Workshop on

Restoring Inclusive Growth in Advanced Economies: A Conversation with Economists and Policy Makers from G20 Countries

Long-Term Growth in the United States: Policies and Strategies

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****Views expressed are personal and not those of Ministry of Finance, GOI***

US Growth Prospects

Barry Eichengreen: Stylized Fact I

- Difficulty in estimating shifts in trend growth relative to pre-crisis levels
  - Relevance of the Korean experience
- Deleveraging may not affect growth as much as we might expect (credit intensive activities, i.e financial sector, likely to be more impaired): non-financial corporate bond financing not a problem presently
- No firm evidence to show the investment declines post crisis due to policy uncertainties (tighter regulation)
  - Persistence of unutilized capacity
  - Sectoral overinvestment in the pre-crisis boom, such as residential real estate, makes skill mismatch a problem
  - Stimulus related Infrastructure investment
- Uncertain where global growth would go, but chances are that growth would not be impaired, although there could be a permanent loss in output

Barry Eichengreen: Stylized Fact II

- The causal link between elevated public debt post crises and lower growth is from the latter to the former, i.e little evidence of crowding out
  - Interest rates do not rise as expected because of weak private demand.
  - Deficits aimed at supporting the financial sector may actually help investment

General Comment

- Very interesting insights on what to expect going forward based on recent economic history.
- Too little emphasis on structural changes that are afoot, that may limit the role of past experience in gauging the future, especially
  - Link between demographic transition and trend growth rates: hinted in the Korean experience.
  - Unravelling of Bretton Woods II ?
  - Changes in the role of the financial sector.
  - Greater globalization

Post War Global Economy

- Close link between rising trend growth and globalization.
- Post War boom led to increasing prosperity of the American middle class: US economy over 20% of global GDP.
- Since the 1970s and the export-driven rise of East Asia, manufacturing in advanced economies gradually losing competitive advantage.
- Since capital was mobile, and labour was not, Corporate profitability maintained through outsourcing production and services abroad: jobless growth.

Bretton Woods II

- Inequalities in the US rose sharply: returns to capital rose while returns to labour stagnated. In Europe social protection schemes countered this trend.
- Middle class living standards maintained by
  - Import of cheap East Asian/Chinese goods, and later Indian services.
  - Global savings glut deriving from global imbalances lowered cost of capital and inflated asset prices.
  - American households reduced savings and borrowed against assets for consumption making them global consumer of last resort.
- From being handmaiden to the real economy the financial sector becomes engine of growth in advanced economies

The Euro-zone microcosm

- The US-China imbalance replicated in Europe in the form of the Germany-Southern Europe imbalance
- Currency Union enabled poorer Southern Europe to borrow cheaply at German Sovereign rates
- Being more productive, given the same exchange rate, Germany more competitive than Southern Europe
- Dis-savings, housing bubbles and leveraged demand fuelled German current account surpluses, and Southern Europe deficits, even as the Euro zone as a whole remained a balanced economy.

Towards Bretton Woods III?

- If financial regulatory reform reins in the financial sector, and there is no return to leveraged consumption, there would be permanent demand retrenchment in advanced economies.
- Rebalancing of the global economy would then be necessary to return to former levels of growth: Bretton Woods III
- Rebalancing would hasten global per capita income convergence with attendant trust and peace dividends.

Rebalancing Prospects

- The Japanese experience closely tracks the Chinese: Failure of the Plaza accord: Japanese growth plummeted while external surpluses have not abated.
- Japanese experience makes it difficult to use exchange rate policy for rebalancing: other tools are monetary and fiscal policies.
- Rebalancing could be deferred by fiscal expansion in advanced countries, as is currently happening.

Growth in Advanced Countries without Rebalancing?

