Global Rebalancing, Sustaining Global Growth, and the G20MAP: Are we on the Right Track?

Presentation given by

David Vines

Department of Economics and Balliol College, University of Oxford;
Centre for Applied Macroeconomic Analysis, Australian National University;
Research Director, PEGGED Research Programme on Politics and Economics of Global Economic Governance, European Union; and CEPR

ICRIER G-20 Conference
New Delhi
September 13 and 14, 2011

1 The Global Policy Problem : Three Problems, Not Two

- It is clear that the world needs *global rebalancing*
    - the scale of international debt of the US must stop growing
    - And some of the US borrowing may need to be repaid
        - cf the case of the UK
    - Risks if adjustment is over-delayed
        - May get overshooting
- As is well known*, two* things are necessary for this rebalancing:
    - Changes in *relative* absorption betn. deficit and surplus countries
    - Changes in *relative* prices betn. deficit and surplus countries
- But also, *third*, the world needs a satisfactory *absolute level* of global growth
- There are significant risks to this
    - continued deleveraging in OECD countries
    - the macroeconomic outcome of the crisis in Europe
    - the gradualness of the adjustment in East Asia
    - the rapid fiscal consolidation in many countries.

- In response to these risks, too many countries are looking for export-led growth
- But we cannot nearly all have export-led growth – there are not enough Martians to buy the exports which would result if the majority of countries aimed for export-led growth
  - There only a small number of Martians: Middle East, Australia…
- This is a *systemic* problem
  - Of course we need to think of our country-by-country needs -
    - cf remarks by many Chinese and German speakers
  - But we also need to think of the world as a system
- The G20 Mutual Assessment Process, G20MAP, is the only available machinery to might help the world manage these risks

- Managing these risks is important
- Unemployment in the US, Europe, and elsewhere in the OECD remains disastrously high
- To solve this unemployment problem requires a sustained recovery.
  - The risks have been identified above
  - 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, and/or the attempts to fiscally consolidate, add to the other risks, and put growth prospects further at risk?

    as happened in 1938

2 When Macroeconomic Cooperation Seemed not to be Necessary

- *A Reminder* In the period after the Asia crisis there was high saving in emerging market economies (and elsewhere)
  - East Asia (Stackelberg leader) set exchange rates to ensure export-led growth
  - The US federal reserve set US interest rates, acting as a 'Stackleberg follower', to ensure satisfactory growth in the US
    - Because of high savings the real interest rate needed to be low (and the stimulus policy was assisted by George Bush's war in Iraq)
- This was a two-target/two instrument system for monetary policy
  - Two instruments: real exchange rates (set in East Asia) and real interest rates (set in New York)
  - Two targets: satisfactory output growth in two regions
- This system ensured satisfactory global growth and did *not* require cooperation
    - the 'Greenspan put' is part of this system–
- This system gave rise to global imbalances – as consequence not cause
  - This targets-and-instruments story can be made to encompass *all* of the imbalances stories that are currently told about China

An interlude

- *<u>Cooperation at time of crisis</u>*
- Was remarkable
- But it was easy to bring about:
  - all had an interest in using monetary expansion, and then fiscal expansion, to avoid collapse.
- And costs – in form of debt –– only became gradually binding
- We now have little fiscal space – see below – and are probably back to the use of monetary policy

Only bn

3 Why Macroeconomic Cooperation is now Necessary .

- *3.1 The New Targets and Instruments Setup* We now have *three* targets:

  i.e. a satisfactory output levels/growth in *three* regions: the US, East Asia and Europe
- We have only one-and-a-half monetary instruments available –
  - the dollar-renminbi real exchange rate, still set in China – and East Asia more generally - to give export-led growth
  - But we are at the zero bound - so the real interest-rate-instrument has gone – although QE is half an instrument – see below
- This is a game which requires cooperation for a good solution to be reached
- The *Stackelberg leader*, China, is adjusting domestic demand at a slow speed, at a speed which suits China – requires depreciated Chinese exchange rate
- There are *two Stackelberg followers* playing an exchange-rate war
  - The US doing QE in order to depreciate the dollar
  - Europe – a policy jungle

    but we can summarise outcomes in Euroland as (i) constrained domestic demand – both public and private – and (ii) monetary easing by ECB (including QE) as response, to depreciate the Euro & stimulate demand

