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The G20 in the Aftermath of the Crisis: a Euro-Asian View

This Letter du CEPII draws on the meeting of the fifth Asia-Europe Economic Forum held in Tokyo on 25 March 2010. The forum brought together a broad range of participants including policymakers, academic experts and private sector specialists. This year, the agenda focused on reforms, national budgets, G20 hopes from both Asian and European perspectives. After focusing in the midst of the crisis on the international financial regulation reform, the G20 has launched at the Pittsburgh summit in September 2009 the Framework for Strong, Sustainable, and Balanced Growth. The rebalancing of global growth requires exit strategies differentiated across countries, structural reforms and a better fiscal coordination in Europe. Moreover, a question remains: the G20 has reacted promptly at the height of the crisis, but it has to prove its legitimacy and its ability to achieve reforms although the appetite for coordination decreases.[1]

A changing landscape

2009 saw the global economy switching from recession to recovery. However, the pace of the recovery has been very different across the world, with the divergence between emerging and mature economies growing greater than expected. Europe and emerging Asia are in this respect in clearly opposite situations, while the situation in Japan is closer to that of Europe than to those of its neighbours (Figure 1).

While in the midst of the crisis, the fiscal expansion was the order of the day for all countries, exit strategies now involve a differentiated approach. Meanwhile, global imbalances have been reduced but they remain a major issue (Figure 2). These developments have a bearing on the implementation of the *Framework for Strong, Sustainable, and Balanced Growth* launched at the Pittsburgh summit of the G20 in September 2009. Peer assessment of national macroeconomic and structural policy programmes however remains essential.

One striking novelty of this ambitious approach is that macroeconomic policy is now fully interconnected with structural reforms. The traditional approach to international coordination tends to focus on macroeconomic policy, whereas structural reforms are mostly left to national decisions and implemented depending on political opportunity windows.[2] In Europe, there is a (very moderately successful) coordination of structural reforms but they are essentially assigned to promoting growth and employment and bear no relationship to any external rebalancing agenda. In the G20 framework, however, structural reforms are contemplated alongside macroeconomic policies as ingredients for the rebalancing growth.

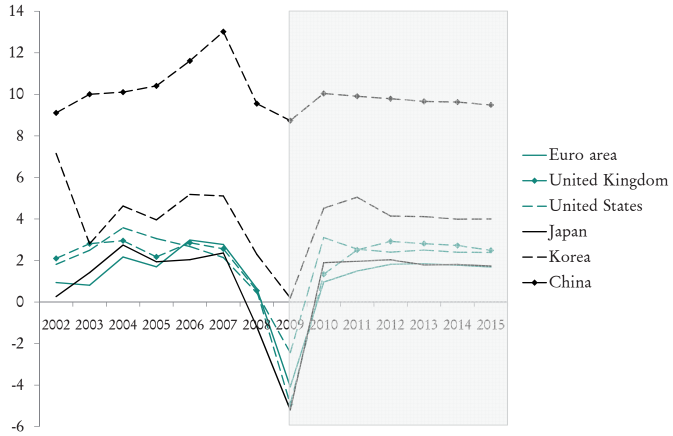
Additionaly, global issues such as the role of the International Monetary Fund or the reform of the international monetary system are increasingly debated as the goal is to create a framework where national policies are subject to appropriate incentives.

Exit strategies: one size does not fit all

Divergence in the pace of economic recovery between emerging and advanced countries has finally rehabilitated the decoupling hypothesis. In China and India, the economic crisis has been short lived, and the priority is not recovery anymore, but to maintain high and sustainable growth rates while avoiding financial bubbles.