- Aggressive and coordinated macroeconomic policies?
  - Monetary transmission affected by uncertainty in financial regulation and private demand (retrenchment of US consumer and fiscal consolidation)
  - Fiscal policy transmission hampered by Ricardian equivalence on high debt concerns
  - Massive liquidity injection and public debt could impair long-term growth prospects
- Structural reforms (OECD's 'Going for Growth Framework')?
  - Would not address demand side problem
  - Political challenges (spate of strikes in Europe)
  - Demographic constraints on growth in advanced countries.
- Labour mobility?
  - Acceptance by civil society: Nation State concept still strong
  - War on terror and security concerns

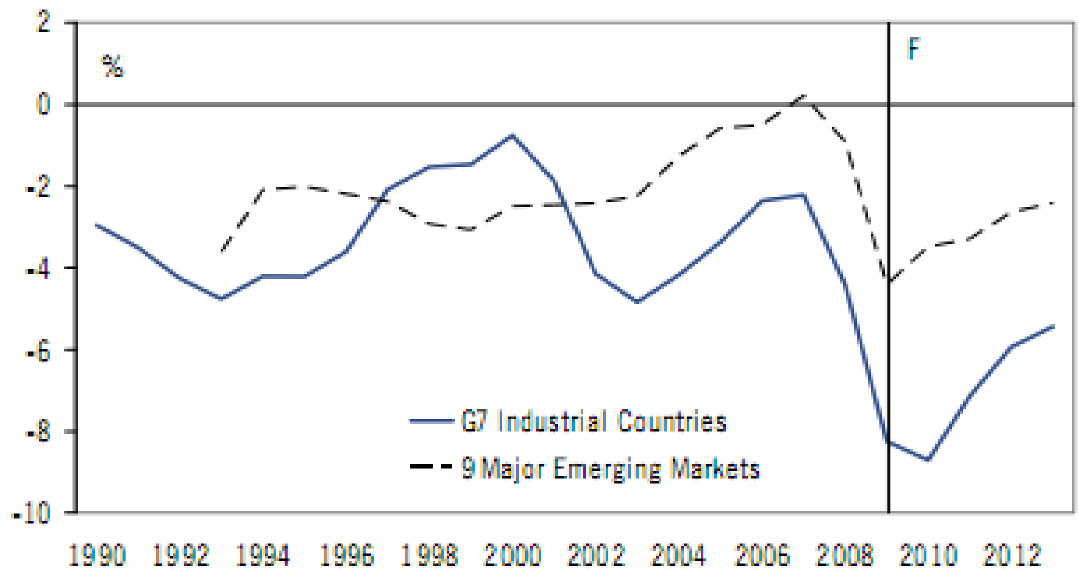
G 20 Initiative on Global Growth: The Framework

- Signature effort of the G 20 at the Pittsburgh and Toronto Summits
- Emphasis on strong sustainable and balanced growth
- G 20 countries divided into groups: advanced deficit, advanced surplus, emerging surplus, emerging deficit.
- Basket of policy tools for each country group so that the upside scenario for the global economy is realised.
- Resolved to move towards country specific action plan at Seoul Summit in November 2010. Divisive?
- Too early to determine outcome of the Framework

