

# After Cannes: The G20MAP, Global Rebalancing, and Sustaining Global Economic Growth



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**Presentation to be given to AEEF by**

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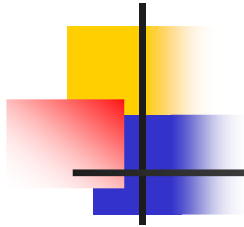
Seoul  
December 9, 2011



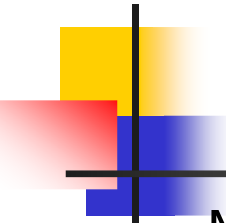
# 1 The Global Policy Problem : Three Problems, Not Two

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- It is clear that the world needs *global rebalancing*
  - the scale of international debt of the US must stop growing
  - And some of the US borrowing may need to be repaid
    - cf the case of the UK
  - Risks if adjustment is over-delayed
    - May get overshooting
- As is well known, *two* things are necessary for this rebalancing:
  - Changes in *relative* absorption betn. deficit and surplus countries
  - Changes in *relative* prices betn. deficit and surplus countries
    - This is made clear in the famous 'Swan diagram' & work of James Meade
- But also, *third*, the world needs a satisfactory *absolute level* of global growth
- There are significant risks to this outcome
  - continued deleveraging in OECD countries
  - the rapid fiscal consolidation in many countries.
  - the gradualness of the adjustment in East Asia
  - the macroeconomic outcome of the crisis in Europe



- In response to these risks, too many countries are looking for export-led growth
- But we cannot nearly all have export-led growth – there are not enough Martians to buy the exports which would result if the majority of countries aimed for export-led growth
  - There only a small number of Martians: Middle East, Australia...
- This is a *systemic* problem
  - Of course we need to think of our country-by-country needs -
    - cf remarks by many Chinese, German and US analysts
  - But we also need to think of the world as a system
- The G20 Mutual Assessment Process, G20MAP, is the only available machinery to might help the world manage these risks
- We will turn to the G20MAP at the end of this talk
  - But first we consider the risks

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- Managing these risks is important
  - Unemployment in the US, Europe, and elsewhere in the OECD remains disastrously high
    - To solve this unemployment problem 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, and/or the attempts to fiscally consolidate, add to the other risks, and put growth prospects further at risk?
    - This is what happened in 1938
  - In the short-run, we face the risks of the Euro crisis, which must be managed
  - But, in the long-run are we prepared for ten years of stagnation in the advanced G20 countries?
  - We want, not just adjustment, but adjustment with growth



## 2 When Macroeconomic Cooperation Seemed not to be Necessary

- **2.1 A Reminder** In the period after the Asia crisis there was high saving in emerging market economies (and elsewhere)
  - East Asia set exchange rates to ensure export-led growth
  - The US federal reserve set US interest rates, to ensure satisfactory growth in the US
    - Because of high savings the real interest rate needed to be low (and the stimulus policy was assisted by George Bush's war in Iraq)
- This was a two-target/two instrument system for monetary policy
  - Two instruments: real exchange rates (set in East Asia) and real interest rates (set in New York)
  - Two targets: satisfactory output growth in two regions
  - This system is explained in *IMF Staff Note* by Blanchard and Milesi Ferreti
- This system ensured satisfactory global growth and did *not* require cooperation
  - the 'Greenspan put' is part of this system—
- This system gave rise to global imbalances – as consequence not cause
  - But, for a time, these imbalances were not treated as a problem and removing them was not a target.



## *An interlude*

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### **2.2 *Cooperation at time of crisis was easy***

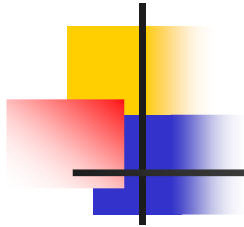
- Outcome in London in April 2009 was remarkable
- But it was easy to bring about:
  - all had an interest in using monetary expansion, and then fiscal expansion, to avoid collapse
  - And costs of fiscal expansion – in form of debt — only became gradually binding
- We now have little fiscal space – see below – and so cooperation is difficult



