The Interdependence of Macroeconomic Policies and Structural Reforms

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The Cannes G-20 Leaders' Meeting in Context

A year ago, many hoped that the November G-20 Leaders' Summit in Cannes would be an opportunity to state that the worst was over and that the world economy was on a solid growth path again. Leaders were expected to turn to long run issues to implement their vision of "strong, sustainable and balanced" global growth.[1] In April, finance ministers already started a discussion of how to monitor key structural variables as a backdrop to a discussion on rebalancing global growth.

Today, it is clear that a sense of urgency over the short-term prospects of the global economy has returned. In the United States, growth is weak and the fraction of the population employed is at historical lows. The eurozone is facing an existential threat and even the German growth engine is slowing, perhaps even stalling. Japan cannot get out of a now two-decade long stagnation. And the widespread confidence prevailing in emerging markets is giving way to greater anxiety as global trade falters again and advanced country banks are recalling liquidity to their home bases. As has always been the case when anxiety mounts, there is a flight into the U.S. dollar despite America's fiscal problems. The emerging market country currencies that are basically floating have depreciated sharply against the dollar. Brazil, a country that had been very worried about the appreciation of the real, has intervened to slow down a sudden marked depreciation. Turkey's central bank is selling reserves. Equity markets have been down worldwide although there is a great deal of volatility and there have been rallies.

In 2009, the G-20 came together with a coherent package of macroeconomic measures to deal with the crisis. Today, the situation is quite different. First, in some countries, while a considerable amount of fiscal ammunition has been spent, the current slowdown in growth is shifting the balance of opinion against immediate fiscal consolidation. An increasing number of observers are now of the opinion that careful support to the recovery is more important than immediate fiscal retrenchment in those economies that have still preserved some fiscal space, including the U.S. Nonetheless, longer-term debt dynamics are very worrisome so there appears to be a serious fiscal conundrum. Second, today's global economy seems to have entered a new phase characterized by heightened uncertainty over long-term growth prospects. In the current environment, there is greater talk of the need to implement structural reforms to provide an impetus to growth and to link macroeconomic policies, especially fiscal policy, with strategies to address structural weaknesses and to restore long-term business and consumer confidence rather than to discuss macroeconomics purely in terms of short-term aggregate demand. Monetary and aggregate fiscal policy have reached their limits as countries have lost fiscal space and as the conundrum caused by the need for short-term support to the recovery, and the need for long-term consolidation remains unresolved. Therefore, it is the interaction between macroeconomic policy and structural reforms that is the topic of the essays in this volume.

The Unfolding of the Crisis

Three years ago in the fall of 2008, the world economy faced its most threatening crisis since the Great Depression of the 1930s. The crisis followed a period of unprecedented worldwide growth, stretching from 2002 to 2007. Some renowned economists believed that serious business cycles and recessions were a thing of the past. In his presidential address to the American Economic Association in 2003, Robert Lucas proclaimed that "[macroeconomics'] central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades."

Reality turned out very different. The "Great Moderation" of 2002-2007 has been followed by the "Great Turmoil" of 2008-2011 and probably onward.

The first phase of the unfolding crisis from mid-2007 to September 2008 was one of slowing output growth in the U.S. and Europe. Stress in the financial sector was increasing, as manifested in the Bear-Stearns crisis in March 2008. However, market and opinion leaders treated this as a one-off problem and did not grasp the systemic severity of financial sector problems so they continued to drive up prices in commodity and energy markets.

The second phase came with the collapse of Lehman Brothers in September of 2008 and the ensuing "heart attack" in the financial sectors of the U.S. and Europe. The effect of the "heart attack" in the traditional center of the world economy affected most of the periphery but with variable virulence. Trade, capital flows and confidence levels were the channels for contagion. All over the world, private demand collapsed, fear about the future increased and firms reduced their workforce. Eastern Europe with its huge current account deficits and hence exposure to capital shocks was most strongly affected, but even China experienced major employment losses and firm closures. The price of oil fell from $147 a barrel in July of 2008 to below $40 a barrel by the end of the year—a vivid reflection of the dramatic, unpredicted and unprecedented nature of the "heart attack".