Fiscal Policy and the Great Recession

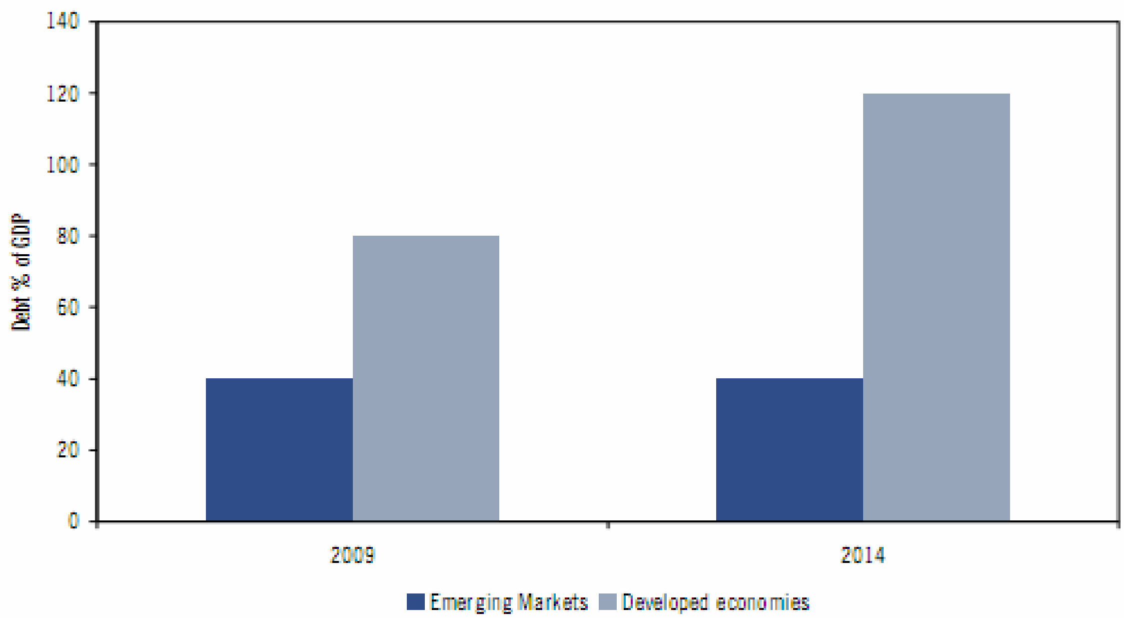
Fiscal Deficits: G 7 and EMEs

Figure 4. Global — Fiscal Deficits in Industrial Countries and Emerging Markets, (% of GDP), 1990-2013F