The role of China in the world…

- QE warfare – and exchange rate warfare - between the Stackleberg followers – (the US and Europe) gives rise to real interest rates which are
  - Too low for China
  - Too low for much of the rest of the emerging market world
  - Too low for commodity markets

3.2 China's role in this world

- China is locked into bubble world
  - China is attempting to control this by capital controls – but this attempt will fail
- It is inappropriate for China to describe QE as being 'irresponsible'.
  - This is the line taken by many Chinese scholars
  - But QE is what any Stackelberg follower would do in this Stackleberg game - and this is what the US and Europe are doing
  - The Stackelberg leader (China) should recognise this.
- Instead, the behaviour of China should be described as 'irresponsible'
  - In this global system, the bad outcomes should be seen as a consequence of a deliberate choice by the Chinese authorities

The role of Germany in the world…

3.3 Germany's role in Europe: the past

- Germany is re-creating the world problem at the European level
- It is inappropriate for Germany to describe European periphery as 'irresponsible'
  - Greece – irresponsible fiscal policy, and loss of competitiveness
  - However:
    - Ireland – house bubble faciltitated by European banks and poor European financial regulation and a fiscal policy, permitted by the SGP, which was too loose
    - Spain – housing boom and fiscal policy, permitted by SGP which was too loose
    - Portugal – uncompetitive and not properly disciplined by SGP
    - Italy: Too high level of debt which was allowed to build up by SGP
  - The Stackelberg leader (Germany) should have recognised this.
- Answer – the SGP was irresponsible because
  - rule-based rather than intelligent, too loose for boom countreies doing asymmetrically well, violated by France and Germany, and so ultimately incredible
- Was accompanied by a financial system in which debt of all European countries bore same interest rate
  - Markets – and policy-makers did not understand the risks of the above

The role of Germany in the world…

3.4 Germany's role in Europe: the future

- Germany imposing adjustment on the periphery –
  - too much is being demanded which may cause the Euro to explode
  - debt too high, competitiveness slow to adjust to bring growth, financing needed during adjustment period; this financing may be denied by Germany
- Even if this does not happen:
  - for the past 12 years Germany has cut costs and kept wages under control and positioned itself to export high-tech goods to the world
    - German competiveness has stolen demand from the periphery within Europe
  - Within Germany:
    - consumers save for future
    - fiscal policy is cautious to 'avoid above-average' level of inflation
- Result: shortage of aggregate demand in Europe
  - German exports steal demand from other regions and
  - no compensating increase in demand in Germany
- To keep aggregate demand up in Europe, Euro must be depreciated
- Germany has turned Europe into ' a second China'

3.5 The Policy Implications

- It should be the role of scholars and others to attempt to explain this to Chinese and German policymakers
- Understanding *global* macroeconomics is useful for understanding policy choices faced by an individual countries – including China and Germany
  - Olivier Blanchard's remarks in Paris in January – in whose interest should China act?
  - Many have argued that China is making a choice between acting in its own interest and acting in the global interest , that it is choosing to act in its own interest, at the expense of the global interest – which is 'understandable' - and that we should all encourage China to 'make sacrifices' and act in the global interest
  - The above analysis suggests that this is not correct: the current strategy appears not top be China's own interest, as well as not being in the global interest
  - Same point can be made about Germany
- I do not think that time is on China's side – or Germany's - side
  - Time is not on the side of any of us
  - This global problem needs to be fixed quickly
  - The G20MAP is important

4 A Game-Theoretic Restatement

- The world is faced with a choice
- Underlying sources of global demand are low –
  - because of deleveraging and policy behaviour of Germany and China:
- As a result, it seems unlikely that there is enough private sector growth to compensate for fiscal tightening
- We risk an outcome which does not rebalance the world but instead leads to stagnation.

