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Which Preconditions for Global Growth and Employment?

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Introduction

Before entering the specific topic I have been assigned, let me start with a general remark about this seminar, starting from the title "G20: an accountable agenda?" The European Union is a full member of the G20, in the sense that it is one of the 20 members. It's not an observer, nor an added member as for the G8 or other groupings. The EU is represented by the Commission and the Presidency of the EU. The best way to achieve accountability is thus for the European Parliament to hear, before each meeting of the G20 – in its various formations, from the Heads of State and Government to the Ministerial meetings – the representatives of the EU and discuss with them the positions that they intend to take. Given that also 4 EU member states are also members of the G20 (Germany, France, UK and Italy), it would also be useful to know to what extent the EU representatives have coordinated their positions with the other four members, and the scope for disagreements. Experience shows that the EU and its members are most effective when they represent a united front.

Coming to the main topic of this panel, i.e. the imbalances in the world economy, the global economy never looked so fragile, less than four years after the start of the global recession experienced in the aftermaths of Lehman brothers' bankruptcy. This poses a series of challenges for the G20 cooperation process, that I would like to examine in this short note.

I will start by examining the main imbalances prevailing in the world economy, and the main factors of fragility for global growth and employment. I will then turn to the policies which have been put in place, and assess progress achieved so far at the national and international level, in particular within the G20 framework, with a view to address these imbalances and create the conditions for sustained growth.

Let me start with the factors of fragility in the current environment. I will examine four.

The euro crisis

The first one is the most evident, and relates to the euro area.

Being in Brussels, I will not elaborate too much on the main factors which have led to the crisis, but will rather focus on the potential for contagion and the main political difficulties which have been experienced in addressing the problem, both within Europe and at the global level.

Let me start with contagion. Contagion can be observed every day across various financial markets. The correlation between the price of several asset classes – equities, fixed income, commodities – has increased enormously over the past months. Political factors, affecting both the core and the periphery of the euro area, have gained a prominent role in influencing prices, even in distant markets.

In fact, contagion goes much beyond the short term financial developments and affects the real economy, through various channels.

A first channel is the increased risk aversion at the global level which has been generated by the uncertainties affecting the euro area. This translates into large capital flows to safe havens, with investments being diverted towards low yield assets such as US Treasuries or German Bunds and away from risky assets, including capital investments. Several companies around the world are filled with cash but are reluctant to invest because of the high uncertainty associated with the possibility of a catastrophic tail event with unknown consequences.

A second channel is the psychological effects created by the situation in crisis countries such as Greece and the fear that similar consequences could spread to other countries. The wide reporting of near panic behaviour generates fear even in very distant location. Such a contagion was experienced already in 2008, after Lehman brothers' failure. It encourages precautionary savings, demand for cash and bank withdrawals.

A third channel consists in the loss of confidence among market participants, which derives from the uncertainty about the creditworthiness of counterparties, financial or non-financial institutions. This leads to a drying up of the markets and a credit crunch. In the Fall of 2008 world trade collapsed as a consequence of such fears.

Finally, the sovereign default which would follow an event like the exit of Greece from the euro area would put into question the creditworthiness of all countries, not only in the euro area. Sovereign risk would rise across the board.

These factors would transform a euro crisis into a world depression. The impact would be greater than what happened after Lehman, because of the public nature of the crisis and the current more fragile state of public finances in the advanced world. After Lehman's bankruptcy, most advanced economies committed – at least for some time and in a rather credible way - to defend the savings of their citizens. Such a commitment would not be credible any more, given the state of public finances in most countries.

The domino effect produced by a euro crisis would not be limited to the euro area itself but would extend to all countries with high public debt. The world economy would most probably turn into a recession.

Emerging markets, which played an important role as shock absorber in the 2008-09 recession, are today in a less robust situation, with their economies slowing down substantially and policy authorities having lost most of their room for manoeuvre.