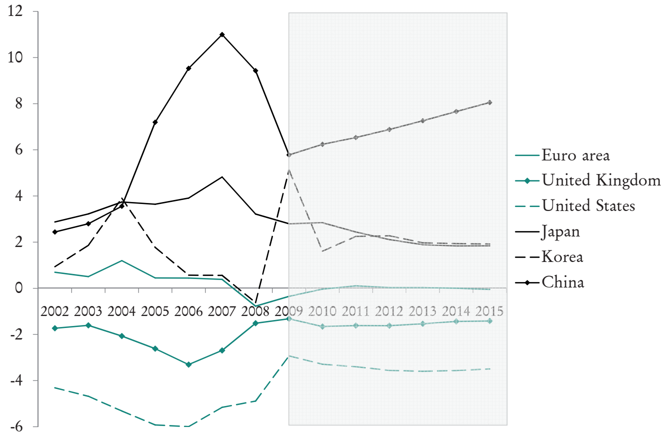
1. All presentations are available at /www.bruegel.org/research/asia-europe-economic-forum-aeef.html. The authors are grateful to the European Commission (DG ECFIN) for having supported the conference and to the Japanese Ministry of Finance for having hosted it. They are also grateful to Benjamin Carton and Hélène Vuillermet for drafting a first version of this paper.
2. This is not an entirely accurate description as G7 coordination in some instances included an emphasis on structural reforms, but the content of these reforms was mostly left to national decisions.

Figure 1 – GDP growth in selected countries and areas
(percentage per year)



Source: IMF WEO, April 2010

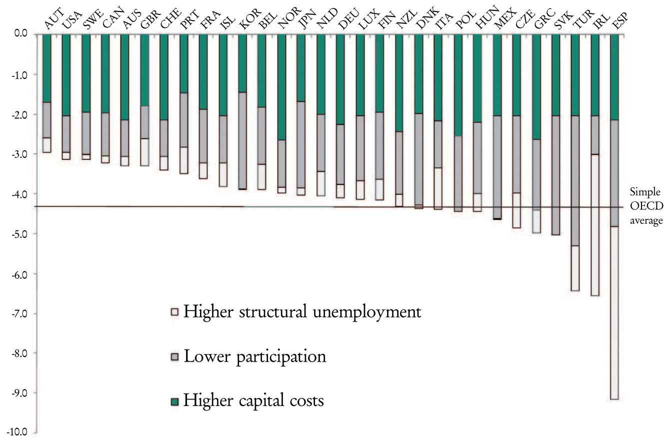
Figure 2 – Current account balance in selected countries and areas
(percent of GDP)



Source: IMF WEO, April 2010

As regards advanced economies, the global crisis may well have a lasting impact on potential output level, although maybe not on potential growth rates. According to the OECD, potential output may on average have fallen by around 4% due to the crisis, and there is considerable variance across countries (the output loss ranges from 3% in Austria and the US to as much as 9% in Spain, see Figure 3). A higher capital cost could account by around 2% of output loss in all countries, the differences across countries being mostly due to asymmetries in the magnitude of the shock and the reactions of the labour markets. The sequencing and timing of exit strategies is crucial, because there is no fiscal space to allow for a second stimulus, in case of a double-dip recovery. Exiting too early would hamper the recovery, and exiting too late would endanger public finance sustainability. Though this trade-off is the same everywhere, the sequencing and pace of the exit differ very much across countries. In Korea, for instance, the government has largely substituted the private sector during the crisis. The exit strategy should then focus on encouraging the recovery of the private sector, in order to reverse this substitution.[3]

Figure 3 – Total estimated peak effect of the crisis on OECD potential output by country, in percent of GDP



Source: OECD (2010), "The impact of the economic crisis on potential output", Working paper No. 1 on Macroeconomic and Structural Policy Analysis, ECO/CPE/WP1(2010)3, February.

In brief, exit strategies from large stimulating macroeconomic policies will differ as resurgent inflation and asset-price bubbles in emerging countries ask for a tightening of monetary policy, while weak private demand and low inflation rate, and the large increase of debt level ask for fiscal adjustment and low interest rates for a prolonged period in mature economies.

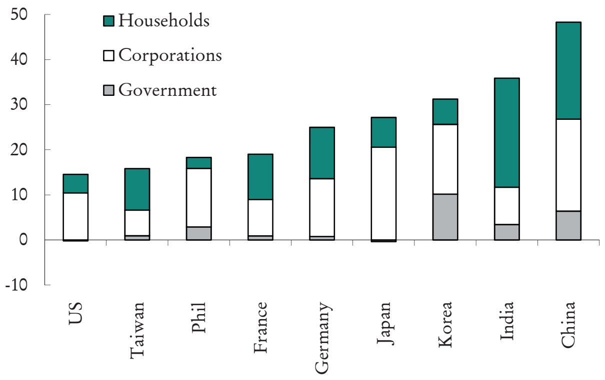
Differentiated situations and policies naturally call for adjustments in exchange rates. Hence, fixed exchange-rate regimes across regions where economic developments differ will be increasingly challenged as the recovery develops. This macro view, rather than the bilateral trade view often held in policy circles, is considered by economists relevant for assessing exchange rate policies. For this reason also, an appreciation of the RMB is no longer seen as a handicap by most of Chinese economists, but their view is that external political pressure will likely delay rather than accelerate a change of policy in Beijing.

