WHAT DO THE EUROPEANS BRING TO THE G-20 IN SEOUL?

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Framing the Issue

As leaders prepare for the G-20 Summit in Seoul, the European economies are performing better than expected with an average annual growth that the IMF estimates at 1.7 percent this year. Germany is leading the pack with a projected growth rate of 3.3 percent, undoubtedly one of the best performances since reunification. Fueled by increasing exports, the German current account balance will stand at more than 6 percent by year-end. This is yet another unprecedented and unexpected performance, explained in part by a weak euro exchange rate reflecting uncertainties and financial turmoil in the peripheral economies of the euro area. Aware that these positive developments were materializing, German Chancellor Angela Merkel had little to ask of her fellow leaders at the June G-20 Summit in Toronto as well as little to offer them.

Despite repeated calls from Washington to pursue a more cooperative macroeconomic stance by increasing German aggregate demand in the face of an anemic U.S. economic recovery, Chancellor Merkel reiterated in Toronto the commitments she had already announced back home before the June Summit. The consequence of that has been, in practice, to sink the G-20 framework for "strong, sustainable and balanced growth" before it could even get afloat. A cooperative U.S. administration had to retrench, facing a unilateralist and inward-looking Europe focused on the potentially devastating implications of the Greek crisis.

Policy Considerations

But the scenario that Chancellor Merkel and the German economy may soon be facing is less appealing than that of a few months ago. For a start, the higher-than-expected growth is projected to level off next year at 2 percent. The euro has strengthened and may rise further, reflecting a weakening dollar as a result of the strategy of further quantitative easing pursued by the U.S. Federal Reserve. The euro has also appreciated vis-à-vis the yuan, as the latter is in practice pegged to the dollar. This will have repercussions on all the euro area economies, not just the Germany economy.

Chancellor Merkel and her fellow European leaders have been under intense pressure from the United States to streamline their representation on the IMF Executive Board, following the unexpected U.S. veto on the current size of the IMF Board in August, soon after the previous G-20 Summit in Toronto. The Europeans have just got the U.S. to go along with their exceedingly shy proposals for giving up a slight chunk of their roughly 8 chairs on the board in favor of greater representation for emerging and developing economies. And if this were not enough, European leaders have just swallowed a 6 percent voting shift from overrepresented to underrepresented countries, which will come primarily at the expense of Western Europe.

President Barack Obama is likely to meet a friendlier Chancellor Merkel this time around. However, the German Chancellor will still have little to offer Obama and the other G-20 leaders on the important policy issue of fiscal cooperation since Merkel cannot backtrack from her previous domestic commitments. Apparently, the German electorate is Ricardian, meaning the only way the Germans can be induced to spend more is if the government itself is willing to reduce its own net spending. This is not merely a question of economic behavior but a formal commitment since the promise to pursue a balanced budget in Germany has just been enshrined into law.

Action Items for the G-20

What then will Chancellor Merkel bring to the table at the G-20 in Seoul? Together with her fellow European leaders, she is going to back the United States in its increasing confrontation with China. This will provide a critical swing in the pressure that other G-20 members can apply on China to pursue greater flexibility in its exchange rate policies by allowing the yuan to appreciate vis-à-vis the major global currencies. This means that other emerging economies—both G-20 members and non-members—will be relieved that they need not openly sideline against China. Simply nodding this time may be enough.

Yet, agreement on moving toward market-determined exchange rates will not solve the global imbalances, though it will certainly generate an important pre-condition. What is key is that G-20 leaders agree in Seoul on a coordinated macroeconomic plan that would reduce savings in surplus countries and increase them in deficit economies. The U.S. has offered its availability to pursue a coordinated phased reduction in its current account imbalances but Germany has dismissed the idea while China has not fully disagreed. Will Chancellor Merkel have second-thoughts on her way to Seoul?