Fiscal challenges in other Advanced economies

The euro area is currently facing the greatest difficulties in de-leveraging from the excessive indebtedness of the private and public sector. This is due in part to the self-imposed prohibition to monetize the debt, which exclude the use of inflation as a way to solve fiscal problems, and the confidence lost by market participants towards several countries. In other parts of the advanced world, Governments are still able to borrow from the markets at very low interest rates, in spite of their record high deficits and rising debts. The ease with which the debt is being financed is taking away the pressure from Governments to adjust. The debt to GDP ratio is projected to increase over the next few years, especially in Japan and the US, but also in the UK.

The situation as such is not sustainable. The low level of interest rates cannot be assumed to persist for ever. It is partly due to the high degree of risk aversion at the global level and the capital flight towards safe haven. A return to normal interest rate levels has to take place sooner or later, unless we think that financial markets will remain in a state of repression for a long time. This should happen independently of the growth scenario.

If, on the one hand, growth strengthens and the recovery picks up, the expectation of a prolonged period of very low levels of interest rates may have to be revised. This would lead to an upward shift in the yield curve and a fall in the price of fixed income. If, on the other hand, growth remains subdued, the budgetary situation becomes more difficult and costly to correct and the adjustment of the debt ratio may be further postponed. Markets may start doubting the safety of Government bonds and to reassess credit risk.

In both cases investors holding low yield assets would suffer a capital loss. Markets participants seem to be aware of this risk, but they may think that they can exit these investments before the other market participants and avoid the loss. This can obviously not hold for all participants. When the first signs of generalised sales will spread even larger sales will follow, leading to selfreinforcing market dynamics which could produce overshooting and massive losses.

In both cases financial markets could suffer severe disruption, with potential large contagion to other parts of the world.

Past experience shows that the next crises tend to come from prolonged optimism and generalised under-appreciation of risk, which leads a large portion of the market to concentrate long positions in low yield assets, without sufficient hedging. This type of imbalance I financial markets may currently be underestimated.

Commodities' markets

The adjustment in advanced economies is made more difficult by the trend change in the terms of trade, resulting in particular from the increase in commodity prices. Such a trend derives from the increased demand for such products by Emerging and developing countries, which are expected to grow at a faster pace over the coming years. Unless supply increases at a similar pace, as a result of technological progress, prices of primary commodities should be expected to increase in line with the world economy.

This will affect countries differently, depending on their access to natural resources. The US, for instance, is expected to benefit from the possibility to extract shale gas and oil at relatively cheaper costs than Europe.

The change in the terms of trade will reduce growth potential for several advanced economies, thus making the needed fiscal adjustment more painful over the medium term.

In several Emerging markets, which benefit from natural resources, the favourable terms of trade is providing for a source of growth, but at the same time also factors of fragility. There is a risk of relying excessively on these products to support growth, while other sectors may be at a disadvantage, especially if protected from international competition. This may generate some form of Dutch disease in several countries, with growth in the sectors related to primary commodities displacing employment in other sectors, thus increasing the degree of specialization of the economy. This may make these economies more fragile, especially in the face of shocks.

This may be the case in Latin America, Africa and countries like Russia.

An important development in the oil market comes from the discovery of new fields and techniques in several countries, in particular Brazil, the US, Canada. This reduces the oligopolistic power of OPEC. Interestingly, most of the largest producers are now in the G20, which may make this forum a relevant one for the interaction between producers and consumers and for developing a more efficient energy market.

Global imbalances

As a result of the factors above, international payments imbalances remain large. The Current account deficit of the US, although lower than in 2006-07, is projected to remain above 3% of GDP for some time. The surplus of Emerging Asian economies is projected to decrease slightly but to remain high. Other Emerging markets areas, like Latin America and Eastern Europe are projected to show a deterioration in the current account. Fuel exporters' surplus is also expected to decrease steadily.

In the capital account sector, in spite of the developments recorded in Emerging markets, there is a shortage in the supply of safe assets, which induces investors, either in the public or private sector, to purchase safe assets mainly in industrial countries, in particular those considered as safe haven.

