

STIMULATE, REFORM, COORDINATE: A MACROECONOMIC AGENDA FOR THE G-20

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Framing the Issue

The global economy remains in crisis. Advanced economies are in dire straits, brought to their knees by broken financial systems and shattered consumer confidence. The troubles have now enveloped emerging markets and low-income countries, with many of them at the brink of economic disaster.

The situation demands firm and decisive leadership to restore economic growth and financial stability. Various policy challenges must be tackled simultaneously—in particular, recovery of financial systems and macroeconomic recovery are inextricably tied together. Moreover, collective action on a global scale is necessary to deal with a crisis of this scope.

Policy Considerations

There are a number of complex and interconnected points of tension in the world economy today.

Short-term vs. long-term aspects of macroeconomic stimulus

In the short run, forceful macroeconomic stimulus is essential to lift economies out of their slump. Conventional monetary policy has run its course, especially in economies such as the U.K., U.S., and Ja-

pan where short-term policy rates are already close to the nominal interest rate floor. Quantitative easing through central bank purchases of financial assets (including government bonds) remains an option, one that has already been exercised recently by the U.K. and U.S. central banks.

Fiscal stimulus in the form of increases in public expenditure and tax cuts is the other option. Many G-20 countries have made significant commitments to [fiscal stimulus](#). However, the size of these commitments has been quite uneven across countries. Implementation of the measures has also been uneven; revisions in the size and composition of fiscal packages are required to cope with the rapidly deteriorating macroeconomic situation.

Monetary and fiscal stimulus can give a short-term jolt to an economy but there are longer-term risks. Quantitative easing may lead to a surge in inflationary expectations. This seems a benign prospect when the immediate risk is of deflation, but inflationary spirals are difficult to manage once they get out of hand.

The U.S. already has a large level of government debt (debt held by the public is about 45 percent of GDP) and large increases in the deficit would fur-

ther increase the debt burden on future generations, increase the cost of financing the debt and crowd out private investment. Concerns about debt sustainability could also feed rapidly into inflationary expectations and raise interest rates, thereby stunting any incipient recovery. Similar dynamics are at play in many other advanced and emerging economies.

A further problem is that, with dysfunctional financial systems, neither form of macroeconomic stimulus is as potent as in more normal times.

Reviving financial systems

The financial regulatory system and oversight based on existing regulations in the U.S. and other advanced economies have both proven to be failures, allowing the build up of huge systemic risks at the national level and cross-border risks at the global level. Regulatory reform is essential but there is a tension between strengthening financial regulation and reviving the financial system. This tension needs to be resolved creatively in the transition to a more stable financial system. A rush towards “more” regulation may be counter-productive if undertaken in the heat of the crisis without getting core principles right.

Government intervention now seems essential to revive frozen financial systems in economies such as the U.S., but this could create more problems in the future. Incentives become distorted when there is an implicit government backing for all financial institutions; this almost invites reckless behavior by investors and investment managers. Ceding to government the entire role of monitoring of financial in-

stitutions and thereby enervating the forces of market discipline is neither practical nor advisable. But market discipline by itself is clearly not sufficient.

Domestic vs. international policies

This is a time when countries should be pulling together to tackle the common challenges that they face. Instead, countries have turned inward, often focusing on their narrow domestic interests and, in some cases, paying little regard to the detriment their actions cause to the global trade and financial systems.

Given difficult domestic circumstances, it is understandable—but not excusable—that politicians are turning to protectionist policies, both implicit and overt. This could easily degenerate into a round of retaliatory actions, thereby affecting world trade—which has already taken a beating—and further dampening consumer and investor confidence. Currency wars, which could be set off if countries try to intervene excessively in currency markets to maintain their competitive advantage, represent another potentially dangerous manifestation of these tendencies.

International cooperation is also necessary in another dimension. In an integrated world economy, the effectiveness of stimulus is contingent on how coordinated it is across countries. If the sizes of the stimulus packages (relative to domestic GDP) are very different across countries or if some countries' stimulus packages are backloaded, then there could be “leakage” of stimulus from countries that act early and forcefully.

The international financial architecture

Global macroeconomic imbalances—manifested in low interest rates and excess consumption in the U.S. fueled by excess savings in China and other emerging market countries—were not the principal cause of the financial crisis. But these imbalances certainly fanned the flames, leading to a cataclysm. In the process of extricating itself from this crisis, the world economy could find itself facing larger imbalances.

The crisis is likely to encourage emerging markets to export and save even more in order to build up larger stocks of foreign exchange reserves and thereby protect themselves from future financial turmoil. Self-insurance through reserve accumulation is costly, but emerging markets see little choice; borrowing from the IMF carries a stigma and remains a toxic proposition for emerging market politicians. In tandem with rising U.S. government borrowing, this could result in larger imbalances and greater risks. Thus, the world economy again faces the classic collective action problem of how to align countries' incentives so they take into account the effects of their policies on global financial stability.

Action Items for Global Coordination

There are no simple or straightforward solutions to any of the challenges facing the world economy. This is a time for concerted action on multiple fronts to revive economic and financial systems.