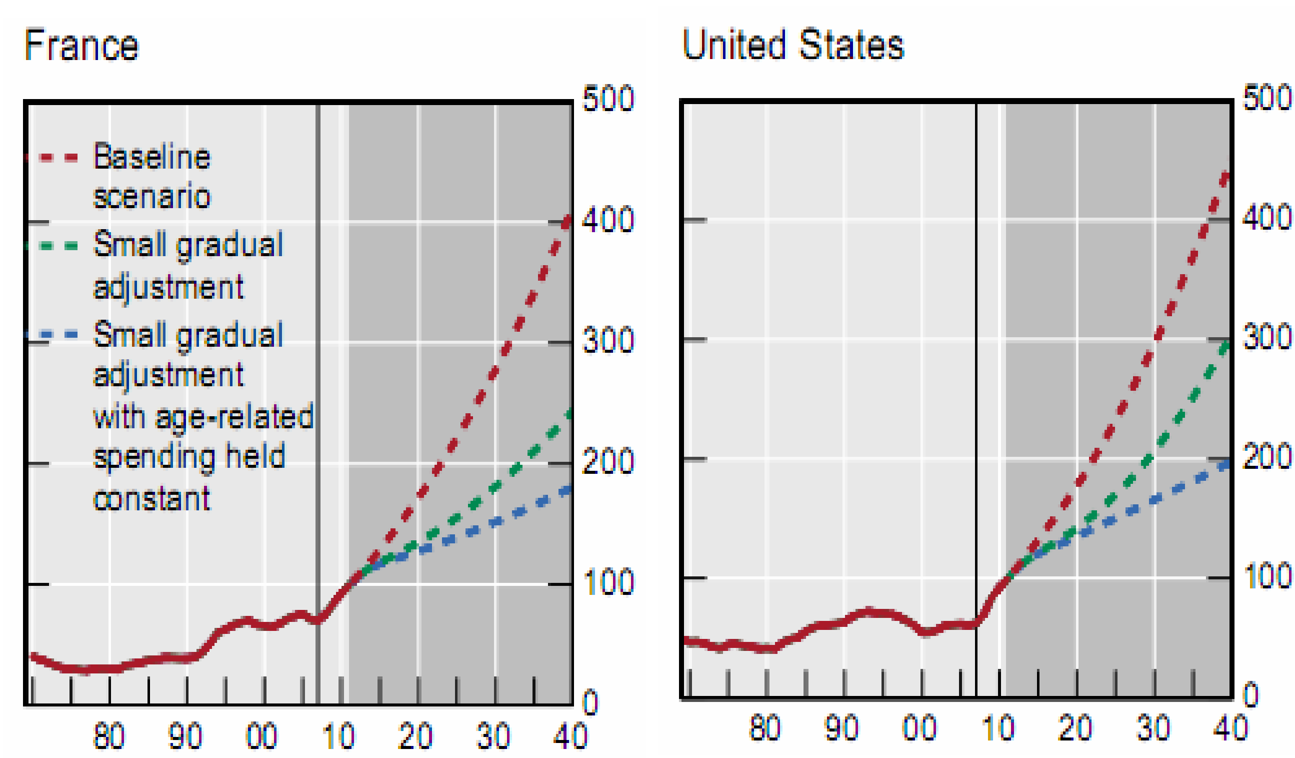


Public Debt: Developed and Emerging Markets

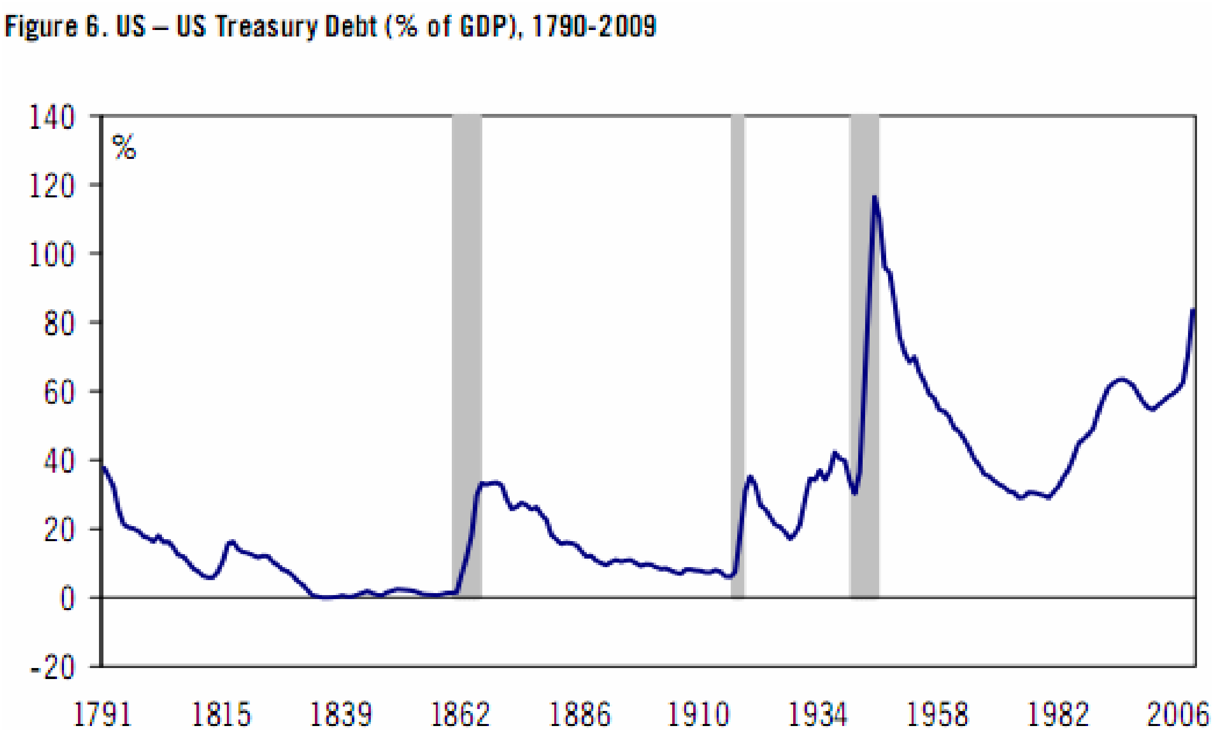
Figure 5. Public debt (% of GDP) in 20 Emerging Economies and 20 Developed Economies, IMF Projections, 2009 and 2014



Fiscal Expansion: BIS Paper



History of US Public Debt



Jeffrey Frankel

- US fiscal policy was not countercyclical prior to the crisis, constraining aggressive fiscal response to the recent crisis.
- EU fiscal rule of capping deficit at 3% too rigid and not countercyclical
- Developing country fiscal policies on the other hand were countercyclical – case of Chile.
- Reversal of past trends: developed countries have forgotten the golden fiscal rule even as developing countries adopted it.
- Developed countries now need to learn from developing ones.

General Comments

- The arguments relating to countercyclical fiscal policy and the upward bias in official GDP forecasts is economically robust but politically difficult to implement.
- The increase in deficits in advanced countries prior to the crisis ***not cyclical but structural*** **: ageing related.**
- In the US the increase compounded by international policing role and war on terror: ***again not cyclical***
- Is Chile's case typical of developing countries? India: decline in fiscal deficits, i.e. creation of fiscal place, almost entirely explained by positive revenue shocks consequent on higher than (***officially projected)*** growth and tax reforms. No conscious expenditure side counter-cyclical policy.
- While using fiscal space developing countries need a trade off between (high growth sustaining) infrastructural investment and countercyclical stance.

