No Clue to the Future*

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Meeting in mid-April on the side lines of the spring sessions of the World Bank and the International Monetary Fund at Washington D.C., Finance Ministers of the G20 countries seemed overcome by a combined sense of despair and fear about the state of the world economy. The Communiqué issued after the meeting describes that state thus: “Growth remains modest and uneven, and downside risks and uncertainties to the global outlook persist against the backdrop of continued financial volatility, challenges faced by commodity exporters and low inflation.” When translated that seems to say the recovery is yet to occur and the prospect of another downturn is real.

The sources of the sense of despair are clear. Though it is eight years since the global financial crisis broke, the world has not put behind the recession that engulfed it. Even the US, which is now expected to lead the recovery, has yet to display evidence of consistent growth over successive quarters. In the event, even numbers suggesting that the deceleration of growth in China is within the expected range are treated as good news.

But this is not the full explanation for the mood of despair. More important is the evidence that governments seem to have no policy levers left to address the crisis. Having flirted with fiscal activism in the immediate aftermath of the crisis, governments gave up on it because of objections that were not necessarily well founded, that such activism was pushing public debt to unsustainable levels. So the main instrument used to address the recession has been monetary policy that combines liquidity infusion with low interest rates and makes cheap credit available. While central banks have been repeatedly resorting to measures aimed at enhancing liquidity in the system, they have also been adjusting policy rates downwards, with the aim of bringing down market rates.

Implicit in this dependence on monetary policy is the idea that private debt at low interest rates would substitute for public debt to revive demand and growth. The problem is that this expected outcome is not being realised, partly because firms and households already overburdened with debt are not confident of raising earnings to levels needed to service additional debt. The flip side of this is that banks and other financial institutions are less willing to lend because of fear of default. Since monetary policy is directed in the first instance at these institutions, the reliance on such policies even when they are not effective has had some bizarre effects. To start with, policy rates set by the European Central Bank (ECB) and central banks in a number of other countries (Denmark, Sweden, Switzerland and Japan, for example) have turned negative. Banks holding deposits with the central bank will suffer losses rather than earn returns (however small). This is expected to force them to find borrowers and lend at whatever positive rate they can garner. In fact, the ECB has gone even further. If banks borrow from it at zero interest rates and use the resources to increase their lending by 2.5 per cent or more, the ECB has promised to pay them the equivalent of 0.4 per cent of what they borrowed from it as interest. The lender pays to get the banks to borrow and lend.

It is not surprising that the failure of monetary policy, even when pushed to this extreme, to deliver growth is leading to a loss of confidence in such policies. Hidden in the bland ‘officialeese’ that ensures that the G20 Communiqué says almost nothing is an admission, if not a warning: “Monetary policy will continue to support economic activity and ensure price stability, consistent with central banks’ mandates, but monetary policy alone cannot lead to balanced growth (emphasis added).” However, that admission is not accompanied by any clear indication of where governments would go, now that monetary policy is not working. There are some signs that the role that fiscal policy can play is being once again recognised,

but the reticence to return to reliance on it is obvious. The Communiqué declares: “Our fiscal strategies aim to support the economy and we will use fiscal policy flexibly to strengthen growth, job creation and confidence, while enhancing resilience and ensuring debt as a share of GDP is on a sustainable path.” In a world facing the prospect of entering a deflationary spiral, that statement implies a commitment not to enhance public spending to any significant extent. Taxes cannot be raised drastically when economies are in recession, and even if they are, slowing growth would partly neutralise the positive effects they would have on revenues. So debt-financed spending by governments is unavoidable if a fiscal stimulus is to be provided. Talk of sustainable debt levels in that context is a reflection of persisting fiscal abstinence.

If a recovery is nowhere in sight, monetary policy is not working and fiscal activism is to be abjured, despair with respect to growth is unavoidable. The point, however, is that the cause of that despair are the governments themselves, who, through their summitry, are unable to arrive at a consensus on how to effectively stimulate a recovery and on the policy coordination needed to ensure that the initiative is feasible.

The result is the picture of a bunch of world financial leaders clutching at straws. One example is the extended reference in the Communiqué to initiatives (such as the OECD’s Base Erosion and Profit Shifting Action Plan) aimed at combating tax avoidance and evasion. Implicit in that discussion is a hope that this could make much difference to the revenues earned by governments and allow them to significantly step up spending. Even if revelations, such as those from the Panama Papers, suggest that avoidance and evasion are substantial, it is hard to believe that those who use that route to save on taxes and see them as legal would stop the leakage. In any case, putting in place systems that work would take time, and there is little time left to address the long-term recession and prevent another downturn.

So to divert attention from the fact that monetary policy is not working and a fiscal stimulus is in order, the drafters of the G20 Communiqué have turned to the adoption of “structural reforms” as a way out of the impasse. What these reforms consist of varies with who is recommending them. But for the conservative lobby within the G20, the so-called structural reform has largely implied deregulation, including of labour markets. Besides absence of any evidence that such reforms can make a difference to growth, especially in the midst of a recession (Greece, for example, provides evidence to the contrary), there is clearly no consensus on the nature of these reforms.

The Communiqué, however, claims that “concrete progress” has been achieved in defining an “enhanced structural reform agenda” and identifying priority areas, based on which a set of principles that would serve “as a reference guide to national reform actions” are to be agreed upon. However, these priority areas and guiding principles “will be applied in a flexible way to allow members to account for their specific national circumstances.” Something, as vague as that, is no plan for action.

In sum, G20 policy makers have no action plan, and hence no clue to the future. That explains the sense of despair. It also leads to a sense of fear. If countries as a group cannot agree to an action plan not just to ensure recovery but prevent a second slump, they may individually adopt beggar-thy-neighbour policies that seek to improve their own condition at the expense of others. One set of such policies, the possible adoption of which has a cause for concern and fear, is some combination of protection and currency devaluation. For example, low or negative interest rates in one country may discourage foreign investment in bonds issued in that country, and the shrinking of cross-border inflows could lead to a depreciation of its currency and adversely affect the competitiveness of its trading partners. But if the currency of one country depreciates, it could set off competitive devaluations elsewhere with damaging consequences for all.

In fact, fears of policies unilaterally adopted that could result in currency depreciation have been rife, as countries seek to individually come to terms with 'their own recession'. One of the successes claimed after the previous meeting of G20 finance ministers in Shanghai in February 2016 was agreement that countries would abjure competitive exchange rate adjustments. That has been reiterated in the more recent Communiqué which states: "We reiterate that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will consult closely on exchange markets. We reaffirm our previous exchange rate commitments, including that we will refrain from competitive devaluations and we will not target our exchange rates for competitive purposes. We will resist all forms of protectionism. We will carefully calibrate and clearly communicate our macroeconomic and structural policy actions to reduce policy uncertainty, minimize negative spillovers and promote transparency."

While such statements may pre-emptively flag beggar-thy-neighbour policies, there is no guarantee that they can prevent them altogether. The longer countries have to make do without growth or experience recessionary conditions, the greater would be the pressure to adopt such policies. This explains the fear of such actions as the period over which the search for recovery is elusive extends. It also explains why even stalling the worst is seen as advance, even when there is no evidence on how or whether things can get better.

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