupled-with', part of both of these actions.
    - Will Europe and/or the world be able to deal macroeconomically with this German resistance?

# Greece

- The rescue means that Greece will not need to borrow again from private markets for three years.
  - The intention is that debt be serviced, and, over the longer term, repaid
  - The Greek programme requires a great deal of Austerity
  - Recovery needs to come from Greece becoming more competitive and achieving export-led growth
- In my view, this will not work
- Greece cannot devalue
  - Recovery blocked by a lack of competitiveness
  - Projections of low level of activity
  - With low activity tax revenue will remain low
- Fiscal correction requires growth, which this strategy cannot deliver
  - The strategy is likely to run aground politically in the next 18 months
  - It appears that Greek debt may need to be restructured
  - Markets suspect this – which is why risk premia were so high early in the summer and remain so high now

- Such a debt haircut is necessary but not sufficient
  - it will not – of itself - restore competitiveness
  - an equivalent of a very large devaluation is needed – perhaps even 30%
- A general wage-cut needed to bring this about
  - already happened in the public sector, but much more is needed, there and in the private sector
  - Doing this slowly, in an uncoordinated manner, will create an extended time in which there are high real interest rates. This will dampen expenditure – worsening outcome
  - Needs to be *generalised,* and *rapid*, to enable activity to recover quickly
- Will need to be accompanied by some official policy towards prices
  - difficult since some activities more import intensive, etc
  - Also requires write-down of *domestic* debts
- A coordination problem - requires strong political leadership
- Combination: debt write down and wage cut needed *together*.
  - can be presented politically as burden sharing
  - At present markets are just waiting

# *Spain and Portugal and Ireland*

- Financial markets will need to be robust enough to withstand the Greek haircut.
- The contagion effect in the rest of the GIPS countries (i.e. Ireland, Portugal and Spain will need to be handled
  - The European SPV – the ESF – *may* come to be very important in managing this trans-border process
- With SPV, Europe has created the capacity to deal with forthcoming crises
  - This may mean that dealing with crises will not need to be delayed – as was the case with Greece – by Angela Merkel and the needs of German politics.
- The important question is whether Europe will use this facility wisely

# *Germany*

*The Need for Hegemonic Responsibility*

- Crisis has also revealed systemic difficulties in the non-GIPS countries
- Germany has cut costs and prices, taking demand away from other countries
  - It turns out to be very difficult to belong to a monetary union with Germany
  - A intra-European ‘competitiveness strategy’ is also a big institution-building task
- Along with this, Germany has also restricted domestic spending
  - condemning Eurozone to low demand -
  - unless this demand is taken from rest of world – a risk to world like that of China
- This is not systemically responsible behaviour
  - serious conceptual issue here:
    - Thatcherite ‘fiscal responsibility’ is possible in a small open economy,
    - but a hegemonic leader has wider macroeconomic responsibilities.
- Will Germany be wise enough to lead?
  - Maybe not - possible outcome is a two-currency bloc
    - Germany leads the North and France leads the South

- The crisis has shown a need to rethink European macroeconomic governance
  - a longer term need for ‘Federal Intervention’ in National Policymaking within EMU
  - effectively the construction of a much tighter political union
  - Wolfgang Munchau (FT) ‘Eurozone will break up unless there is acceptance of this’.
- The rules for this intervention will need to more intelligent than the Stability and Growth Pact
    - Requires Trust, not Mechanical Rules
  - I sense a reluctance in German policy-making circles
    - to accept the need for ‘constrained discretion’ of this kind in the weaker members of the union and a continuing wish for fixed rules
- The crisis has also shown a need for Germany to temper its own policy in the needs of the union.
  - Germany seems reluctant to do this, but there seems to be no alternative
  - There are risks here – with global implications

# 4 What next? Global Fiscal Consolidation

- The planned fiscal reductions are large in Europe
  - In the UK the plan is for a reduction in demand of 1.6 percent a year , over five years, ie a total of 8 percent of GDP
  - In Germany the numbers are small, maybe only 1.4 percent a year but starting from a lower base
  - In France and Italy the planned consolidations are four or five percent over five years
  - Much larger cuts in Portugal, Italy, Greece or Spain.
- Japan – a large consolidation is planned
- The US
  - Stimulus package is being withdrawn
    - This is what Krugman was complaining about
  - But no long-run consolidation package appears yet to be on the table.
  - This has significance

- What is the size of the multiplier?
  - Even if fiscal cut is permanent so that debt falls, results quoted in the National Institute for July suggest that the number is likely to be close to unity, even if the cut is permanent and so causes debt to fall.
- Results reported from e.g. the IMF's GIMF model may underplay the negative effects of the consolidation
  - Estimates will be smaller the more forward looking the private sector is assumed to be and so the more the private sector looks forward the resulting future tax
  - Estimates may include effects of interest rate cuts which follow fiscal consolidation
    - Such cuts will not be possible for some time yet
  - Crucially, many estimates based on assume that currencies depreciate in countries which consolidate, so as to crowd in demand.
    - This cannot happen in all of the US, Europe and Japan at the same time.
    - This is the global adding up problem – see over

# 5 Fiscal Consolidation, Global Adjustment and the Global Adding Up Problem

- We have seen that we need:
  - *Global rebalancing.*
    - This requires
      - Changes in *relative* absorption between deficit and surplus countries
      - Changes in *relative* prices
  - *And satisfactory global growth*
    - We have reviewed the prospects for this and have seen that there are risks
- Fiscal consolidation adds to these risks.
  - It does not cause not a change in *relative levels of* absorption
  - Instead it causes a cut in the *absolute* level of global absorption
- To ensure a satisfactory growth requires demand to grow fast enough, , world-wide, to compensate for the effects of fiscal consolidation.
  - Otherwise the fiscal consolidation might cause a global adding up problem.
- Thus we should support the Enrique Alberola when he notes that fiscal consolidation is needed for global rebalancing.
  - But it might cause global deflation instead
  - There is a crucial issue of timing – to which Blanchard has drawn attention

# 6 A Game-Theoretic Restatement

- The world faces a choice:
  - either there is enough private sector growth to compensate for the fiscal tightening;
  - or the fiscal tightening can lead to an outcome which does not rebalance the world but instead leads to stagnation.