Fiscal Lessons for Developing Countries

- Social security and safety nets set up following the Great Depression being unwound now.
- Generous welfare schemes back loaded and affordable when population is young and trend growth high.
- They become unsustainable as society ages and trend growth declines.
- However difficult to renegotiate social compacts.
- Shift focus from social welfare to automatic stabilizers.
- Experience of European Stability and Growth Pact indicates that
  - Fiscal Rules should be counter-cyclical
  - hard budget constraints necessary.

Fiscal Lessons for Developed Countries

- Deficit and debt levels should be calibrated to potential growth
- Growth creates fiscal space.
- Fiscal space likely to be created through revenue increases rather than expenditure reform.
- Fiscal space should be used wisely: for infrastructure not distorting and unsustainable subsidies.

The Fiscal Aftermath of Deep Recessions

- Cyclical deficits widen and public debt typically rises steeply.
- Effective macroeconomic management entails growing out of cyclical deficits and debt.
- Unlike post-war period, current environment not supportive of high levels of debt: Trend growth expected to drift lower because of financial regulation and ageing
- Current levels of public debt in advanced countries unprecedented in peace time:
- Combination of cyclical and rising structural deficits fuelling fears of debt trap and inflationary outcomes.
- Sovereign debt problems compounded by market response to irresponsible macroeconomic management in some euro-zone countries: PIGS

How long can this be sustained?

- Japanese public debt 200% of GDP without crowding out impact because of externally generated private domestic saving. External environment no longer benign.
- US deficits dependent on foreign savings, and hence on continuing global imbalances.
- The tight embrace of US and Chinese economies sustained the pre-crisis ‘goldilocks’ economy.
- Sustainability of the model hinges on the extant international monetary system where dollar occupies the role of the global reserve currency.
- Strategic depth, first mover advantage and continuing globalization makes it difficult to dislodge the dollar.
  - Current crisis has further underscored its status
  - Chinese attempts to diversify into yen drove Japan to buy dollars to defend its currency: result same if China had directly bought dollars!
- European sovereign debt crisis indicates that other countries expand their fisc at their own peril.

Fiscal Policy: Effectiveness

- New Roles:
  - Macroeconomic policy of last resort
  - Stabilizing the financial sector
  - Addressing global imbalances
  - Major role in new forms of protectionism
- Debate over effectiveness: Fiscal multipliers and Ricardian equivalence. Japanese experience not encouraging.
- IMF's 3 Ts: Timeliness, Targeted and Temporary: Difficult to navigate politically.
- Fiscal policy more political than monetary. Easy entry difficult exit. Flogging fiscal policy also leads to loss of monetary independence as central bank has to accommodate.
- Arguably, monetary Policy should be first line of macro-economic defense and fiscal policy the last resort.

Fiscal Policy: Sustainability

- ‘Growth friendly’ fiscal expansion and consolidation: expenditure v/s taxes.
  - Expansion: spend rather than reduce taxes because latter might be saved? (Jeffrey Frankel) But timely exit politically difficult.
  - Consolidation: European experience that expenditure reduction rather than tax increase is more growth friendly.
- Sustainability linked to growth rates: India able to sustain much higher levels of fiscal deficits (over the European Maastricht norm of 3%) and public debt because potential GDP much higher.
- Developed countries have no fiscal space to respond to a second dip while major emerging countries still do.
- Jeffrey Frankel underscores the importance of effective institutional restraints, as in Chile.

Capital Flows and Growth

Capital Flows and Growth

- Development Economics: developing countries should run sustainable CADs to top up domestic savings with capital inflows. However:
  - Recent experience indicates capital flowing uphill
  - Recent research shows little positive correlation between capital flows and economic growth

