Introduction: The G-20 and Central Banks in the New World of Unconventional Monetary Policy*

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Five years after the first meeting of G-20 leaders, and decisive action by the central banks and treasuries of the world's major economies that prevented the financial crisis of 2008-2009 from turning into a 1930's style world-wide depression, the world economy still remains fragile. The original *fiscal* stimulus agreed upon in the April 3rd 2009 second leader's level G-20 London meeting has been withdrawn in the U.S. and Europe after 2011, not through a coordinated decision of the G-20, but in response to fears of rising public debt and a political process in which these fears came to dominate the debate. In China too, fiscal policy became less expansive, after the mega-stimulus of 2009, although a mini-stimulus has been declared for the summer of 2013 to counter a greater than expected output slowdown.

Monetary policy, however, remained extraordinarily expansionary in the U.S., the U.K., Japan and the eurozone. The balance sheets of the Federal Reserve (Fed), the Bank of England (BoE), the Bank of Japan (BoJ) and the European Central Bank (ECB) expanded by $2 trillion, £310 billion, ¥50 trillion, and €1.5 trillion, respectively between December 2007 and December 2012. The Fed's, the BoE's, the BoJ's and the ECB's balance sheets were as big as 6 percent, 7 percent, 21 percent and 15 percent of their GDP in 2007, whereas in 2012, their balance sheets represented 19 percent, 27 percent, 33 percent and 32 percent of their 2012 GDP levels, respectively. Repeated rounds of quantitative easing no doubt helped the U.S. economy recover, and the actions of the ECB prevented the crisis in the eurozone periphery from spinning entirely out of control. In Japan, renewed monetary expansion has led to significant output growth. While central bank policies have had these effects, there are now growing doubts about the desirability of the continuation of these policies. These doubts stem from the prolonged economic weakness in high-income economies translating into fears that these limited benefits from unconventional monetary policy, "quantitative easing (QE)", may no longer justify the moral hazard and adverse selection that they encourage. Equity prices and prices of riskier financial assets in much of the world seem to have de-linked from underlying real fundamentals, driven by an almost desperate search for yield, in an environment where liquid funds and high quality treasury bonds yield a zero or even negative real return.

The economic backdrop to the St. Petersburg leaders' meeting is one of such very mixed progress and great uncertainty. The essays in this collection contributed by leading analysts from the G-20 countries, reflect that uncertainty and strong concern for the world economy. The worst fears over collapse of the eurozone and major bankruptcies have receded, but growth remains sluggish, job prospects are weak, and many fear new bubbles in some asset and commodity markets. The difficulties of an orderly unwinding of QE policies were clearly shown by the volatile market response to Fed Chairman Bernanke's first statements about the possible timing of QE exit which he essentially had to retract. Many emerging market economies have experienced serious pressures on their exchange rates due to significant weakening of inward capital flows. The first two quarters of 2013 also saw a general slowdown in emerging market GDP growth, although it still remains relatively much stronger, particularly in Asia, than in the advanced economies. The general picture of "trend decoupling" in medium-term growth rates, but continued strong cyclical interdependence among advanced economies and emerging market economies remains similar to what it has been since the turn of the century.[1] Although it may be that the ongoing eurozone crisis is leading to an "internal divergence" among advanced economies, with the eurozone performing substantially worse than the U. S. and Japan as well as such countries as Canada and Australia. The very strong trade links between the U.K. and the eurozone, as well as the questionable success of its own fiscal austerity, put the U.K.'s performance closer to the eurozone than that of the U.S. or Japan.

The articles in this collection highlight three fierce debates that are ongoing and surround the next G-20 Summit in St. Petersburg.

First, every author signals that weak and erratic effective demand continues to be a drag on global output. But they also highlight concerns over the limits of accommodative fiscal and monetary policy, given the rapid accumulation of public debt and the unprecedented expansion in central bank balance sheets. Many authors question whether zero or negative real interest rates and continued reliance on central bank credit (the ECB) or central bank asset purchases (the Fed, the BoJ, the BoE) will be wise. At the same time, however, large developing country members of the G-20 also have slowing economies. A key question therefore, is whether private demand, including investment demand, can finally be expected to replace monetary stimulus. Ideally, as argued by the IMF, there should be a globally coordinated "world economic policy mix"—with countries having some fiscal space refraining from fiscal consolidation, while others, with higher budget deficits and debt ratios, proceeding with cautious consolidation. Monetary policy should very slowly prepare for an exit from the various extraordinary modes it has been in, but allowing only very slow increases in interest rates. Given the overall weak effective demand conditions, such a policy could be called a "globally-coordinated growth management" policy. While the international spillovers of policy from large countries are obvious (and in some cases becoming larger than ever), the benefits of coordinated macroeconomic policy, very unfortunately, remain largely theoretical, with little evidence that policymakers take IMF scenarios on alternatives seriously and calls for greater coordination.

