Global Fiscal Consolidation, the G20’s Mutual Assessment Process, and Reform of the International Monetary System

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1 Introduction

- The GFC led to unprecedented global cooperation in the setting of macroeconomic policies.
- There is a need for this cooperation to be continued, to assist both
  - adjustment of global imbalances, and
  - sustaining the global recovery.
- The present paper examines risks to this process
  - it suggests that a too rapid fiscal consolidation might add to these risks.
- And it suggests that the G20MAP might help the world to manage these risks.
The Global Policy Problem: Three Problems, Not Two

It is clear that we need *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* on 5 September in a piece called ‘1938 in 2010’

- These worries have been echoed by Roubini

Nevertheless projections of the recovery – e.g., 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

- Fiscal consolidation compounds these risks
- So there are risks of a ‘global 1938 problem’
3 The Global ‘Adding Up’ Problem

The USA
- Risks have been presented by Altshuler and Bosworth

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?
Overall, 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 de-leverage by means of large mark-up on loans
  - Balance sheet risks to German and French banks
  - Additional effects on growth of Basel III

There is, possibly, too much of a need to rely on export-led growth
Within emerging markets

- Optimism about Chinese rebalancing eg Laurence Lau
- Caution about Chinese rebalancing expressed by
  - Yu Yongding
  - Yiping Huang and Bijan Wang
- Simulations by Blanchard and Milesi-Ferretti:
  - suggest that Chinese net exports will subtract nearly 1% of world GDP from the level of demand facing other countries

There is, possibly, an inability to move quickly away from an export-led growth model

Overall

- There is thus a significant risk of a global ‘adding up problem’
  - with too many people seeking export-led growth
4 What next? Global Fiscal Consolidation

*There should be a fine balancing act about timing*

- **Short run**
  - The issue is: who has the ‘balance sheet of last resort’
  - What is the alternative to fiscal support if the private sector recovery is weak

- **Long run**
  - A danger that recovery by continuing fiscal laxity –
    - by a fiscal crisis
    - by sustained fiscal difficulties
Sizes of the Planned Cuts

- In Europe the planned fiscal reductions are large
  - In the UK the plan is for a reduction in demand of 1.6 percent a year, over five years, i.e., a total of 8 percent of GDP
  - In Germany the numbers are small, maybe only 1.4 percent a year but starting from a much lower base (and with a restrained private sector)
  - In France and Italy the planned consolidations total 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 last point has significance later in the paper
What is the size of the multiplier?

- Even if the 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.

- 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 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 – all over again

- To repeat: why such urgency?
  - Is it fear of markets?
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 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 e.g. Enrique Alberola (2010) when he notes that fiscal consolidation is needed for global rebalancing.
  - But it might cause global deflation instead
  - To repeat - there is a crucial issue of timing
5.1 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 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 spending cut in deficit countries
   - Adjustment of relative prices to bring about expenditure switching

(ii) A Non-cooperative outcome 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 outcome 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 cooperation not only about macroeconomic policies, but also about financial policies.
  - It is far from certain that the reforms will be robust enough
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 there is inadequate global growth
- Adjustment does not happen but growth remains adequate
Country officials have been 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 of 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 timeframe, 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.

- There could be a valuable move towards greater transparency.
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 (2010) asserts 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
  - ensure that the rules are followed, and/or
  - ensure that when they are not followed, it is for cogent, and agreed, reasons.

The G20MAP might insitutionalise a process in which this can happen.