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

2 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
    - See paper by Corden in *Oxford Review of Economic Policy*, First Issue, 2010

- 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, 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 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

6 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 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.

7 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 (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.