## 3 Why Macroeconomic Cooperation is now Necessary .

### 3.1 *The New Targets and Instruments Setup*

- Now have *three* targets: i.e. a satisfactory output levels/growth in *three* regions: the US, East Asia and Europe
- We have only one-and-a-half monetary instruments available –
  - the dollar-renminbi real exchange rate, still set in China – and East Asia more generally - to give export-led growth
  - But we are at the zero bound - so the real interest-rate-instrument has gone – although QE is half an instrument – see below
- This is a game which requires cooperation for a good solution:
- China is adjusting domestic demand at a slow speed, at a speed which suits China – this requires depreciated Chinese exchange rate and export-led growth
- There are *two* other players, playing an exchange-rate war
  - The US doing QE in order to depreciate the dollar to enable export-led growth
  - Europe – a policy jungle but we can summarise outcomes in Euroland as:
    - (i) constrained domestic demand – both public and private – and
    - (ii) monetary easing by ECB (including QE) as response, to depreciate the Euro & bring about export-led growth



- QE warfare – and exchange rate warfare - between the Stackleberg followers – (the US and Europe) gives rise to real interest rates which are
  - Too low for China
  - Too low for much of the rest of the emerging market world
  - Too low for commodity markets

### ***3.2 Reminder about what is needed***

- *Two* things are necessary for this rebalancing:
  - Changes in *relative* absorption between deficit and surplus countries
  - Changes in *relative* prices between deficit and surplus
- But also, *third*,
  - the world needs a satisfactory *absolute level* of global growth





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### **3.3 *China's Role in this world***

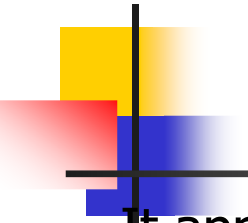
- China is locked into bubble world
  - China is attempting to control this by capital controls – but this attempt will fail
- It is inappropriate for China to describe QE as being 'irresponsible'.
  - This is the line taken by many Chinese scholars - seen as continuation of 'exorbitant privilege' by which the US can manipulate outcome
  - But QE is what any rational player would do in this uncooperative game - and this is what the US and Europe are doing
  - China should recognise this.
- Instead, the behaviour of China should be described as 'irresponsible'
  - I will argue that, in this global system, one of the reasons for bad outcomes should be seen as a consequence of a deliberate, mistaken, choice by the Chinese authorities



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### **3.4 *The Policy Implications for China***

- Understanding *international* macroeconomics is necessary for Chinese policymakers to understand their policy choices
  - Many believe that China is making a choice between acting in its own interest and acting in the global interest , that it is choosing to act in its own interest, at the expense of the global interest – which is ‘understandable’ - and that we should all encourage China to ‘make sacrifices’ and act in the global interest
  - The above analysis suggests that this is not correct: the current strategy appears not to be China’s own interest, as well as not being in the global interest (cf Blanchard, AEEF, Paris, January)
  - Why is China acting in this way?
  - It appears that they have not understood the work of Meade and the importance of the Swan diagram

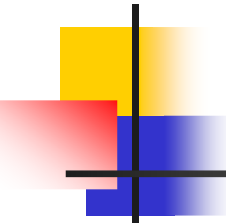


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It appears that, instead, some Chinese policymakers show a basic misunderstanding of macroeconomics. This may be what is causing them to act in a way which appears to be selfish

- Faulty analysis:
  - Global imbalances caused by exorbitant privilege of the US
- This leads to inappropriate policy response desired by some Chinese analysts:
  - Revaluation of renminbi, and of other Asian currencies, would be damaging – this is often compared with the Japanese experience of the last 20 years
  - Instead “answer” is reform of international monetary system - to create multi-currency reserve asset system
  - A very similar line was taken by Gongpil Choi and Haesik Park in previous session
- Sadly, this analysis shows a failure to understand basic macroeconomics
  - Reform of global monetary system would not change Chinese absorption relative to Chinese output, or absorption relative to output in East Asia more generally
- What is required is (as explained in Swan diagram)
  - expansion of domestic absorption in China and elsewhere in Asia, associated with
  - a very large appreciation of the renminbi and other Asian currencies

### ***3.5 Germany's role in this world & its policy implications***



Germany re-creating the world problem at the European level...  
It is inappropriate for Germany to describe European periphery as  
'irresponsible'