Macroeconomic stimulus

Reversing the economic contraction and setting the global economy on the way to short-term recovery

is the key priority. This will require forceful stimulus measures with all available policy tools in each country, even if these measures are likely to deliver less of a punch than in normal times because of financial sector problems.

There are legitimate questions about the effectiveness of fiscal stimulus, especially in economies where the financial system has imploded. Moreover, excessive government borrowing to finance large budget deficits could itself raise serious concerns about medium-term sustainability of fiscal positions and generate instability. The risks of future sustainability of rising public debt have to be weighed against the prospect of greater and more prolonged economic disruption that could result from weak policy responses. Given the fast-deteriorating economic situation, G-20 economies have little choice but to engage in frontloaded fiscal expansion. The consequences of timidity, as history teaches us, could be even worse.

Focus on the long term, including thorough clear plans for future deficit reduction once the recovery gets underway, should be made consistent with the emphasis on short-term stimulus. Indeed, one reason to not lose focus on the long term is precisely to remove long-term uncertainty and the perception that today's remedies might lead to more bitter medicine in the future.

It is also important for policymakers to send a strong signal that their measures are considered ones and are not merely mortgaging the future for the present. Well-targeted spending on infrastructure is a good example—the short-term stimulus would then feed

into longer-term productivity gains. China's stimulus package contains elements of this approach. In the U.S., by contrast, the lack of emphasis on infrastructure spending in the past few years means that America has relatively few shovel-ready projects, which will delay the short-term impact. We need other creative solutions that tie together short-term stimulus with longer-term benefits.

Regulatory reform

This is a difficult area and one where careful consideration will have to be given to rethinking the fundamental principles of regulation, including the balance between private and government monitoring. This balance was clearly off kilter, with weak government monitoring compounding the problems created by ineffectual private monitoring (including the role of rating agencies).

The origins of the crisis and the ongoing futile attempts to revive the major financial institutions show the dangers of partial or implicit government intervention in the financial system. In the short run, however, we must not dismiss even drastic solutions like public ownership of systemically important institutions that are now too weak to stand on their own; partial solutions only appear to make matters worse. We will eventually need an exit strategy that preserves the government's essential roles in effective regulatory oversight and prevention of systemic risks but leaves in place incentives for innovation, risk-taking and private monitoring of financial firms.

There is a natural rush toward more regulation in the midst of a crisis that was partly set off by regu-

latory failures. But a more considered approach to reforming the regulatory systems, both at the national and international levels, is needed. There are risks to undertaking massive regulatory reforms in the midst of a crisis, when short-term prerogatives may overwhelm generally sound principles. For instance, mark-to-market accounting is making a bad situation worse as markets for some financial assets have all but disappeared. However, the fundamental concept underlying mark-to-market accounting, that the true economic value of assets should be reflected on firms' balance sheets, is a sound one; abandoning it altogether could come back to haunt us.

In any event, regulatory frameworks clearly need a massive overhaul, along with a reconsideration of the nature, scope and coordination of regulatory mechanisms. Eventually, the cross-border dimensions of this issue will also need to be tackled, although wide differences in the levels of financial development and regulatory capacity across G-20 countries make this a particular challenge perhaps best left for calmer times.

Global coordination of policies

Greater coordination of macroeconomic stimulus measures would increase the global bang for the buck of individual countries' policies. Such coordination would not only have a direct effect by preventing leakage of any one country's stimulus measures, but would also bolster confidence.

At a time when consumer and investor confidence are fragile, it is also important for G-20 leaders to

make an explicit commitment to free flows of goods and capital, and to refrain from protectionist policies. On this front, words do need to be backed up with actions rather than giving in to temptations of appeasing domestic constituencies. It does little good to espouse free trade in global forums and then accede to protectionist measures when leaders return home.

Reform of the international financial architecture

The G-20 has displaced the G-7 as the de facto agenda-setting body in the international economic policy arena. This is a positive development as the G-20 includes a broader set of key stakeholders in the international financial system. Expansion of membership in the Financial Stability Forum to the G-20 is another positive step. But a lot more needs to be done.

Substantive governance reforms of the international financial institutions, especially the IMF, are essential for global macroeconomic stability. Emerging markets need to be given a more prominent role at the IMF so they are more vested in the effective functioning of the institution in terms of both its surveillance and lending functions. The IMF needs more resources but also has to up its game to provide more credible and balanced macroeconomic surveillance of all of its member countries.

Even with major governance reforms and additional resources, it will take time to build up confidence in the IMF's role in providing insurance against financial and balance of payments crises. In the mean-

time, creative solutions to dealing with the insurance needs of emerging markets can play a useful role in reducing incentives for these economies to accumulate larger reserve stocks and reducing the probability of large global imbalances being built up again.

From the embers of this global conflagration could arise a new and more inclusive international economic order that brings countries together in creating a system that promotes global macroeconomic and financial stability. This calls for visionary leadership from the G-20 countries and an understanding that there is a commonality of interests that needs to be recognized and acted upon. The alternative for G-20 leaders is to put narrow domestic interests and political expediency above long-term benefits to the global economic system—this would prolong the crisis and ultimately pull down all countries. The choice is clear.