The G-20 and Two Scenarios for the World Economy

Paolo Guerrieri *Professor of Economics, University of Rome Sapienza; Professor, College of Europe, Bruges*

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We Are Very Far from Rebalancing the World Economy

It is quite clear that the effects of the 2008-09 global financial crisis are far from over. Since mid-2009, the global recovery has been the cyclical result of massive stimulus combined with short-term inventory corrections. Once these factors weaken, as is already happening in many countries, economic growth will weaken as well. Although a double-dip recession is unlikely, the process of adjustment will bring to the fore many structural problems left over from the crisis, including the fragile banking sector and the need for fiscal austerity. Among these structural problems, the key issue is that global imbalances are rising again.

Although the recent global downturn has led to a natural rebalancing of economies, the latest estimates from the IMF and OECD suggest that world current account imbalances are likely to remain substantial through 2015. Along with the large Asian surpluses, the German and new European countries' surpluses will probably increase the U.S. current account deficit

The Risk of a New Financial Crisis

This is very far from the rebalancing strategy agreed upon by the leading G-20 economies as being critically important for sustaining global expansion. And it is a very risky trend since current and expected account deficits and surpluses are indeed a fundamental threat to global macroeconomic and financial stability in the medium and longer term. The higher imbalances themselves could favor a new financial crisis, just as they were the fundamental contributing factor of the last crisis.

Global imbalances need to be viewed in the context of the shift in economic power from the West to the East. The West—or at least countries like the U.S., the U.K. and Spain—need to spend less and save more. In contrast, regions like the Asia Pacific need to save less and spend more. What is needed globally is for both debtor and creditor countries to rebalance their economies. A shift in the mix of international saving and consumption flows would be the only effective way to neutralize the imbalances. The incentives to change are indeed very high, yet the obstacles to change are even more formidable.

Too Soon for Asian Decoupling

There is a lot of optimism in this post-crisis recovery era that China's, and the rest of Asia's, economic growth will spill over and benefit the rest of the world and help rebalance the world economy. Asia has changed dramatically in the past decade. Most East Asian economies have staged a rapid recovery from late 2009 and are going to register robust growth in 2010. Furthermore, the global economic crisis has prompted East Asian governments to reflect on the recalibration of development models. Equally important, the crisis has generated renewed incentives for East Asian governments to push for deeper and broader regional cooperation, particularly in the domains of trade and financial policy management.

An optimistic scenario to follow these changes include Chinese and East Asian growth that are increasingly driven by domestic demand and intraregional markets, absorbing more exports from outside and thus easing the balance of payment problems of the United States and Europe. But that is a forecast of medium- to long-term growth. Policies proposed by China to rebalance economic activity toward private consumption are only the beginning of a multi-year process and need greater political will. That leaves the region still very dependent on external demand.

The Global Collective Action Problem and the New Multi-Polar World Economy

Currently, the long-awaited global rebalancing is still very far from being realized. Even more so since the world economy operated under a "market-led international monetary system" in which incentives incorporated in it either do not induce any correction of the imbalances or favor serious asymmetry in the global imbalances adjustment process.

Over the 15 years before the crisis, the macroeconomic arrangement benefited both the United States and Asia. In this system, the United States could finance persistent current account deficits by exploiting the role of the U.S. dollar as the international reserve currency; surplus countries could avoid any adjustment by pegging their currencies to the dollar. The United States thus played the n^{th} country role in the system by widening its current account deficits to accommodate the sum of ex-ante external surpluses and deficits of other *n-1* countries given the zero sum game of the countries' balance of payments at the world level. Exchange rate manipulation remained mostly unregulated in this international monetary regime and there was a complete absence of effective remedies against it. In the medium to long run, the macro-system was clearly unsustainable.

Similar macroeconomic imbalances are challenged today because neither the U.S., with its huge debt accumulation, nor any other country is able to play the *n-th* country role in the current international macroeconomic regime. It means that a well-known, serious asymmetry exists in the adjustment process for global imbalances in the current international monetary system. Current account deficit countries must adjust as they run out of foreign exchange reserves and/or financial market-imposed discipline. Surplus countries, however, do not feel pressure to reduce their current account surpluses or to prevent their currencies from appreciating. Therefore, persistent surpluses of China, Japan, Germany and most of Asia will not be mitigated anymore and will produce a lack of global aggregate demand and deflationary bias on the world economy.

There is a classic "collective action" problem in the current multi-polar global economy since export-led growth (neo-mercantilism) is justified at an individual country level. However, at a systemic international level, these mercantilist strategies can generate a world depressionary and deflationary bias. And this is not a cyclical phenomenon but a key feature of the new multi-polar global economy. Current macro imbalances could have penalizing negative effects upon world demand and growth, inducing a game of competitive devaluations which most economies are playing today. Unless a long-term solution is jointly worked out, currency and trade conflicts will worsen and they will become increasingly hard to reverse.

Scenario One: A Painful and Prolonged Pause in Global Growth

In the short to medium term, the resulting lack of global aggregate demand relative to supply—or equivalently, the excess of global savings relative to investment spending—will lead to a weaker recovery of global growth with most economies growing much less than their potential growth rate.

In this instance, current macro imbalances could have penalizing negative effects upon world demand and growth, thus fueling increasing currency and trade tensions among major countries. Even more so since debt-ridden Europe must now come to grips with a fiscal consolidation, economic growth may be restrained for a long period of time.

According to Dominique Strauss-Kahn, IMF managing director, "national and global growth would be slower than many countries hoped because too many were relying on exports to underpin expansion." In a world in which all countries are trying to obtain as large a share as possible of deficient aggregate demand, such conflicts are inevitable. This could lead to risky and worrisome currency and trade tensions between the West and the East, as the former takes action to protect hard-pressed workers while the latter relies on export-led growth as the antidote to poverty and a massive overhang of surplus labor. In the end, the negative consequences for global economic growth would be huge and all nations would suffer.

Scenario Two: International Macroeconomic Cooperation for Global Growth

To avoid beggar-thy-neighbor policies and initiatives, each country should recognize that macroeconomic cooperation is critical. This relates to the aforementioned problem of asymmetry between surplus and deficit countries, which in turn is rooted in the mercantilist attitudes of key major countries. Keynes worried about the potentially damaging effects of global current account imbalances and the fact that market forces were not very effective in compelling surplus countries to adjust.

International macroeconomic cooperation is crucial to achieving higher global growth and is better than most of the other potentially negative alternatives. We should try to restore some shared rules of the game for international macroeconomic adjustment. In this perspective, the agreement reached at the 2009 G-20 Summit in Pittsburgh, the "framework for strong, sustainable and balanced growth," is fine in terms of broad principles but it lacks specifics and enforcement mechanisms.

We need to endorse a strengthened surveillance regime for the IMF to induce coherent mutually compatible macro policies and allow real exchange rates to adjust. Formal thresholds for current account balances are needed—perhaps similar in some ways to the recent U.S. proposal discussed by G-20 finance ministers —beyond which countries would have to correct these imbalances and adjust their policies. In this regard, the IMF should have some sort of enforcement rule incentives and mechanisms. Otherwise, we are going to repeat past mistakes where peer pressure hindered significant results.

Finally, without a greater perception of IMF legitimacy, members of the institution will be reluctant to embrace the mutual consent of the peer-review processes that is necessary for the IMF to be able to meet its regulatory challenges in the future, including the global adjustment process. That in turn will need root-and-branch reform of its governance structure to reflect the changing realities of the world balance of economic power. It is very encouraging that agreement was reached by the G-20 on a reform of the IMF to give a bigger voice to developing countries.