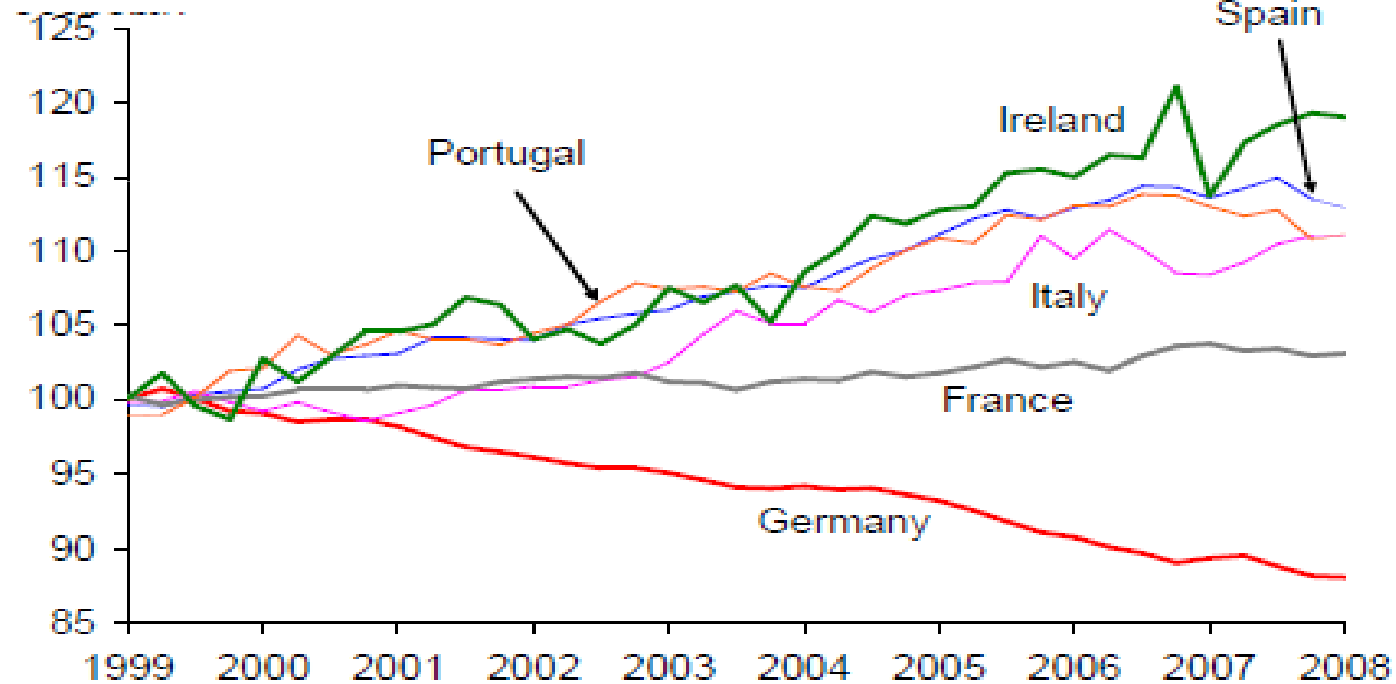
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- Greece – irresponsible fiscal policy, and loss of competitiveness. However:
  - Ireland – house bubble facilitated by European banks and poor European financial regulation and a fiscal policy, permitted by the SGP, which was too loose
  - Spain – housing boom and fiscal policy, permitted by SGP which was too loose
  - Portugal – uncompetitive and not properly disciplined by SGP
  - Italy: Too high level of debt which was allowed to build up by SGP
- The leader of Europe, Germany, should have recognised this.
- Germany's analysis – and the analysis of Momigliano this morning - profoundly misunderstands what went wrong
- The two pictures overleaf show what went wrong
  - Competitiveness diverged cumulatively for ten years The SGP was wrongly focussed:
  - Assisted by destabilising movements in real interest rates – the Walters critique
- Was accompanied by a process of financial integration under Single European Market
  - A financial system in which debt of all European countries bore same interest rate
  - Markets – and policy-makers - did not understand the risks
- Keynes understood – in 1931 - what is wrong with this analysis
  - The Euro crisis was *caused* by the SGP – an irresponsible macroeconomic framework



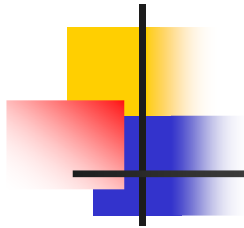
## Real Exchange Rate, relative to the Eurozone