The third phase of the crisis saw the effects of a massive globally-coordinated Keynesian policy response, accompanied by extraordinary direct intervention by governments in the financial sector. This allowed the patient to survive. By spring 2009, a partial recovery started and a world depression was successfully avoided. The first signs of a recovery were seen in financial markets but soon extended to the real economy as inventories were rebuilt (or at least stopped falling). Yet, the output recovery did not involve a significant pick-up of private investment, new capacity building or significant new demand for labor. On the contrary, in many advanced economies, notably in the United States, employment and output trends diverged in a way that had seldom been experienced before.

Nonetheless, from the summer of 2009 to the spring of 2011, a moderate recovery seemed to take hold in the U.S. and Northern Europe while the emerging market economies, notably China, regained growth momentum to levels close to their pre-crisis pace. It seemed that world economic growth was reverting to trend; the International Monetary Funds's April 2011 World Economic Outlook (WEO) had 2011-2012 growth predictions of 2.8 percent for the U.S., 1.7 percent for the eurozone and 3.6 percent for the world economy as a whole.

The Fourth Phase of the Crisis

By the summer of 2011, however, the world economy was entering a fourth phase of renewed slowdown. The September 2011 WEO projections have lowered U.S. growth projections for 2012 by 1.1 percent, those of the eurozone by 0.6 percent and those for the world economy as a whole by 0.5 percent. Some economists are now predicting at least a 50 percent chance of actual economic contraction in the U.S. and Europe for the last quarter of 2011 and the beginning of 2012. The confidence crisis in the eurozone triggered by the peripheral economies is now slowing growth throughout the continent, including in Germany. The buoyant growth in many of the emerging market economies is also declining. Even China is affected. There is little doubt that global economic policymakers are back in crisis mode, although more so in the advanced economies than in the developing world so far.

In this fourth phase of the crisis, the policy strategy of gradual fiscal tightening that was developed in the third phase has come under severe attack. The most prevalent recommendation in the fall of 2011 is to loosen fiscal policy for the immediate future, wherever there is fiscal space, while announcing future tightening. From a theoretical point of view, there has always been concern about the feasibility of "provide stimulus now, while announcing retrenchment for the future." One does not have to be a strong "Ricardian" to believe that economic actors look ahead at least to some degree when they make their spending decisions—tax cuts today create expectations of future tax increases. But from a practical point of view, the reverse arguments are also being made—tax cuts today create pessimism over the political ability to raise taxes (reduce deficits) in future. Financial markets are questioning the realism and adequacy of projected fiscal cuts and some politicians in advanced countries are calling for more substantial short-term fiscal contraction as a way of building confidence in the sustainability of public sector debt. In the United States, this option was fueled by Standard & Poor's downgrading of U.S. public debt in the aftermath of the collapse of bipartisan budget negotiations. The signs of weakening in output growth trends have significantly altered public debt dynamics. In an important editorial in the *Financial Times*, Christine Lagarde, the new IMF managing director, noted that markets are even more afraid of slow growth than of high deficits.[2]

It is worth remembering that debt ratios have a numerator (the amounts of public debt) and a denominator (GDP), and that debt dynamics are driven by the interaction of deficits, growth and interest rates. With interest rates already at historical lows, there is not much more favorable news that can be expected on this score. When growth slows, deficits rise because of automatic stabilizers (both on the tax and expenditure sides) and because of the risk of renewed contingent liabilities in banks and public pension funds. If fiscal cuts to reduce deficits also reduce growth, they can become self-defeating in terms of the underlying debt dynamics. When interest rates also adjust to unfavorable debt dynamics because of sovereign risk, as is happening in parts of Europe, the room for maneuver becomes even narrower. Moreover, if uncertain debt dynamics and slow growth policies are synchronized across borders, the system in each individual country becomes even more unstable. That is what is happening now with ongoing fears of currency wars and associated worries of trade wars and additional negative growth shocks. Given this strong interdependence, the danger of simultaneous substantial retrenchment in macroeconomic policies should not be underestimated.

