## The G20 in the aftermath of the crisis: a Euro-Asian view[1]

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### A changing landscape

In 2009 the global economy switched from recession to recovery. However, the pace of the recovery has been very different in different parts of the world, with the divergence between emerging and mature economies becoming greater than expected. Europe and emerging Asia are in this respect in clearly opposite situations, while the Japanese situation is closer to that of Europe than to those of its neighbours (Figure 1 on the next page).

In the midst of the crisis, fiscal expansion was the order of the day for all countries, but exit strategies now involve a differentiated approach. Meanwhile, global imbalances have been reduced but they remain a major issue (Figure 2 on the next page). These developments have a bearing on the implementation of the *Framework for Strong, Sustainable, and Balanced Growth,* which came out of the Pittsburgh G20 summit 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 are implemented depending on political opportunity windows[2]. In Europe, there is a (very moderately successful) coordination of structural reforms, but they are essentially targeted at the promotion of growth and employment and bear no relationship to any external rebalancing agenda. In the G20

[1] This policy paper draws on the meeting of the Asia-Europe Economic Forum held in Tokyo on 25 March 2010. 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 supporting the conference, and to the Japanese Ministry of Finance for hosting it. The authors 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.

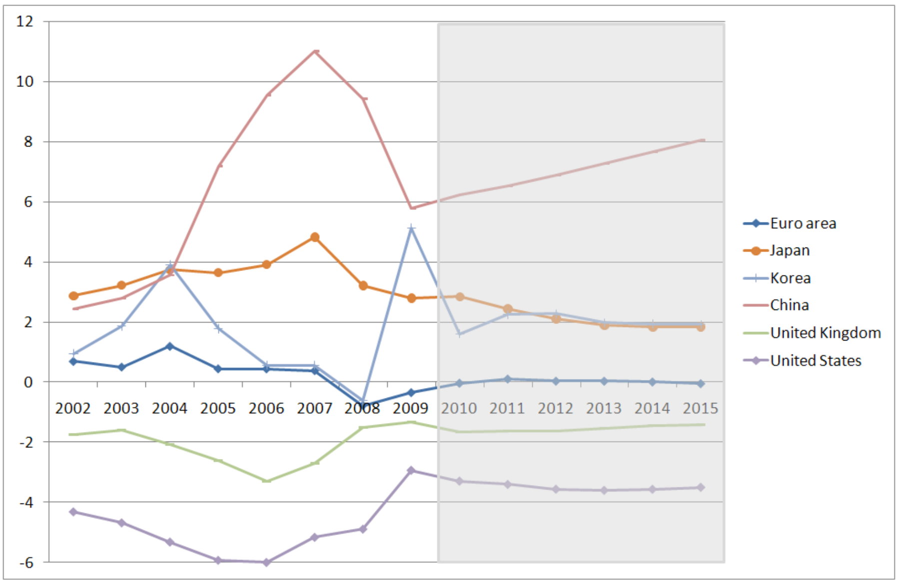
framework, however, structural reforms are contemplated alongside macroeconomic policies as ingredients for the rebalancing of growth.

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

**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)**



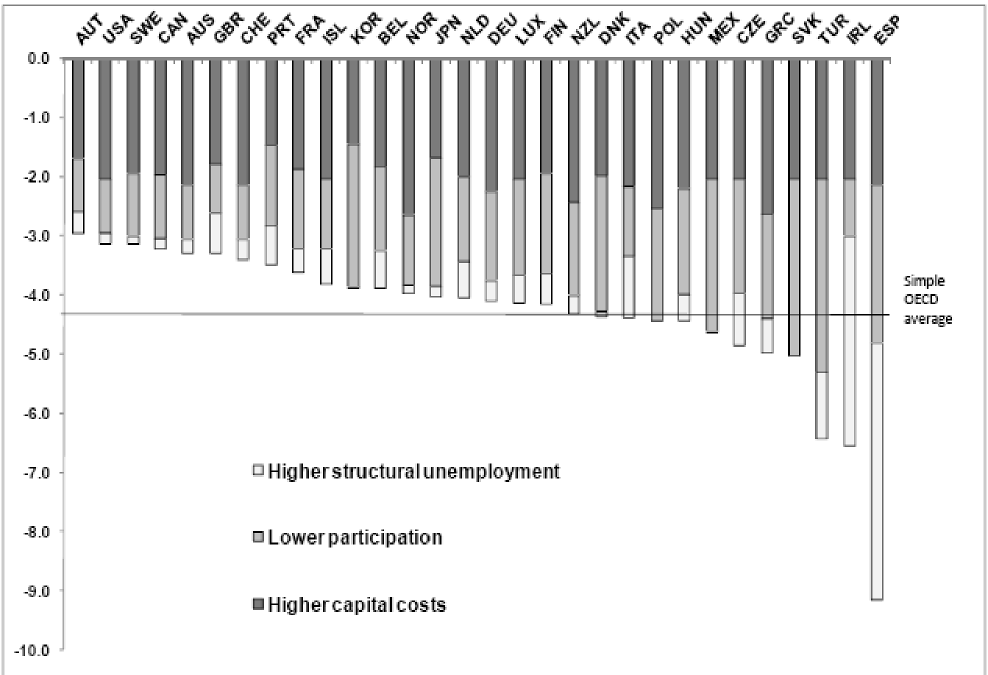

Source: IMF WEO, April 2010

**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 no longer recovery, but maintaining high and sustainable growth rates while avoiding financial bubbles.