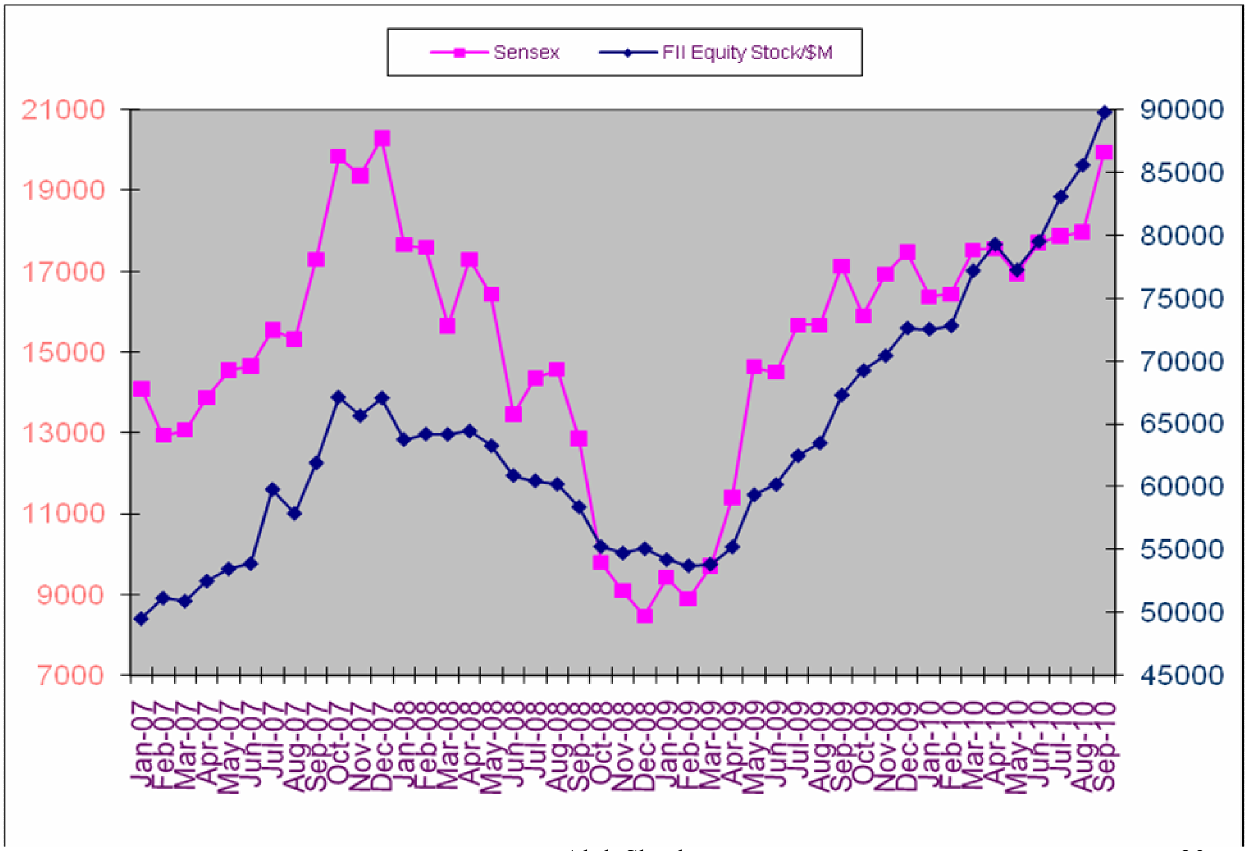
Why Capital Flows Uphill

- Export led growth strategy along with the New 'mercantilism' where holding global reserve currency has replaced bullion as the source of national power.
- Self insurance and 'IMF stigma avoidance' following the East Asian Crisis of 1997
- Demographics (Underscored by David Backus): developed ageing societies become net dis-savers.
- Global reserve currency effect in case of the US.

Recent Problems with K Flows

- Capital inflows far in excess of trade flows: India has accumulated reserves of almost $ 300 billion despite a structural current account deficit of 1-3% of GDP over the last 20 years.
- Volatile (portfolio) component of capital flows increasing
- Adversely impact the real economy through sharp fluctuations in exchange rates
- Queers pitch for monetary management: the impossible trinity
- Awkward timing: Too much when not needed, and sudden stops when required
- US Fed policy impacts direction of flows
- Excess inflows lead to asset bubbles in EMEs

India: Capital Flows and Asset Prices



Addressing the Problem

- Volatile flows have revived talk of 'Tobin Tax': requires high level of global consensus
- Central Bank intervention in currency markets
- IMF's evolving views on capital flows: from recommending capital account convertibility to regulating inflows, including using capital controls as last resort
- G 20 grappling with the issue: Financial Safety Nets work stream, but no practical 'innovative' solution in sight yet. Focus on sudden stop rather than on surge.


Thank You!