A New Debate on Structural Policies

This fourth phase of the crisis presents policymakers in advanced countries with a huge challenge: how to offset deficient private demand, which is not recovering fast because of balance sheet effects as well as increased income concentration at the very top, while maintaining financial market confidence in the stability of public debt dynamics. Political majorities have to be forged for the packages proposed in the middle of a widespread lack of confidence in policymakers due to the failure of the economic predictions made over the past few years. The lack of confidence in turn curtails the demand for labor and investment in new capacity and deepens the economic gloom.

If aggregate fiscal policy is really constrained because of the potential negative impact on short-term growth prospects and hence on contingent liabilities, as well as a serious danger of social unrest in some countries, then the only way out is to pay more attention to structural policies and that is now the focus of attention in many countries. But structural policies are notoriously difficult to implement in political terms (the balance of winners and losers is hard to manage) and often take time to yield results. In Europe, the extent of progress on implementing the Lisbon agenda has been very slow. In the short term, even having a discussion on the exact nature of structural reform can generate policy uncertainty and further curtail growth.

Structural reforms are easier to take forward when there is fiscal space. For example, bilateral trade agreements in the United States were held up partly because of disagreement over how to fund worker retraining to smooth the adjustment of labor from affected industries.

In most advanced economies, governments are now able to borrow at interest rates that are at historical lows—in fact, close to zero or even negative in real terms. If the public sector can create assets that are useful to the economy, it can actually improve its balance sheet and reduce its degree of indebtedness by spending more today on building productive assets. In most advanced economies, infrastructure spending to lower logistics costs seems to offer obvious opportunities. And fees or tolls can be charged in many cases, generating not only a positive economic rate of return for the economy but a positive financial return for the public sector. Yet, while in theory all public investments where returns exceed the cost of borrowing should improve debt dynamics, in practice there is skepticism in some countries over the government's ability to choose sound projects and implement them without cost overruns. Some of that is pure ideology, but it weakens the ability to combine sufficient public spending and policy reform in packages to achieve structural change.

We believe that further discussion about aggregate fiscal measures will not be sufficient in the current context. Policymakers have to look at the distribution of income and adjust the structure of policy to achieve real impact. For example, tax relief or income support targeted to the poor can be effective, even if it is accompanied by announcements of tax increases for the richest top segment of the population in the medium-term future because of marginal propensities to consume or save differ across income groups. Poorer households facing strong liquidity constraints tend to spend what they earn. The very rich, who have a substantial cushion of wealth, on the other hand, are unlikely to strongly adjust their immediate spending downward in the face of longer-term tax increases announced for the future. The strength of these distributional effects is an empirical question, but policy should be formulated on the basis of the research evidence rather than on the basis of simple ideological beliefs.

Of course, a big distributional issue is intergenerational—managing the costs of long-term social, retirement and health policies. There is again little doubt about the strong upward trend in societal costs thanks to an aging population and an increase in the cost of health care due to the otherwise good news that effective treatment now exists for many diseases. Reforms are needed to reduce that cost, but how this is done has an impact on growth and debt dynamics. For example, a simple increase in the age of entitlement to Medicare in the U.S. might reduce the immediate projected cost of the Medicare program. But if it is done in a way that creates anxiety for older people, leading them to reduce their expenditures, it could actually worsen public debt dynamics. Again these relative effects are subject to empirical analysis and it is on the basis of such empirical analysis that reforms should be designed. A well-designed reform aiming at greater cost sharing by the rich is not just about redistributional goals. It is also likely to be more effective in terms of the impact on aggregate demand than distributionally-neutral reforms. Similar considerations are relevant for pension reforms. Entitlement cuts can be strongly deflationary, even if announced only for the future, unless distributional targeting is included in their design. Hence, both Keynesian and Fisherian insights are needed when analyzing the current set of challenges.

