

THE G-20 AND MACROECONOMIC POLICY COORDINATION AT THE CROSSROADS

A MACROECONOMIC AGENDA FOR THE G-20

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Framing the Issue

The G-20 leaders meet in Seoul at the end of the first decade of the 21st century and at a highly uncertain and unusual time for global policymakers. The depression that threatened the world economy in 2008 has been averted and the G-20 played a significant role in the global policy response, as symbolized most notably by the 2009 London Summit. It is important to stress at the outset that the utility of the G-20 leaders meetings should not be evaluated only by what happens at the meeting itself, but by looking at the whole process that leads up to the summits. In the weeks leading up to the London Summit, the immediate challenge was to ensure that a broadly coordinated global fiscal expansion took place—one that was sufficient enough to compensate for the collapse in private demand triggered by the worldwide panic and coordinated enough so that leakages abroad would not frustrate national efforts. At the time, it also appeared urgent to give the IMF enough financial fire power to prevent the crisis that had erupted in the advanced countries from spreading to the emerging

markets. The London and then Pittsburgh meetings also helped launch the longer-term work toward Basel III and reforms in the financial sector.

The Seoul meeting faces a substantially different world economy and an altered set of challenges than those of London and Pittsburgh. While there are many important issues to discuss at Seoul, such as development, financial sector supervision and Basel III, I will specifically focus on the key interrelated macroeconomic policy challenges, which are critical and urgent for the upcoming meeting.

Policy Considerations

Much is at stake in Seoul for macroeconomic policy. The G-20 will survive and meet again in Paris in 2011, but whether it can really become a steering group for the world economy and strengthen international economic cooperation depends to a significant degree on the Seoul meeting and its aftermath.

The first macroeconomic challenge remains that of fiscal policy coordination, but in a context different from that of 2009 and amidst renewed concerns that large current account imbalances are a key dimension of the overall macroeconomic policy coordination challenge. U.S. Treasury Secretary Timothy Geithner's proposal made at the October 23-24 finance ministers meeting for "current account target zones" reflects the concern for the spillover effects of national macroeconomic policies and for the need to see surplus countries contribute more to overall effective demand.

The increasing share of trade in total demand throughout the world means that the effectiveness of any one country's fiscal policy often significantly depends on the fiscal policies of other countries. But while the world economy at the time of the London meeting necessitated a broad global fiscal expansion, the challenge for Seoul is how to orchestrate a gradual transition toward fiscal policies that are more differentiated by country and address the concern about rapidly climbing gross and net debt to GDP ratios in many advanced economies. However, this transition toward more "normal" fiscal policies has to take place at a time when the recovery in the advanced countries remains very fragile, with unemployment stubbornly high in many countries, particularly the United States. Debt worries have to be addressed while job creation must be the primary concern in many countries. An across the board panicked fiscal retreat, where the retrenchment taking place in one country would be amplified by the retrenchment in others, would likely lead the industrialized world into a second recession. It is undeniable that some countries have lost fiscal space. For them, the costs of immediate fiscal consol-

idation are smaller than the costs they would incur if there were a complete loss of confidence and a chaotic inability to service public debt. Greece and some other peripheral European countries have been such examples. At the same time, strong effective demand in countries like Germany and China is essential to help countries like Greece succeed in their efforts.

The fiscal policy coordination questions for Seoul are: who can afford to and should maintain an expansionary fiscal stance and for how long? Who should consolidate rapidly and by how much? What does this imply for the overall structure of world demand?

The recent U.S. proposal for current account target zones recognizes that it is overall economic policies rather than just exchange rate policies that determine national saving, investment and current accounts, and that national policies have international implications. It is exactly in order to answer this type of question that the mutual assessment process aiming to achieve strong, sustainable and balanced growth was launched by the G-20 meetings. The Seoul meeting will test this commitment and the process through which it is supposed to be implemented. Failure to reach and project broad agreement on the next stage of macroeconomic policy coordination would severely undermine the G-20 as the "premier forum" for global economic cooperation. While the major advanced countries may have most to suffer from failure, it is unlikely that the emerging markets would be able to maintain the very high growth rates experienced in 2010 if the advanced countries approached zero GDP growth. At market prices, and that is the relevant metric in this context, the advanced countries still account for about two-thirds of world

GDP. While there is a clear difference in the pace of potential and actual growth between the emerging markets and advanced economies, there is no total decoupling. Growth rates go up and down in substantial synchronization. There is a decoupling of trend growth rates but no clear cyclical decoupling (Canuto and Guigale, World Bank 2010). Emerging market economies, therefore, have a clear stake in the recovery of the advanced economies. At the same time, growth in the emerging markets has become a much more significant driver of global growth and of growth in the advanced economies.