Structural reforms and growth

A reduced fiscal space and the desire to normalise monetary policy (even though events do not necessarily favour it), have shifted attention to structural reforms, which are now viewed as being part of the policy mix, including in some cases because of their demand effects. In India, for instance, where there is little space for boosting aggregate demand due to current-account deficits, financial reforms aim at orientating domestic savings towards financing domestic investment, especially on infrastructure, and supply-side policies focusing on the non-tradable sectors are part of employment and anti-inflation policies. In China, the high saving rate is not the result of an anomaly specific to households, firms or the government: China is unique in piling up large savings

3. From the presentation by Jae-Young Lee, "Korea: Growth Recovery and Exit Strategy".

Figure 4 – Savings 2005-2007, in % of GDP



Source: Guonan Ma (2010), "China's high saving rate: myths and realities".

from the three sectors simultaneously (Figure 4). This calls for complementing the measures directed to the households (especially the building up of a universal social security system) with structural reforms of the financial sector and of the government sector (for instance to better channel central revenues to the local governments).

Budgetary policy

As regards Europe, the question today is how to restore fiscal sustainability while carrying out structural, growth-enhancing structural reforms. It is now recognized that macroeconomic surveillance has failed in the EU over the last decade, in part because it has not been effective enough and in part because it was excessively focused on public savings, while neglecting private behaviour. For instance, while the real estate bubble was building up in Spain, public action in order to curb the surge in prices was dismissed by the Spanish authorities on the grounds that it would have distorted private behaviour. With the bursting of the bubble and the global crisis, the fall in GDP and tax revenues were so pronounced that public finances suddenly moved from a 2% of GDP surplus in 2007 to an 11% deficit in 2009. The cases of Ireland and the UK are even more spectacular, as gross public debt increased stepwise as the governments had to massively recapitalize the banks.

Hence, a lesson from the crisis is that it is a mistake to focus only on public sector balances, since the private sector may not save optimally: fiscal, tax and regulatory policies can help providing right incentives for private savings, particularly regarding pensions and house prices.

The international monetary system

Whether the international status of the US dollar and the exchange-rate regime of China have been important causes of the global crisis is still hotly debated in academic circles. Still, the most popular view is that the crisis resulted from a mix of misguided micro and macroeconomic policies, including too low interest rates that may have partially resulted from the functioning of the international monetary system.

As to the agenda, the debate is still relatively quiet. The most widely held view among economists is that the US dollar will remain the dominant currency for a long time. Although they admit a move to a multi-polar system to be likely in the long run, this appears to them as a remote perspective.

One reason for such a view is that the euro is not considered as a compelling competitor to the dollar. When the dollar overtook the pound,[4] the move was consistent with the relative dynamics of the two countries in the global economy. Today, the euro area is by no way a more dynamic zone than the United States and even if it is able to reform and grow, its share in the world economy is set to shrink in the decades to come. As for the renminbi, it is based on a strong, fast growing economy but cannot gain international status before its complete convertibility is achieved. Hence, the status quo may last for some time.

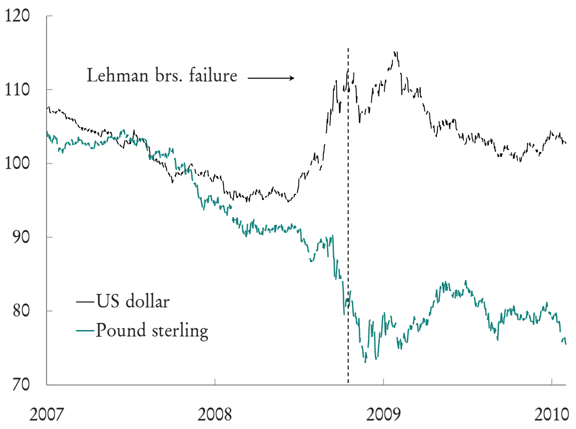
Additionally, some features of the international monetary system, such as the technicalities of the Chiang Mai scheme, continue to encourage reserve accumulation in dollar. As a matter of fact, the evolution of the exchange rate of the dollar since the fall of Lehman Brothers status cannot be understood without the help of the safe-haven hypothesis.[5] A comparison with the British Pound is in this respect telling as the two countries broadly suffered from the same type of shock at the same moment (Figure 5).