1999=100, measured as unit labour costs, whole



Source : Oxford Economics / Haver Analytics

Figure 1: Real Exchange Rate



## Real long term interest rates

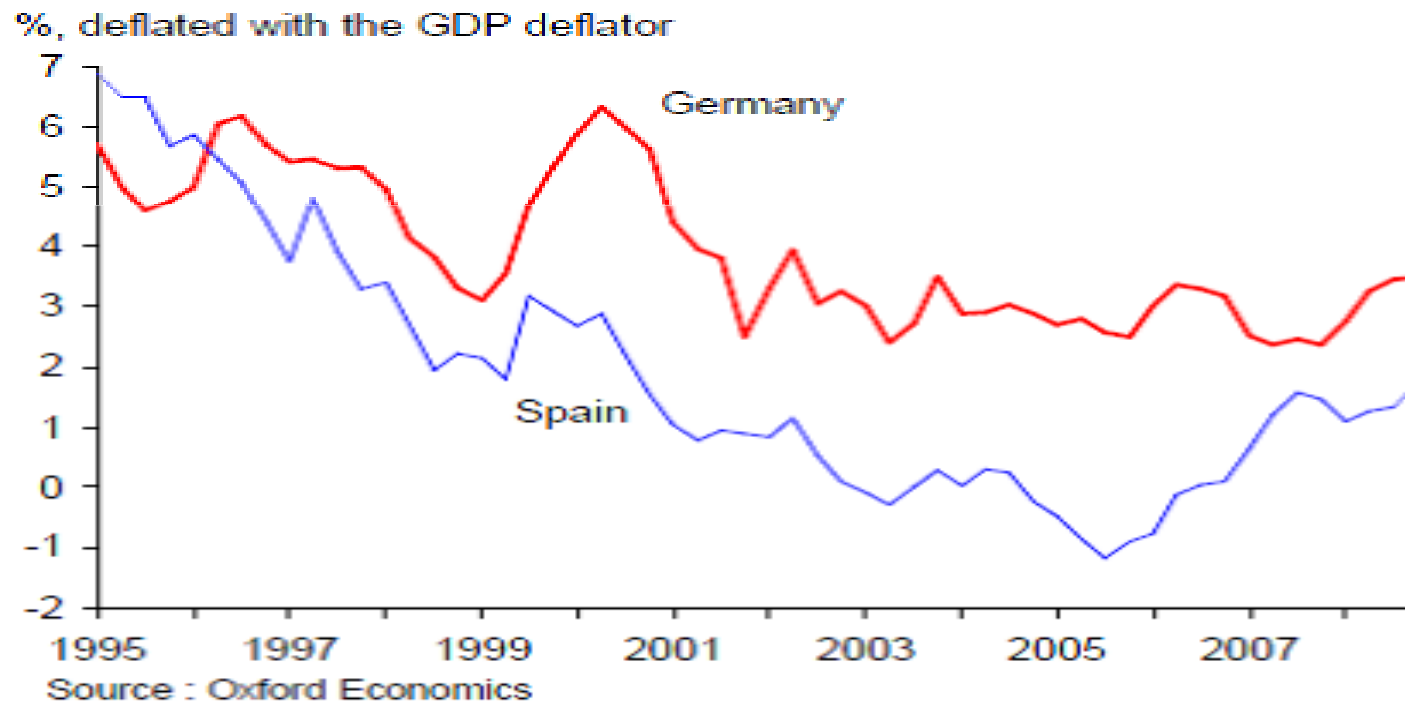


Figure 3: Real long term rate of interest



- The SGP was wrongly focussed:
  - Rule-based rather than intelligent, broken by Germany, and so completely incredible
- Wrong target:
  - too loose for boom countries from 2000 to 2007 which were inflating and creating imbalances
  - now too tight for Germany which is becoming more and more competitive and creating internal imbalances
- Should focus on relative competitiveness internally
  - doing that will ensure sustainability of public debt, by means of GDP identity
- Germany's answer this week, a focus on tightening the SGP through fiscal integration, is irresponsible and bound to fail, unless
  - Fiscal policy focuses on correcting internal imbalances
  - A means is found of adjusting internal competitiveness
- Furthermore these two things must be accompanied by an unlimited commitment by ECB to act as lender of last resort,
  - Soros plan – may need the 'IMF circle'
  - China might make an important contribution by supporting the IMF
    - Very different from being China asked to support EFST which is leveraged and fragile
  - Accompanied by issue of Eurobonds
  - Normalisation of European financial market and abolition of risk premia ,



*To put the point analytically:*

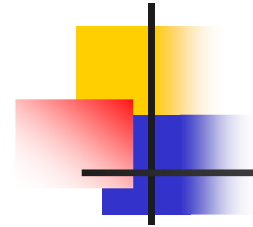
German Policy-makers also need to understand international macroeconomics and need to learn about the Swan diagram

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*Two* things are necessary for rebalancing within Europe:

- Changes in *relative* absorption between deficit and surplus countries within Europe
- Changes in *relative* prices between deficit and surplus countries within Europe
- But also, *third*,
  - Europe needs a satisfactory *absolute level* of global growth
- This is why the proposals on the table this week – for austerity and discipline - are not sufficient
  - German analysts need to understand: these austerity demands, whilst necessary, are not sufficient
- The German proposals will be difficult to achieve politically. So to some observers like me, there appears to be a lurking plan, amongst German policymakers centred around Jens Weidman at the ECB (but also Axel Weber and Jurgen Stark), to eject Spain, Italy, Portugal and Greece, break up the Eurozone, and create a German co-prosperity zone in the north.
  - It is important that this happens by “accident” – through a crisis – rather than by design
  - The breakup crisis would be much more catastrophic than the Lehman weekend
    - Willem Buiter, in yesterday’s FT, shows how dangerous this would be
  - But Some German policymakers appear to think, instead, that there would be a ‘quick victory’<sub>16</sub>





- Thus if crisis is avoided, for the past 12 years:
  - Germany has cut costs and kept wages under control and positioned itself to export high-tech goods to the world
  - Relative costs have grown remorselessly in the periphery
    - German competitiveness has stolen demand from the periphery within Europe
  - Within Germany:
    - consumers save for future
    - fiscal policy is cautious to 'avoid above-average' level of inflation
- Result (Swan diagram for Germany) – internal balance with external surplus:
  - shortage of aggregate demand in Europe
  - German exports steal demand from other regions and
  - no compensating increase in demand in Germany
- To keep aggregate demand up in Europe, Euro must be depreciated
- Germany has turned Europe into 'a second China'



### ***3.7 The Role of the US and Policy Implications for the US***

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- The US remains spender of last resort for the world (cf Krugman's push for continuation of the Obama stimulus package)
  - This is possible as a result of the exorbitant privilege which worries some Chinese scholars
  - But we should be grateful for this
- Nevertheless this role for the US is being blocked by the Tea Party and by bond-market vigilantes
  - Both of these groups should also learn about international macroeconomics and about the Swan diagram
- The problem is that continued stimulus in the in US is not credible without credible promise of future discipline in the US
  - US Politics, plus bond-market vigilantes, make agreement on this almost impossible
    - Democrats want tax increases
    - Republicans want expenditure cuts
  - What is needed is fiscal expansion now and promises of fiscal discipline in the future
    - But bond market vigilantes make this almost impossible want discipline now as<sub>18</sub> evidence that there will be discipline in the future

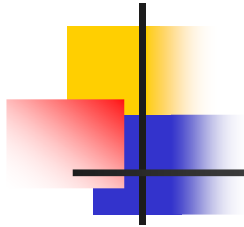


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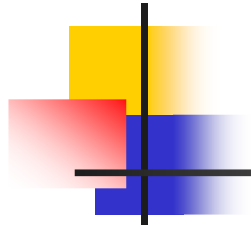
# A Game-Theoretic Restatement

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- The world is faced with a choice
- Underlying sources of global demand are low because of
  - Global deleveraging
  - Policy behaviour in China
  - Policy behaviour in Germany
  - Difficult circumstances in the US
- As a result, it seems unlikely that there is enough private sector growth to compensate for policy tightness
- We risk an outcome will not rebalance the world but instead will lead to years – possibly a decade – of stagnation.



- The choice will be *ameliorated* if one global authority – the US Federal Reserve – keeps interest rates low – and promises to keep them low - and does QE, to sustain US spending, and keep stimulating global spending.
  - But such a re-run of the 'Greenspan put' is pushing us towards another low-interest-rate bubble for the world
  - And at the zero bound this is still not be enough to sustain global growth
  - Pressure not to continue the Obama stimulus
- In this case it appears that the growth trajectory will be inadequate and that it will be one with continued global imbalances.
  - 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.