A second challenge facing the G-20 process is to clarify and ameliorate the *nature* and *quality* of fiscal policies and more broadly macroeconomic policies in the context of a cooperative approach to policy design and implementation. It is important to look at fiscal, monetary and structural policies together, rather than in isolation, and to improve the balance between and quality of these policies. For example, too strong a belief in the ability of fiscal policy to *fine tune* the evolution of demand is dangerous. It is unlikely that short-term expansionary measures such as tax cuts “today,” accompanied by announcements of “future” tax increases, can lead to the desired expansion in private demand. Expectations about the future will certainly have some impact on today’s behavior. It is not that easy then for fiscal policy to be expansionary in the immediate future while concurrently launching a process of medium-term consolidation. In that context, differentiation between types of fiscal policies is crucial. If a public sector—such as that of the United States which can access funds at very low long-term interest rates—borrows to invest in infrastructure and other assets with a good long-term rate

of return, it should be able to support the recovery by increasing public investment without harming its balance sheet. On the other hand, if long-term untargeted tax cuts are enacted while economic actors are holding back their investment and consumption because of a combination of ongoing deleveraging and anxiety about the future state of public finances, that kind of fiscal expansion is not going to support immediate recovery. It will harm the public sector’s balance sheet and increase concern about the future. Therefore, the G-20 has to come up with packages of growth friendly medium-term fiscal policies and fiscal rules and structural reforms that are differentiated by country to reflect very different national circumstances but mutually complementary and reinforcing in a way that anchors expectations, reduces uncertainty and projects the strong global cooperative spirit achieved at the London and Pittsburgh meetings.

A third challenge relates to monetary and exchange rate policies. Capital mobility and the actual and potential size of capital flows make the spillover effects of the national monetary policies of systemically important countries even greater than the spillover effects of fiscal policies. Flexible exchange rates, while helpful, are not a panacea that can protect domestic monetary policy independence as much as is argued in some of the basic theoretical literature. Sharp up and down movements in exchange rates have real economic costs. Sterilization of large capital inflows is feasible only up to a point. Rapid, steep appreciations can have serious effects on employment in the tradable sector—a key fear behind the unwillingness of China to let its currency float. An entirely unilateral approach to monetary policy and its implications for capital flows and exchange rates by major countries

would be a huge problem for global economic cooperation.

In the context of Seoul, the wave of capital inflows into emerging market economies has been perceived as linked to very unilateral U.S. monetary policy pronouncements on quantitative easing, so that the pre-summit dynamics have actually weakened cooperation between the U.S. and other non-Chinese emerging members of the G-20 even though they also want the yuan to appreciate. While there is real concern in the emerging market countries about their competitiveness being undermined by Chinese exchange rate policies, there is also concern about U.S. monetary policy and the perceived unilateralism of its decision making. Some still remember the early 1980s, when Paul Volcker sent U.S. and global interest rates soaring, contributing to the emerging market debt crisis of that decade. The worry today is about zero interest rates in the U.S. sending huge amounts of volatile capital flows into emerging markets rather than the other way around. If the major participants in the G-20 process give the impression that they will conduct their macroeconomic policies entirely independently of the process of international cooperation, the G-20 cannot become the "premier forum" set forth in Pittsburgh. It is important to underline that perception is also important. It would help a great deal if U.S. policy pronouncements could be more closely linked to the calendar of the G-20 and would show real concern for the spillover effects of U.S. policies. The best way to induce China to cooperate is to stress the benefits of cooperation and to build large coalitions of members willing to cooperate. At the end of the day, international cooperation can only work if there is such concern over spillover effects

and if there are some further steps toward shared sovereignty. Unfortunately, the G-20 is still far from such an approach.