- The choice will be *ameliorated* – in the short run - if one global authority – the US Federal Reserve – keeps interest rates low enough to help keep global spending growing
  - But such a re-run of the 'Greenspan put' might push us towards another low-interest-rate bubble for the world
  - And zero rates might still not be enough
- The choice will be *ameliorated* – in the short run - if one government (the US) continues to borrow enough too much
  - But such an 'Obama put' would store up adjustment problems for the US in the future
  - And Krugman sees it as unlikely
- In this last case the growth trajectory would indeed be sustained, once again, by an outcome in which there are global imbalances.
  - But such a trajectory risks – after, say, another five years - a significant further fall of the dollar
  - This dollar fall might have a significant overshoot – because the carry trade is so highly leveraged.

## *This looks like a Prisoner's Dilemma in which there are three possible outcomes:*

(i) A Cooperative solution in which there is

- sufficient increase spending in surplus countries
- sufficient cut spending in deficit countries
- Adjustment of relative prices to bring about expenditure switching

(ii) A Non-cooperative outcome is one in which

- The risks reviewed above exert a strong negative influence
- fiscal retrenchment takes place in deficit countries
- there is an insufficient increase spending in surplus countries
  - in Germany, China, Japan etc, although for different reasons in each case
- as a result there are beggar-thy-neighbour currency depreciations in deficit countries, as each - like the UK - attempts to go for export-led growth

(iii) A Stackelberg 'solution' in which

- there is insufficient increase spending in surplus countries
- there is fiscal retrenchment in deficit countries, except for the US
- the US keeps spending – by fiscal and by monetary means – the US acts, yet again, as 'spender of last resort'
- the US, acting in this way, plays the role of a Stackelberg follower, attempting to recreate the 'great moderation', all over again

Neither the second ooutcome nor the third outcome is good

- The *WEO* of the IMF warned in June against outcome (ii). But it does not reveal whether, this is avoided because the outcome is more like (i) – the cooperative outcome - or like (iii) – the Stackelberg outcome.

- Notice that the Stackelberg outcome would put enormous pressure on international cooperation about financial reform
    - Running such persistent imbalances, in the face of continued low interest rates, would require strong enough financial regulation to prevent a new global financial bubble from developing.
    - This would require a considerable degree of international not only about macroeconomic policies, but also about financial cooperation.
        - It is far from certain that the reforms will be robust enough

# 7 The Role of the G20 and the IMF

- The G20 and IMF, of course, do not have the instruments to ensure the cooperative outcome.
  - The previous system of IMF ‘multilateral surveillance’ did not work at all.
- This has been replaced by a new process, the ‘G20 Map’, at present under construction.
- In this process it has become the task of the G20 – working with the IMF - to ensure that countries propose policies.
- Officials at the IMF then integrate these policies into alternative global scenarios in which, either
  - Adjustment happens – in that China adjusts, the US adjusts, and Europe undertakes the necessary ‘structural’ reforms – as in outcome (i) above
  - Adjustment does not happen and – amongst other things - a spread emerges on sovereign debt, with the outcome that there is a double-dip recession.

- Country officials have given the task, by the G20, of committing to policies which will bring about the adjustment outcome, rather than the non-adjustment outcome
- This process will – it is hoped – lock officials in international organisations, and the officials of various countries, into a process to which they are committed to adjustment - unlike the IMF's previous ineffectual process of multilateral surveillance.
- What is happening with regard to this process may turn out to be a very important development in international institutional design.
  - The hope is that what is happening will produce a community officials – both in the separate nations and in the IMF - who share the objective of resolving global macroeconomic problems
  - The aim is to create a longer-term time-frame, in which the longer-term consequences of not cooperating became more apparent.
  - If it works, this process will institutionalise, globally, a shared responsibility for managing the global macroeconomy

# 8 Conclusion

- In 1944, when Bretton Woods was established, Keynes saw
  - The need for global support of good policies in individual countries,
  - The need for global coordination of polices – to guard against the risk of what he described as the ‘scarce currency’ problem.
    - Keynes saw this risk as the reason why a system was required which constrained national policies
    - Tomaso Padoa Schioppa stated, in his lecture, a continuing need for such a system
- This was a rules-based system, in which there was global surveillance of national policies.
- Now – in the face of a similar global problem - we need something similar.

- There will of course be different details, but, as in the Bretton Woods system:
  - there will need to be a *multilateral regime,* in which
    - there is a set of rules shared by countries, which countries agree to follow
    - there is also allowance for countries to act with discretion and not follow the rules, where necessary
  - There is also *a formal process of surveillance*, carried out within the IMF - a multilateral institution - which will
    - ensures that the rules are followed, and/or
    - ensure that, when they are not followed, this is for cogent, and agreed, reasons.

Montek Ahluwalia suggested a way to strengthen this process.