Macroeconomic Policy Coordination Through the G 20 Mutual Assessment Process

By W R White

Over the last year or so, the G 20 has been living under a dangerous misapprehension. As recently as April, the Communiqué issued jointly by their Finance Ministers and Governors stated that "the global recovery is broadening and becoming more self sustained". Implicitly, the global crisis which began in 2007 was declared to be over. However, a closer examination of the economic and financial data reveals the continuing influence of the headwinds of debt built up before the crisis began.

Indeed, essentially all the "imbalances", both internal and external, which precipitated the crisis are still there. Not least, the process of deleveraging in heavily indebted countries has hardly begun, and the solvency of those institutions that lent the money in the first place is increasingly questioned. In some respects, the situation is reminiscent of the late 1920's and in some respects even worse. The joint buildup of large private sector and public sector debts in some advanced market economies is surely unprecedented in peace time, as is the low level of interest rates. In effect, for many countries, the limits of macroeconomic policies to stimulate demand have now been reached.

What does this mean for the G 20 process? First, the sense of urgency which characterized the meetings of the G20 in 2008 and 2009 must be reestablished. This is all the more important since slow growth or

recession threatens to unleash the social and political tensions built up over recent decades in which income inequality increased enormously. We see manifestations of this in the Arab Spring, increasing recourse to street demonstrations in Europe, China and elsewhere, and high turnover rates in governments almost everywhere. An increasing recourse to protectionism could well follow. Second, the G 20 process must focus much more on crisis management than crisis prevention. We have clear and pressing problems that threaten to affect all the G20 participants, creditors as well as debtors. These problems need to be, and can be, urgently addressed in a cooperative way.

This is not to deny that the accomplishments of the G 20 Mutual Assessment Process to date have been significant. This is especially remarkable given the extent to which important countries still seem to be pursuing different objectives and also have different views about how market economies operate. The focus of the MAP process on "imbalances" is a particularly big step forward, since most analytical models in wide use totally ignore such concepts. And the fact that these imbalances include, not only external imbalances but also the underlying domestic imbalances that drive them, is a further sign of progress. Finally, the emphasis put by the G20 on maintaining stability within the financial sector is surely welcome given the important role played by financial dysfunction in recent years.

Yet the fact that the "indicative indicators" used to identify external imbalances do not include measures of competitiveness, as is the case internally in Europe, is surely regrettable. And it must also be admitted that, absent both hard numbers (targets) to motivate a policy response and any enforcement mechanism, the process threatens forbearance in

the face of identified problems rather than urgency. Finally, the welcome emphasis on the pursuit of financial stability by the G 20 must not be allowed to divert attention from “imbalances” building up in the non financial sector. Severe economic downturns can occur even given an initially robust financial sector. Note, for example, that the Great Depression began in the United States in the summer of 1929, but the collapse of the banking system began only in the autumn of 1931.

In the period leading up to the Cannes summit, what should the G 20 do? The first task will be the most difficult. It will be to forge agreement on the need for enhanced attention to crisis management, and on the need for cooperative solutions to the continuing problems posed by the overhang of debt. It must be fully accepted that creditors and debtors both made errors in allowing debt levels to grow so high, and both bear responsibility for trying to resolve this problem. Put more dramatically, creditors must see the threat of a further descent into crisis as a material threat to their own well being. It is important to recall that it was the intransigence of creditors, and those seeking impossibly large War Reparations during the 1920’s, that contributed materially to the problems of the 1930’s and everything that followed.

Assuming agreement can be reached on the character of the problem, what cooperative solutions suggest themselves? Existing imbalances constrain the use of stimulative macroeconomic policies in many advanced market economies facing slow growth. At the same time many emerging market countries are facing resurgent inflationary pressures. Nevertheless, considerable room for maneuver still remains given the possibility of both nominal exchange rate movements and supporting structural reforms.

It seems broadly agreed that consumption spending in many emerging market economies is too low, and fixed investment too high, while the very opposite is the case in many advanced economies. China and the United States are cases in point. To achieve these objectives, further exchange rate appreciation in rapidly growing creditor countries would seem to benefit everyone. Not only would substitution effects help achieve the desired real rebalancing, but the direct effects on prices would also be welcome. Inflation would be reduced in countries where this is a problem, but deflationary fears in debtor countries would also be reduced.

As for supportive macroeconomic policies, more government spending on infrastructure in advanced market economies would provide an earning asset as well as a liability. Credible promises to reduce future deficits, even if current ones were allowed to rise, would provide further solace to financial markets worried about high levels of sovereign debt. In emerging market countries, a more restrictive monetary policy might dampen inflation while leaving more room for improved government safety nets and spending on health and education. Such developments would help bring down high household saving rates and encourage domestic consumption.

Structural reforms would also help. In many highly indebted countries, the purpose of these reforms would be to spur growth and help make the burden of debt more bearable. In creditor countries, faster growth due to structural reform would also be welcome in itself. But, in addition, reforms could help ease the problem of external imbalances. In important creditor countries like Germany, Japan, China, Korea and others, the domestic services sector remains very highly regulated.

Deregulation, with all of the associated opportunities for increased profits, would decrease the production of tradeables, and increase import penetration as well.

Finally, two other sets of policies suggest themselves.

First, if debt overhang is a fundamental problem, then orderly means of debt reduction need to be given much more serious attention. This applies to many households, to a number of sovereigns, and to the resolution of systemically important financial institutions. Prospective future declines in the value of the US dollar, which effectively reduces debts denominated in dollars, also needs to be carefully managed to avoid disorder.

Second, the one sector that stands out as not being constrained by debt, but still reluctant to invest, is the private corporate sector in the advanced market economies. For investment to accelerate, given uncertainty about the robustness of domestic consumption, protectionism must be credibly ruled out. More broadly, businesses will be encouraged to make risky investments only given a more certain domestic policy environment and by policies that are generally supportive of business. Recent political developments in the United States and Europe have not been helpful in this regard. Credible policy statements, forged in the G 20 Mutual Assessment Process, could go a long way towards establishing such a supportive environment.