- The choice will be *ameliorated* if one global authority – the US Federal Reserve – keeps interest rates low – and promises to keep them low - and does QE, to sustain US spending, and keep stimulating global spending.
  - But such a re-run of the 'Greenspan put' is pushing us towards another low-interest-rate bubble for the world
  - And at the zero bound this may still not be enough to sustain global growth
  - What has been done fiscally – the 'Obama put' – has not been enough
- In this case the growth trajectory will be inadequate and will be one with continued global imbalances.
  - 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.

- The choice could be *further ameliorated* if the US government spent more – the Krugman strategy – and Kemal Dervis advocated a carefully constructed version of this
  - This - would require living with – and ultimately resolving - even worse global imbalances
  - To be successful there will need to be stronger commitment to long run fiscal commitment in the US
  - Otherwise markets will continue to take fright at fiscal stimulus

This is 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* - an attempt to rerun the Greenspan put:

- The risks reviewed above exert a strong negative influence
- fiscal retrenchment takes place in deficit countries including in US and Europe
- 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 low interest rates, QE and beggar-thy-neighbour depreciations in deficit countries, as each region goes for export-led growth

(iii) A *Stackelberg* 'solution' – the Krugman strategy - 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 – i.e. the US acts, yet again, as 'spender of last resort' and increases imbalances even more
- the US, acting in this way, uses fiscal policy to play the role of Stackelberg follower, attempting to recreate the 'great moderation' again, by fiscal policy

The third outcome is unlikely. The second outcome looks likely, and bad.

- *WEOs* of the IMF have warned about outcome (ii) – the likely outcome with persistent imbalances, continued low interest rates, and QE.
- Outcome (iii) - the Stackelberg follower outcome – would put pressure on global financial markets
  - the US fiscal balance sheet would bear the burden of the global recovery
  - Markets would need to accept this
  - It would also put pressure on international financial markets since the fall of the dollar –when it came – would need to be even larger and might overshoot
- Outcome (ii), the likely outcome, will make it difficult for financial regulation to prevent a new global financial bubble from developing.
  - This will require a considerable degree of international cooperation about financial cooperation.
  - It is far from certain that the financial reforms will be robust enough

5 The Role of the G20 and the IMF

- In 1944, when Bretton Woods system 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
    - Many now see a need for re-establishment of 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 - need something similar.
- This is what the agenda for reform of the International Monetary System (IMS) should
  - Fundamentally the IMS is about macro-management of the world economy
- The G20 Mutual Assessment Process, G20MAP, is the machinery which might to might manage this reform

How might the G20MAP push us towards the cooperative outcome?

- The G20MAP has superseded the IMF's multilateral surveillance process (MSP)
  - China and the US created a bilateral standoff in that process
- We can separate the G20MAP into two aspects –
  - analysis and decision making
- *Analysis.* The IMF does this in collaboration with Framework Working Group
  - Agreement on facts and policy presumptions (country ownership)
  - Analysis done by IMF (arguably best practice): discussion of analytical assumptions
  - The IMF is producing detailed studies of: US, China, Japan, Germany, India, France and UK, plus an overall study.
  - Results will be published.
- *Decision-making.* Results of the analysis will be published. They will then go on to
  - finance ministers, then to
  - sherpas, then to
  - leaders at Cannes

- Why might this process be stronger then the MSP
  - Personal involvement of officials involved and commitment to success
  - It is multilateral
  - G20 leaders are overseeing the process
- Monek Ahluwalia has suggested a global body of outsiders to oversee this two-stage process and prevent the IMF's analysis being diluted 'along the way'
  - The cooperation between Framework Working Group and IMF appears to have created ownership, and to have made the process less likely to be either disowned or captured.
  - The publication of the analysis will make it obvious whether leaders are facing up to the questions put forward by the IMF's analysis
  - Nevertheless comment by outsiders might help ensure that policymakers face choices put to them seems useful – for reasons which he explained.
- India does not seem to have a particular interest in the distribution of gains in this global bargain. But India has an interest in success, and this seems to be why India has put time, resources, and human effort into this process. India may come to be in a position where it can exert influence and help to lead to success