For advanced economies, the global crisis might well have a lasting impact on potential output levels, although maybe not on potential growth rates. According to the OECD, potential output might on average have fallen by around four percent as a result of the crisis, and there is considerable variance across countries (the output loss ranges from three percent in Austria and the US to as much as nine percent in Spain, see Figure 3). A higher capital cost could account for around two percent 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 the sustainability of public finances. Though this trade-off is the same everywhere, the sequencing and pace of the exit differ very much between countries. In Korea, for example, the government has largely substituted for 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 Party No. 1 on Macroeconomic and Structural Policy Analysis, ECO/CPE/WP1(2010)3, February

[3] From the presentation by Jae-Young Lee, 'Korea: growth recovery and exit strategy'.

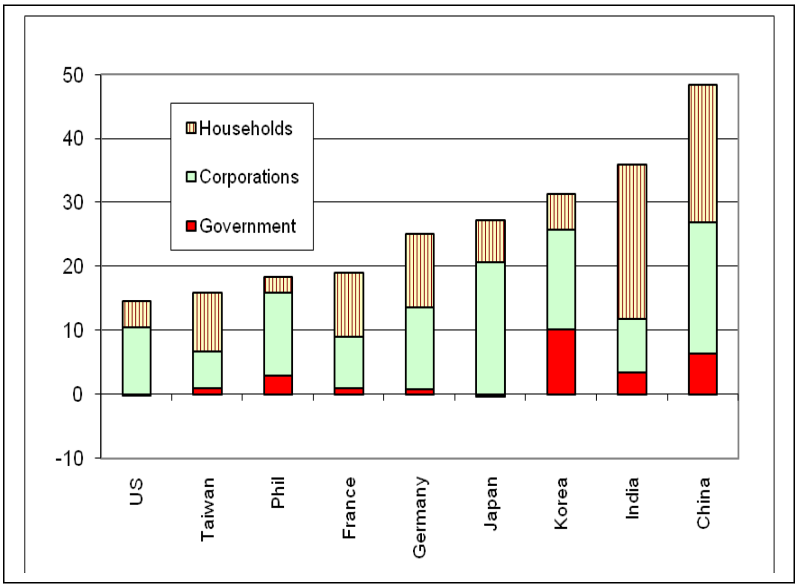
In brief, exits from large-scale, stimulating macroeconomic policies will differ as resurgent inflation and asset-price bubbles in emerging countries lead to a tightening of monetary policy, while weak private demand and low inflation rates, and the significant increase of debt levels lead to fiscal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

Different situations and policies naturally call for adjustments to 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 renminbi is no longer seen as a handicap by most Chinese economists; 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, in some cases because of their demand effects. In India, for example, where there is little opportunity for boosting aggregate demand because of current-account deficits, financial reforms aim to direct domestic savings towards financing domestic investment, especially for infrastructure, and supply-side policies that focus on non-tradable sectors are part of employment and anti-inflation policies. In China, the high savings rate is peculiar to households, firms or the government: China is unique in piling up savings from the three sectors simultaneously (Figure 4). This calls for complementing the measures directed at households (especially the building up of a universal social security system) with structural reforms of the financial sector and of the government sector (for example, better channelling of central revenues to local governments).

**Figure 4: Savings 2005-2007, in % of GDP**




Source: Guonan MA, 'China's high saving rate: myths and realities', forthcoming

## Budgetary policy

For Europe, the question today is how to restore fiscal sustainability while carrying out growth-enhancing structural reforms. It is now recognised that macroeconomic surveillance has failed in the EU over the last decade, in part because it was not 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 to curb the surge in prices was dismissed by the Spanish authorities on the grounds that it would distort 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 two percent of GDP surplus in 2007 to an 11 percent deficit in 2009. The cases of Ireland and the United Kingdom are even more spectacular, as gross public debt increased stepwise because the governments had to massively recapitalise 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 in an optimal fashion: fiscal, tax and regulatory policies can help to provide the 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 major causes of the global crisis is still hotly debated in academic circles. The most common view is that the crisis resulted from a mix of misguided micro and macroeconomic policies, including interest rates that were too low, which 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 is likely in the long run, this appears to them as a remote prospect.