A fourth challenge is to complement concerns about and focus on current account imbalances and spillovers with careful consideration of internal growth dynamics and imbalances. Variations in net foreign demand for a country's output have no doubt become an increasingly important element in changes in total demand. They are far, however, from being the only or even the main driver of growth, particularly for the very large U.S. economy. There is a strong element of wanting to blame "someone else" in the currency wars and global imbalances debate. The economic press often makes it seem like macroeconomic outcomes are entirely determined abroad. It is true that changes "at the margin" are important in economic dynamics and one must look at both levels and rates of change. A 5 percentage point decline in the Chinese current account surplus would amount to a little more than half a percentage point addition to net demand in the rest of the world. That is certainly very significant, but cannot be the driver of world growth or U.S. growth. There is need for a little "rebalancing in the rebalancing debate." Policymakers and politicians oscillate between not paying any attention to international matters and arguing that everything is determined abroad. Surely, reality lies somewhere in between. In that spirit and in the context of the need for "domestic rebalancing," particularly in the U.S. and China, it is important not to let the valid concern for current account imbalances obscure the need for far reaching internal structural reforms. Part of that rebalancing may have to address the stunning income concentration at the top that has taken place

in both countries and the implications it may have for the management of effective demand, employment and financial intermediation. Recent research at the ILO but also at the IMF—not a hotbed of radical liberalism—suggests that the way productivity gains are shared may have implications for the effectiveness of traditional macroeconomic policies (see Kumhof and Ranciere’s “Unemployment Crisis,” Rajan’s *Fault Lines* and Reich’s *Aftershock*).

Actions Items for the G-20

The G-20 should and hopefully can be the premier international forum for economic and financial cooperation. It should even become a kind of steering group for the global economy. It can make proposals, launch cooperative processes and use the summit attendance of leaders to increase the attention given to the issues at stake. It must do so in the spirit of enabling, rather than replacing, the more formal and universal institutions of global cooperation in the macroeconomic policy context, particularly the IMF. Increased emphasis on the IMF’s role in the mutual policy assessment process proposed by Secretary Geithner should be welcomed. While the G-20 nations represent an overwhelming share of global GDP and population, sovereign nation states still make up the fabric of the international community and no self-appointed grouping can claim universal legitimacy. Moreover, smaller countries are not only experiencing the spillover effects of what happens in G-20 countries, but can themselves generate spillover effects despite their small size, as exemplified by the Greek crisis. Finally, while in need of further development, the IMF has an implementation capacity that an informal grouping such as the G-20 cannot and

should not have. It is essential therefore that the proposals brought forward through the G-20 process are submitted to the universal and more legitimate governing organs of the IMF and other international institutions—imperfect as they may still be—for formal decision and follow-up. In that perspective, it would be much better if the G-20 met in early September, *before* rather than *after* the formal annual meetings of the Boards of Governors of the IMF and the World Bank, as happened in the case of the Pittsburgh meeting. Otherwise, the G-20 process might inadvertently weaken the more inclusive cooperative decision making within the Bretton Woods institutions. Pressing ahead with governance and quota reform at the IMF remains crucial, of course, and the tentative agreement reached by finance ministers in Gyeongju is a significant step in the right direction.

There is much concern expressed in the days leading to the Seoul meeting that the G-20 is not able to do its job. Part of this disappointment has to do with the exaggerated claims that have been made for the G-20 by its most ardent supporters in academia as well as some of the G-20 leaders themselves. Part of it is due to viewing the G-20 simply as a summit meeting rather than as a whole process of cooperation between countries and their civil servants and civil societies leading up to the summit. Part of it is due to an underestimation of the difficulties involved in moving from the smaller G-7 setting to the absolutely necessary larger and more complex G-20. No doubt the question of the effectiveness of the G-20 remains open. But in looking at what has been achieved in two years, there is reason for optimism. Never before have these systemically important countries analyzed and debated data and issues so intensively together.

Never before have the large new economic actors of the 21st century shared the head table with the older mature economies. Never before has an emerging country such as Korea prepared such a meeting as the host with this admirable degree of professionalism and dedication. The big problems of international economic policy coordination will not be solved overnight. Patience and persistence are of the essence. I remain hopeful that the Seoul meeting will symbolize one more significant step in the direction of managing our global interdependence and security.

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