The debate about appropriate structural measures needs to be conducted on an international stage because it is clearly very difficult to insulate oneself in today's world economy. National policies clearly remain the drivers of what is happening and what can happen in each country. However, these policies unfold in an increasingly interdependent world and everyone would benefit from much greater efforts by the leading nations to approach problems in a forward looking, cooperative manner that takes full account of the factors that bind the world economy into an interdependent whole. This is both the challenge and the mission of the G-20. Whereas in the past the burden of global adjustment fell disproportionately on deficit countries that could not attract private capital flows, today surplus countries are also affected by the threat of rapidly appreciating currencies and potential deflation. Thus, no country is immune from problems in the major economies.

Emerging market economies that had seen some evidence over the last two years for "trend decoupling" in growth rates between themselves and advanced economies are starting to realize that there is no clear "cyclical decoupling"; interdependence through trade and finance, as well as through expectations and sentiment (animal spirits) ensures that problems in any important part of the world economy continue to have an impact on the entire world economy. The nature of the fiscal deal that the Obama administration and the U.S. Congress is seeking - and the difficulty they are having in striking such a deal – is having an effect on the entire world economy. The uncertainties surrounding Greek and other peripheral European sovereign debt are also affecting the entire world economy, despite the small size of the peripheral economies.

We believe structural and distributional issues are crucial for the advanced economies. The emerging market economies and developing countries are in a better position, with younger populations, generally much lower debt ratios and often rapid "catch-up" growth. But for them too, structure and distribution matter. As forcefully argued by Dani Rodrik, catch-up growth is much faster in some sectors than others and should not be regarded as an automatic and aggregate mechanism. Developing countries need thoughtful microeconomic and structural policies to maintain rapid growth and indeed in most developing countries the key policy concerns today are about the pace of microeconomic structural reforms. Macroeconomic prudence, while required, is not enough. Moreover, income distribution is becoming more unequal in many developing countries or is still very unequal in others. Inequality can easily become a factor of instability, particularly if the pace of overall growth slackens. So developing countries too must embed and complement their macroeconomic policies in proactive structural and distributional policies.

This fall 2011 collection of the Think Tank 20 (TT-20) essays has been commissioned with these considerations in mind. This collection contains many different perspectives. There is no agreed or "common" policy line which makes the G-20 discussions all the more difficult. Jacques Mistral from France draws attention to the new challenges that the huge income concentration at the top—particularly but not only in the U.S.—poses for both the political economy of reform and the effectiveness of macroeconomic policy. Qiao Yu and Lan Xue from China do not seem to worry about income concentration at the top but about the growing share of income going to the state rather than the private sector. They appeal to as free as possible markets as the solution, thereby providing a striking example of how some emerging market economists have become strong advocates of what used to be views centered in the right-of-center segments of the political spectrum in London and Washington. The specific conditions in different countries vary and the contributions reflect this diversity. There is no doubt, however, that the G-20 will meet in Cannes in early November amidst great worries about the world economy, worries that are reminiscent of the dark days of late 2008. Now, as then, is a time for courageous and coordinated action based on sound and empirically grounded analysis.

If there is one common thread throughout all the essays in this volume, it is that the composition of public expenditure and taxes matters, as well as the aggregate levels. In the contributions by authors from advanced countries, questions abound whether enough attention has been paid to the long-term growth strategy. In Japan, the euro area and the United States, sluggish short-term growth is creating doubt about the path of future output. Those essays call for structural reforms to invest for the future, largely in infrastructure and education, echoing data showing that global investment as a share of global GDP is at a low point due to low investment in the advanced countries.

The contributions by authors from developing countries, where growth performance is still good, emphasize the impact on social stability of a better composition of public spending. Brazil and Turkey have histories of recovering from their own crises with a mix of macroeconomic, structural and social policies that produced "fair" distributional outcomes. It is that sense of social stability that now stands these countries in good stead in dealing with the current global crisis.

Each G-20 nation will pursue policies that reflect its own specific circumstances, historic memories and political constraints. But there is too much interdependence in the world economy to give up on the hope for greater coordination. Common ground can be found to develop policies that can lead to win-win solutions. We hope that the TT-20 network can contribute to such analysis and usefully accompany the official process.

References

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Endnotes

[1] Pittsburgh Summit Declaration
[2] Lagarde (2011).