One reason for such a view is that the euro is not considered to be a compelling competitor to the dollar. When the dollar supplanted sterling[4], the move was consistent with the relative dynamics of the two countries in the global economy. Today, the euro area is in no way a more dynamic zone than the US and, even if it is able to reform and grow, its share of the world economy is set to shrink in the decades ahead. 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 dollars. As a matter of fact, the evolution of the exchange rate of the dollar since the collapse of Lehman Brothers cannot be understood without the help of the safe-haven hypothesis[5]. A comparison with sterling is in this respect telling, because the UK and the US broadly suffered from the same type of shock at the same time (Figure 5 on the next page).

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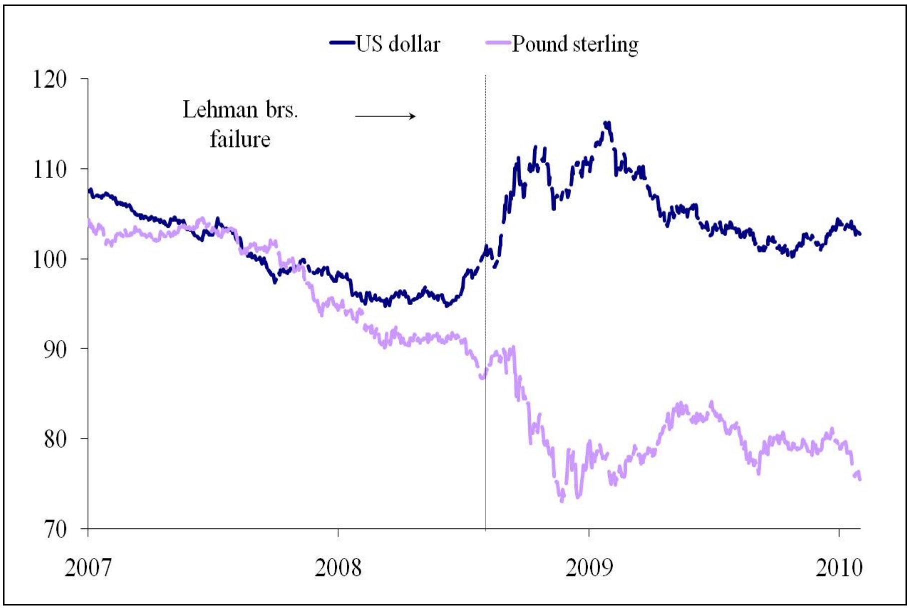
4 The date of this shift is still very controversial, from the 1920s to the second world war. See Barry Eichengreen (2008) 'The rise and fall of the dollar, or when did the dollar replace sterling as the leading international currency?', National Bureau of Economic Research (NBER), working paper 14154, July

5 See Bénassy-Quéré, A. (2009) 'The dollar: unsafe haven', *La Lettre du CEPII* No. 989, July

**Figure 5: Nominal effective exchange rates of the US dollar and sterling in the crisis**




Sources: Federal Reserve, BIS. Last observation: 9 March 2010. Note: nominal effective exchange rates (US: 27 currencies; pound sterling: 58 currencies)[6]

The debate on the comparative stability of a multicurrency monetary system compared to a system that relies mostly on a single currency has not been resolved so far. The theory of hegemonic stability argues that a system organised 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[7].

The problem with this theory is that it can hardly be argued that the US has been doing more than its share of maintaining global stability. Additionally, its share in world GDP is declining, which reduces the scope for the stability of a system based on the US dollar[8]. 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 this 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 response to the crisis and initiated an ambitious revamping of financial regulation. However the momentum for cooperation has

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6 From the presentation by Frank Moss, 'Global currency constellations'.

7 See Charles Kindelberger (1973) *The World in Depression*, University of California Press, and for a critical discussion, Barry Eichengreen (1987) 'Hegemonic stability theories of the international monetary system', NBER *Working Paper* 2193

8 Jean Pisani-Ferry (2009) 'China and the world economy', Bruegel

weakened since the green shoots of the recovery were observed[9]. 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, than when the storm is over and the focus moves to avoiding the next crisis. In the latter case, some structure may be useful to regularly remind heads of state and government of their commitments.

Second, although obviously more representative of economic power and world population than the G8, the G20 lacks legitimacy compared to international organisations such as the United Nations 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 for 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 organise 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 reduce the effectiveness of the G20 as it would turn it into an information-sharing rather than a decision-making forum, and would weaken the heads of states and governments' ownership of it.

Although in Pittsburgh the G20 was declared the premier forum for international coordination, it does not yet have an established future. Its future as the key international-coordination forum 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 the leverage-cum-South-North capital flows spiral; (iii) organise an effective dialogue with those countries that have been left out of the G20 but nevertheless will be strongly impacted by G20 action on the points mentioned above.

[9] The unambitious chararacter of the G20 ministerial communiqué of April 2009 is telling in this respect.