Second, despite the old adage that "a crisis is a terrible thing to waste", many authors express concern that getting used to very accommodative monetary policy has reinforced the moral hazard that created the crisis in the first place, and is now reproducing the infamous "Greenspan put ". Signs of bubbles and overheating in selected asset markets such as in some developing country sovereign bonds some local government bonds, some commodity markets, and high-end property are noted with concern as evidence that financial markets again display significant speculative risk-taking and carry renewed vulnerabilities. The Chinese contributors even go as far as arguing for a return to the gold standard. There is therefore the longer-term question of what will or should replace both the pre-crisis inflation targeting framework and the current unconventional monetary policy mode? What is or should be the new normal for central banks and monetary policy?

Third, the structural reform agenda concerning financial market regulation, structural fiscal reform, energy pricing and subsidy reform, income distribution, labor market skill mismatches, and other areas has become bogged down in a hostile political environment. Economic recovery in high income countries, weak as it is, has overwhelmingly benefited the top income earners, leaving median incomes unchanged or, in the peripheral European countries, much lower than before 2008. In emerging market economies, income distribution is also of increasing concern. The relatively higher overall growth rates in these countries allow poverty to continue to fall and median incomes to rise moderately, despite a tendency of income gains to favor the very top, not different from what is seen in many advanced economies. The debate over how this is linked to technology and scalable innovations, globalization and competition in labor markets, or simply political power and influence, and what to do about it, remains. The challenge for political leaders to connect a G-20 agenda supportive of globalization with the concerns of voters is as great as ever.

Central Bank Unwinding and Policy Coordination

QE policies in large advanced economies do seem to have been effective in raising short-term growth rates, reducing long-term interest rates and supporting asset markets. The cost, however, has been an unprecedented expansion in central bank balance sheets. In some countries this has taken the form of bond purchases, in others claims on banks have increased. The other major instrument is forward guidance and shaping of expectations; Mario Draghi's "whatever it takes" remark being the prime recent example of how expectations can be changed with real economic consequences.

In this setting, it is likely to be "forward guidance" that will be the first instrument used to signal an unwinding of unconventional policies. However, this is a blunt instrument and may not lend itself well to coordinated strategies. The impact of forward guidance depends also on context and the likelihood for fiscal and structural policy reforms (and hence the expectations for future growth), something about which there are likely to be sharply diverging views across the world.

The difficulty that is posed is such that in an increasingly connected world, the feedback mechanisms between countries are unpredictable. In a search for yield, foreign investors had sharply increased their holdings of Mexican, Turkish and South African treasury securities. If yields rise sharply, these investors could see significant reductions in the value of their holdings. If monetary authorities have full information on the foreign asset holdings of their residents, they can factor in these losses into their determination of the best monetary policy. But in the absence of full information, there can be unpredictable losses among investors that can have spillovers into other parts of the financial system. How large these losses may be, and whether they are of sufficient magnitude to warrant the attention of policymakers is one of the new considerations that needs to be taken into account in determining how to unwind expansionary monetary policy. The issue of policy coordination, therefore, has evolved from working through the benefits of joint actions that could lead to a superior global outcome, to also considering the nature of the informational requirements each central bank needs to decide on an optimal monetary policy for its own country.

Moral Hazard and Risk

The 2008 economic crisis has been attributed, at least in part, to a long period of easy money and an associated under-pricing of risk. A concern that is reflected in almost every paper in this collection is that the recent period of QE and unconventional monetary policy, while desirable for macroeconomic demand-management reasons, might have within itself the seeds of the next crisis—driven again by an under-pricing of risk. Asset bubbles in places as disparate as the London property market, Chinese local governments, some sovereign bonds, are indicators of potential risk.

Several authors stress two issues in managing risk. First, governments and fiscal authorities have a dominant role to play in ensuring that risks are contained. A strong sovereign fiscal situation is the best safeguard against a range of unpredictable outcomes. Second, risk needs to be better diversified within economies. As long as risks are disproportionately concentrated in banks, they will become more of a concern and more closely tied to the fiscal health of sovereign states. When capital markets spread risk more broadly, there is likely to be less pressure on governments for bailouts in the event of bad economic outcomes. But building effective capital markets is a complex process requiring regulations to ensure "fairness, integrity and transparency", as one paper suggests. More broadly, as financial products become more sophisticated and globalized, international harmonization of capital market regulations becomes desirable, something on which there has been limited progress and on which prospects for future progress appear dim.

In this environment, there is considerable concern over how unconventional monetary policy in major money centers will evolve. Those countries that have relied on the availability of predictable, risk-free assets in global money centers must now take more responsibility for their own monetary stability. The period of free-riding on global financial stability may be ending.