The debate on the comparative stability of a multicurrency monetary system and a system that relies mostly on a single currency has not been decided so far. The theory of hegemonic stability argues that a system organized around only one currency may be more stable insofar as the country issuing the international currency accepts to internalise externalities and take on more than its share of the burden of maintaining global stability.[6]

The problem with this theory is that it can hardly be argued that the United States has been taking more than its share in maintaining global stability. Additionally, its share in world GDP is declining, which reduces the scope for the stability of

4. .The date of this shift is still very much controversial, from the 1920s to the Second World War. See Barry Eichengreen, "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading International Currency?", National Bureau of Economic Research (NBER), working paper 14154, July 2008.
5. See A. Bénassy-Quéré (2009), "The Dollar: Unsafe Haven", *La Lettre du CEPII*, No 989, July.
6. See C. Kindelberger (1973), *The World in Depression*, University of California Press, and for a critical discussion B. Eichengreen (1987), "Hegemonic Stability Theories of the International monetary system", NBER Working Paper 2193.

Figure 5 – Nominal effective exchange eates of the US dollar and the pound sterling in the crisis



Source: Federal Reserve, BIS. Last observation: 9 March 2010. Note: nominal effective exchange rates (US: 27 currencies; Pound sterling: 58 currencies).
* From the presentation by Frank Moss, "Global currency constellations".

a system based on the US dollar.[7] Conversely, a multipolar system may yield more exchange-rate instability due to higher substitutability across key currencies. However such instability may be easier to live with due to enhanced portfolio diversification and possibly regional arrangements.

Governance

At the Pittsburgh G20 summit in September 2009, it was decided to make the G20 the main international coordination forum for economic policy and financial regulation. Was it a good decision in view of the fact that the agenda from the previous summit in London in April 2009 had still not been entirely implemented? The G20 in 2009 succeeded in organising a common reaction to the crisis and it initiated an ambitious revamping of financial regulation. However the momentum to cooperate has weakened since the green shoots of the recovery have been observed.[8] Nevertheless the G20 has burdened itself with a new, difficult task: the rebalancing of global growth.

Although it is surely too early to assess the achievements of the G20, two weaknesses are worth noting.

First, the G20 remains an informal grouping without a permanent secretariat. Some argue that the flexibility of the G20 is the necessary condition of its effectiveness. However flexibility may be more valuable in the middle of the storm, when reacting to immediate threats is at stake, than when the storm is over and the focus moves to avoiding the next one. In the latter case, some structure may be useful to regularly remind heads of states and governments of their commitments.

Second, although obviously more representative of economic power and world population than the G8, the G20 lacks legitimacy compared to international organizations such as the UN or the Bretton Woods institutions. Indeed, most countries in the world are not represented at the G20. This was not a problem for the G7/G8 as it was clearly not representative of the world at large but it is a problem of the G20 which is at the same time too large for a club and too small for a representative body.

One possibility that has been discussed could be to organize representation on a regional basis. This would make sense especially when global imbalances or the international monetary system are at stake. However, such move would probably weaken the effectiveness of the G20 as it would turn it into an information-sharing rather than decision-making forum and weaken the heads of states and governments' ownership in it.

Although it was declared the premier forum for international coordination in Pittsburgh in September 2009, the G20 does not yet have an established future. Its future as the key international-coordination device depends on its success in carrying out three major undertakings: (i) achieve the ambitious revamping of international finance; (ii) carry-out the global-rebalancing agenda while introducing new incentives to avoid a repetition of leverage-cum-South-North capital flows spiral; (iii) organize an effective dialogue with those countries that have been left aside from the G20 but nevertheless will be strongly impacted by G20 action along the points mentioned above.

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7. J. Pisani-Ferry (2009), "China and the world economy", Bruegel.
8. The unambitious chararacter of the G20 ministerial communiqué of April 2009 is telling in this respect.

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