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- The choice could be *ameliorated* if the US government spent more – the Krugman strategy
    - This - would require living with – and ultimately resolving - even worse global imbalances
    - To be successful there would need to be stronger commitment to long run fiscal commitment in the US
    - Otherwise markets will continue to take fright at US fiscal stimulus



*This is a Prisoner's Dilemma with three possible outcomes:*

(i) A *Cooperative* solution in which there is

- sufficient increase spending in surplus countries
- sufficient cut spending in deficit countries – with cooperative global austerity plan (Saito)
- Adjustment of relative prices to bring about expenditure switching

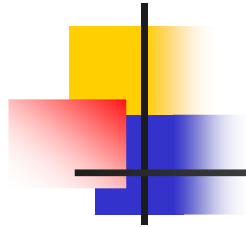
(ii) A *Non-cooperative (Nash) outcome* - a rerun of the Greenspan put:

- The risks reviewed above exert a strong negative influence
- fiscal retrenchment takes place in deficit countries including in US and Europe
- 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 low interest rates, QE and beggar-thy-neighbour depreciations in deficit countries, as each region goes for export-led growth. Outcome is exchange-rate warfare

(iii) A *better non-cooperative outcome*– the Krugman strategy - 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 – i.e. the US acts, yet again, as 'spender of last resort' and increases imbalances even more
- the US, acting in this way, uses fiscal policy to play the role of Stackelberg follower, attempting to recreate the 'great moderation' again, by fiscal policy

The third outcome would be better than the second, but still bad.  
We seek the first outcome. It seems far away.



- *WEOs* of the IMF have warned about outcome (ii) – an outcome with persistent imbalances, continued low interest rates, and QE.
- Outcome (ii) will make it difficult for financial regulation to prevent a new global financial bubble from developing.
  - This will require a considerable degree of international cooperation about financial cooperation.
  - It is far from certain that the financial reforms will be robust enough
- Outcome (iii) – a better non-cooperative outcome – would put pressure on global financial markets
  - the US fiscal balance sheet would bear the burden of the global recovery
    - Markets would need to accept this
  - Global imbalances would be even larger
  - This would also put pressure on international financial markets since the fall of the dollar –when it came – would need to be even larger and might overshoot



## 5 The Role of the G20 and the IMF

- In 1944, when the Bretton Woods system was established, Keynes saw
  - The need for global support of good policies in individual countries,
  - The need for global coordination of policies – 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
- This was a rules-based system, with global management of macroeconomic policy making in a global system of macroeconomic policy-making.
- Now – in the face of a similar global problem – we need something similar.
- This is what the agenda for reform of the International Monetary System (IMS) should be about
  - Fundamentally the IMS is about macro-management of the world economy
  - Discussion in previous session appeared to me to be much too descriptive and without sufficient purpose
  - Reform without purpose seems pointless to me
  - This – in my view - is why the French agenda for reforming the IMS was a failure
- The G20MAP is the machinery a global macroeconomic-policy-system
  - This machinery is an important new policy framework

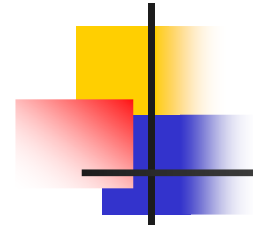




## *How might the G20MAP push us towards the cooperative outcome?*

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- The G20MAP has superseded the IMF's failed multilateral surveillance process (MSP)
  - China and the US created a bilateral standoff
  - The governance of the IMF prevented this standoff from being resolved
  - The G20MAP evades this blockage in an important way
- We can separate the G20MAP into two aspects
  - analysis and decision making are separated – governance improvement
- *Analysis.* The IMF does this in collaboration with Framework Working Group
  - Agreement on facts and policy presumptions (country ownership)
  - Analysis done by IMF (arguably best practice): discussion of analytical assumptions
  - The IMF produced detailed studies of: US, China, Japan, Germany, India, France and UK, plus an overall study.
  - They were published in September.
- *Decision-making.* Results of the analysis went to
  - finance ministers, then to sherpas, then to
  - leaders at Cannes
- *Result*
  - No action taken at all
  - Everything at Cannes overshadowed by Euro-crisis
  - But the world goes on -
  - the longer-term issues discussed above will need to be dealt with



- Why this process might become *much* stronger than the MSP
  - G20 leaders overseeing the process, not just IMF
  - G20 officials are involved and there is commitment to success
  - It is multilateral, not bilateral US/China
  - The Cannes Declaration makes commitments to develop this process
- Montek Ahluwalia has suggested a global body of outsiders to oversee this two-stage process and prevent the IMF's analysis of choices being diluted 'along the way'
  - The cooperation between Framework Working Group and IMF appears to have created ownership, and to have made the process less likely to be either disowned or captured.
  - The publication of the analysis makes it obvious whether leaders face up to the questions put forward by the IMF's analysis – at Cannes they simply ran away
  - Comment by outsiders might help policymakers & officials face up to choices – for reasons which Montek explained.
- Asian countries have a particular interest in the outcome of this global bargain.
  - That is why this is such an important topic for today's meeting