Structural Policies and Growth

Unconventional monetary policy has been successful in stabilizing financial markets, but far less successful in achieving the "strong, sustainable and balanced growth" that the G-20 seeks to achieve. In high-income economies, especially in Europe, employment remains the major concern; the transmission mechanism from monetary policy to jobs has been very weak in an environment where households and corporations have been deleveraging. All the authors in this collection call for more forceful action on structural reforms; few express optimism that such action will happen with sufficient speed.

The question for G-20 leaders is whether the forum can be used to accelerate structural reforms through an informal pact to regenerate faster global growth. They face strong headwinds in doing so.

First, there remain sharp ideological divides over major aspects of policy. Many of the promises that have been made by governments across the world need to be revisited. That is true of some of the across-the-board entitlements in high-income countries as well as the also often across-the-board subsidies in many developing countries (fuel subsidies in particular). Programs promoting health, education, social security, energy, water and other areas have price tags that are less affordable in current circumstances. Continued growth in public spending within the old policy frameworks would divert resources from urgent investments in infrastructure and targeted quality improvements that may be needed for a long-term growth agenda. At the same time, the poorest and most vulnerable segments of most societies remain in need of social support, in some cases, more than ever. In the peripheral European economies, poverty has actually increased in a way unseen for decades. The quality of fiscal adjustments deserves as much attention as the quantity, but the latter gets all the headlines.

Second, there is a sharp divide as to whether globalization and international economic cooperation is a positive or a negative force for structural reform. The intertwined questions about the roles of globalization versus technology as a cause for the observed increases in inequality and the concentration of income at the very top remain, but with conventional wisdom increasingly attributing slow wage gains and employment in high-income countries to automation, global factors and the integration of major emerging economies into the global trading system. With this backdrop, global trade talks are stalling over issues of the distribution of the gains from trade, and more attention is being paid to regional and bilateral trade agreements among more like-minded countries. Regionalism and country blocs are replacing multilateralism and global agreements as a pragmatic way to advance structural reforms.

In some instances, a regional focus is appropriate. Structural reforms in the eurozone may have as much to do with policy reforms and the distribution of benefits between surplus countries in Northern Europe and deficit countries in Southern Europe, as with the evolution of the global economy. On the other hand, as Pascal Lamy, who is ending his two terms at the head of the WTO, has been stressing in his "legacy" speeches, that replacing the more universal and multilateral WTO negotiating framework, with "coalitions of the willing" mostly involving the more powerful economies, will hurt those left outside these possible regional agreements, Africa in particular.

Concluding Remarks

The main drivers of the global economy for the last five years have been the central bankers of the world's major economies. But the papers in this collection suggest that they may have spent much of their ammunition. Monetary policy, like fiscal policy before it, may have reached its limits. Most authors, though not all, see the unconventional policies of the last five years as a necessary price that had to be paid in order to prevent a global depression. Many doubt that these policies can continue, and yet they worry about how the "exit" will be managed. All see a desirable passing of the baton of priority instruments towards structural reforms, and better quality fiscal adjustments. The commitments that are made on this agenda could be the foundation upon which forward guidance and the unwinding of QE policies can take place in a both cautious and credible fashion.

The challenge of the G-20 Summit is to move beyond the state of complacency and acceptance of slow structural reforms to an *accelerated program of action*. In the best of worlds, decisive structural reforms, as well as macro-economic policy adjustments would happen in a coordinated way among the major economies that are represented in the G-20. More likely though, policy will unfold in a variety of ways, framed by national political debates but supported also by other regional forums, and still broadly inspired by the G-20 process. In the worst of worlds, G-20 leaders will retreat into the narrow spaces entirely constrained by their own domestic politics. That would prolong the uncertainty over the direction of long-term policymaking that continues to dampen economic recovery and fuel the frustration of many throughout the world with the way in which global interdependence is managed.

The G-20 process has lost a lot of its initial force and promise. Make no mistake, however; it has contributed to managing the crisis that erupted in 2008. The global economy is and will remain very interdependent and there are large gains to be realized through intelligent coordination. These gains could produce more rapid growth as well as more equitable and balanced growth. We hope that the excellent essays in this collection, coming from a multitude of different perspectives, will be widely disseminated and read across national borders and continents. The G-20 process must involve much more than the meetings of leaders and the negotiations of civil servants and bureaucrats. For the G-20 to survive and to thrive again, it must involve very strong academic, business, labor and civil society engagement. We hope that these essays provide a good example of such engagement and we are grateful to all the contributing authors and cooperating institutions. This is a joint effort by all of us, to be disseminated by all of us cooperating in this venture, with the objective of supporting better policies, greater understanding of different perspectives and more effective international cooperation.

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References

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Endnotes

[1] Derviş (2012).