This trend has been accentuated by the recent tendency in Emerging markets, in particular Latin America, to restrict capital inflows, in the fear that these would produce an undue appreciation of the exchange rate and an asset price bubble.

Exchange rates have not been allowed to adjust in order to facilitate the reduction of imbalances. Underlying fundamentals would suggest that countries with faster productivity and income growth should experience an appreciation of the exchange rate. This would avoid an overheating in Emerging markets and allow for a quicker recovery in advanced economies.

Without such re-equilibrating forces, advanced economies have to implement stronger stimulus, in particular of a monetary nature, which pushes interest rates to very low levels and in turn fuels capital outflows towards Emerging markets. This creates a vicious circle.

In current circumstances, the prevailing rigidities in the foreign exchange market is especially penalizing the euro area. Several euro area countries are in a recession, while at the same time recording current account imbalances. The malfunctioning of the money and financial markets in the euro area does not allow the capital surplus to finance appropriately the deficit countries. A depreciation of the euro would ease the adjustment in the latter, improve the prospects for recovery and release financial tensions within the euro area, which would benefit global financial stability.

Capital flows from Emerging economies towards the euro area are concentrated mainly on those countries –like Germany - which already benefit from relatively favourable financial conditions. This creates two type of distortions. First, it maintains the euro exchange rate at an artificially high level. Second, it widens the spreads between low and high yield government bonds.

In this context, the euro is suffering from the lack of a unified representation in international fora where exchange matters are discussed and decided. Progress in this field, especially on the side of the Eurogroup, is essential for Europe to pursue its interests at the global level. I will come back on this issue below.

Policies to address imbalances and global fragilities

After the 2008-09 crisis the international community has equipped itself with a new instrument of coordination, in the context of the G20. The MAP is a key part of this process.

The system is more efficient than the traditional IMF surveillance alone, which was mainly of a bilateral nature and lacked some form of consistency check and ownership. The MAP is more of a bottom-up approach, which complements the traditional top-down IMF framework. Consistency checks are made by the IMF.

How did it work so far?

A long time has been wasted to agree on a system of indicators that would trigger closer surveillance and early warning. That is part of the cost to be paid when starting a new system, with a broader and more representative set of countries. Buying in their consensus and confidence requires time. There is now a common language and a common framework to address international issues.

The system maintains two shortcomings, which are to some extent unavoidable.

The first is that policy makers continue to take decisions mainly aimed at national objectives. This is linked to the fact that policy makers are elected, or appointed, on the basis of national platforms. It is very difficult to bring international issues in national policy debates, if not for scapegoating, and to explain that cooperative solutions at the international level may be preferable to national ones.

Large countries are the most affected by the domestic bias of the political debate. This has always been a limit, even to the IMF’s bilateral surveillance that was always taken more seriously by small players than large players. Ultimately, it depends on the independence of the IMF and the willingness of the other shareholders to put pressure on large countries so that they appropriately take the international repercussions of their actions in their internal decision making.

Some progress has been achieved. For instance, the whole issue of currency wars, raised by some Emerging markets, in particular Brazil, has raised the awareness of the spill-over effects of the very expansionary monetary policy conducted in advanced economies, in particular the US, on the international capital markets and on exchange rates. It is not clear whether these discussions have led to change the policy stance. To some extent the polemic was not directed at the right target. As mentioned previously, the main cause of the international monetary imbalance comes rather from the pegging of the exchange rate by some Emerging markets to the dollar and the euro, which prevent the relative price adjustment between advanced and Emerging economies and thus leads the monetary authorities in the former to provide extra stimulus.

Another example is the pressure which has been made over the last few years on euro area countries to adopt lasting and credible measure to overcome the crisis in the euro area. At every G20 meeting the euro members are called to increase the firewalls against contagion and implement the adjustment measures, especially in the banking system, in order to calm the markets. The G20 has been instrumental in fostering an increase of the IMF resources to help countries, or currency areas in difficulty and limit contagion to the rest of the world.

The persistent crisis in the euro area shows nevertheless that the ability of the G20 to influence domestic decision making remains limited, although not negligible. Further work needs to be done to strengthen the influence of the G20.

The second limitation of international cooperation, including in the context of the G20, is the inability to address issues of time inconsistency, which tend to make policy makers more attentive to short term objectives rather than longer term issues. In the present context, the main objective of policy cooperation seems to be that of getting back as quickly as possible to the situation prevailing before the crisis, especially in terms of growth and unemployment. This tends to give prominence to policy recipe which aim at stimulating growth over the short term, even if this may add to imbalances over the medium term. The reference to credible medium term fiscal strategies remain vague. Priority to anchoring of long term inflation expectations is often counterbalanced by recommendations of implementing stimulative monetary policies over the short term.

What is not being discussed is whether the growth targets set for economic policies are sustainable over the medium term, or whether they are excessively optimistic.

The crisis of 2008-09 suggests that the growth paths achieved over the previous years were not sustainable. They were supported by excessively expansionary monetary and fiscal policies, unjustified wage growth expectations which fuelled excessive debt, domestic and external. This means that the pre-crisis situation was neither balanced nor sustainable. Trying to go back to that situation as quickly as possible, with all means, may lead us to make the same mistakes again.

The current fragile state of recovery in most countries, growth and employment being below target, is interpreted by some as the result of an insufficient monetary and fiscal stimulus. The opposite interpretation is that the stimulus is ineffective because unbalanced and affects the behaviour of economic agents in an unexpected way. In particular, adding new debt to the already high level of existing debt, public or private, does not necessarily induce economic agents to spend more, and thus to stimulate growth.

Thus more effort is needed, also in the context of the G20, to define the medium term conditions for balanced growth, and align the short term policy options accordingly.

The Challenges for the euro area

The euro area has two main tasks within the current G20 coordination framework.

The first is to put its house in order. I will not elaborate on this issue, knowing that it’s easier said than done. However, if the euro area wants to be considered as such, and be an active member of the international community, it has to behave accordingly, instead of exposing itself to criticism for not being able to deal with its problems.

The second task is to better promote its own interests, in the various fields of international cooperation, from trade to finance, exchange rates and macroeconomic adjustment. There is a lot of room for the euro area to improve in this field. The way in which the euro area is represented is one of the key issues. At present the four largest countries sit at the G20 table, together with the representative of the Commission and the EU Presidency. This is not very effective, for a series of reasons.

First, while some issues are of interest mainly to the euro area, like exchange rates, others, like trade, are the competence of the EU at 27. Coordinating the various policies affecting these fields is difficult, but necessary.

Second, the Eurogroup, which represents the finance ministers of the euro area, is not sufficiently present in international fora. It is actually absent from the G20, although it participates in some bilateral meetings and in the G7.

Third, European issues are increasingly taking the top of the agenda of IMF meetings, with European countries now being the main receivers of IMF assistance. This requires that the European – especially euro area – representation in the IMF become more effective, while Emerging markets are becoming increasingly nervous about the rather favourable way in which Europeans are treated by the IMF. Currently euro area countries’ representatives are dispersed across different constituencies in the IMF executive board. Some regrouping is necessary to be more effective, and over time a single representation is the rational step forward.

Conclusions

The euro area crisis is one part of the global imbalances which have remained unresolved after the Great Recession. If unresolved, it would jeopardize the fragile state of the world economy. As for other sources of imbalances, the adjustment would be more efficient if it involved a joint cooperative effort, involving in particular policies which are currently adding to the distortions in international capital and trade flows between Emerging markets and Advanced economies.

What is certainly required is a more efficient representation of the euro area in international fora and groupings, where these issues are discussed, staring from the IMF and the G20. This is part of the further steps in the process of political integration that Europe needs to make, and the world is waiting for.

Thank you for your attention.