The G20 MAP, fiscal austerity and financing for investment

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The G20 leaders’ declaration at St Petersburg called for policies that would increase the momentum of the global recovery, while avoiding policies that could promote growth at the expense of other countries, and at the same time ensuring fiscal sustainability. This paper suggests that fiscal austerity is at present inadvertently leading to policies which promote growth at the expense of other countries. It suggests that the G20 Mutual Assessment Process (MAP) might encourage increased finance for infrastructural investment – partly through public investment and partly through public–private partnerships (PPPs) – in a way which encourages global demand and reduces the macroeconomic pressures created by policies of fiscal austerity. It also suggests that there is an opportunity here to connect the objectives of the G20 economic/finance process with the G20 objective of increasing financing for investment.

The current global macroeconomic position

The Great Moderation came to an abrupt end in 2008, with financial collapse and subsequent deleveraging, and the most rapid decline in economic activity in advanced countries since the Great Depression. Since then, recovery has been slow in the United States, in Europe (both within the euro zone and outside it, including in the United Kingdom), and, until recently, in Japan.

The initial policy response in advanced countries in 2009 was one of fiscal and monetary expansion. But since 2010, fiscal austerity has replaced fiscal expansion. And monetary policy has become unable to respond to the recession, and to the fiscal contraction, as a result of a zero bound. As a result, policy response has turned to quantitative easing (QE).

QE is temporary in its effects – like all monetary policy. But in the interim, QE has led to increased risk-taking of the kind observed at the time of the Greenspan Put, not just as a result of lower short-term interest rates but also because of the lower long-term interest rates which QE has been able to sustain. Economies are vulnerable to the unwinding of these low interest
rates, as concerns about tapering in the United States have shown. Of course, if a sufficiently large private sector recovery were to rapidly emerge, so that a tapering of QE becomes possible without reducing the demand for credit, then a good outcome might be possible. But there is the real possibility that this will not happen. In the absence of such a private sector recovery, an additional source of stimulus appears necessary to prevent a long-lasting period of slow growth.

**Spillovers and policy conflict**

The policy responses which have been adopted since 2010 – fiscal contraction accompanied by QE – were undertaken in the belief that outcomes would be better than they have been. It appears that a failure to predict outcomes occurred partly because of a neglect of international interactions, and, in particular, through a failure to realise that these policies had the effect of promoting growth at the expense of other countries.

Fiscal consolidation was undertaken in the belief that increased private sector expenditure would substitute for lower public expenditure, but without a clear understanding that such a private sector response would be unlikely unless interest rates were lower (which was not possible with the zero bound) or the currency depreciated, leading to a crowding in of exports and a reduction of imports. In the United States, it was not made clear enough that a moderation of the negative effects of fiscal consolidation would depend on a depreciation of the dollar. Within Europe, the fiscal contraction both in the GIIPS countries of the European periphery (Greece, Italy, Ireland, Portugal and Spain) and in Germany was undertaken without a clear understanding that contraction in the periphery would lead to severe depression unless accompanied by fiscal expansion in Germany, and that if consolidation happened in both parts of Europe at the same time, a depression would result unless the euro depreciated. In the United Kingdom, fiscal consolidation was undertaken in the belief that the currency would depreciate and so enable exports to grow to replace a reduced level of domestic demand. In Japan, Abenomics has led to an initial fiscal expansion, but this is to be followed, after one year, by fiscal consolidation; it is hoped that domestic demand will be replaced by demand coming from net exports, as a result of currency depreciation.

QE has augmented these spillovers and policy conflicts. A significant part of the workings of QE – like the effects of ordinary monetary expansion – comes from the effects of a depreciated exchange rate in diverting demand from other countries. Such a ‘beggar thy neighbour’ policy is appropriate for an individual country after it suffers from an individual financial crisis, if the rest of the world is growing – a policy of currency depreciation enabled Thailand and Korea to recover rapidly after the Asian financial crisis. But this cannot happen – in the United States or
in other countries and regions – if other countries are pursuing QE at the same time. That is, the expansionary effects of QE, if it is implemented in many countries at the same time, are much less strong than if QE is implemented by only one country, as happened with Japan in the early 2000s.

Difficulties in Europe

Within Europe, austerity is imposing a recession of a kind which threatens the survival of the monetary union. The GIPPS countries of the European periphery have been forced into a severe fiscal consolidation, which, in the absence of an ability to depreciate their exchange rate, has led to massive unemployment. The level of costs and competitiveness in these countries needs to adjust after the ten years of excessive inflation in the periphery in the run-up to the financial crisis.

But this adjustment to the level which is required is happening slowly – in contrast to what could happen with a regime of floating exchange rates. Such adjustment is being hindered by the fact that inflation in Germany is low, and further hindered by the additional fiscal consolidation on which Germany is now embarking. The recent move by the European Central Bank to lower short-term interest rates is designed to help offset such negative pressures on demand, and will do so partly by creating downward pressure on the euro. In addition, it seems likely that Europe will embark on some version of QE, creating further downward pressure on the euro. Again, in Europe, fiscal austerity is generating pressures towards currency depreciation and a reliance on an externally led recovery.

Difficulties in emerging markets

QE has also created spillovers and policy conflict between advanced countries and emerging market economies. Until recently, QE led to an inflow of funds to these economies, particularly those economies which have been pegged to the US dollar. It is clear that exchange rate appreciation will be necessary for emerging market economies, as they become more competitive and increasingly able to produce a range of manufactured goods and services which were previously produced only in advanced economies.

But many of these emerging-market economies have resisted appreciation in their exchange rates and have used capital controls – in a variety of forms – to enable them to run tighter monetary policy, so as restrain domestic demand, without this causing currency appreciation. Such capital controls, and the associated tight monetary policies, are limiting the extent to which these economies can increase imports and run increased current account deficits, and are
therefore hindering the growth in the demand for exports which is being sought by the United States, Japan and Europe.

What is needed for advanced countries, until the recovery becomes sustained, is a moderation of the effects of fiscal austerity, so as to expand demand globally, and a reduction in the reliance on QE.

**Expanding global demand by promoting infrastructural investment**

In sum, pressures towards fiscal austerity in many countries are impeding the global recovery, and are leading these countries to act in a non-cooperative manner by seeking to expand demand through export growth, propelled by currency depreciation. International cooperation is necessary, of the kind which the G20 MAP was designed to ensure, to encourage the development of policies which expand global demand.

But restraints to fiscal austerity – that is, increases in fiscal stimulus as compared with the current position – would lead to increases in public debt. Any such changes must, of necessity, be matched by a longer-term commitment to fiscal discipline, including a commitment to a future gradual reduction in public debt, when the recovery strengthens. There is a risk in the United States that the bipartisan agreement necessary for this will not be obtainable; in these circumstances, many believe that tight fiscal policy in the United States in the short term is a necessary part of the process by which such longer-term consolidation can be achieved. In Europe, there is a concern about the levels of peripheral public debt which will become a burden on Germany and so a reluctance to carry out the necessary fiscal expansion in Germany – indeed, as described above, significant fiscal consolidation is taking place in Germany. In the United Kingdom there is a belief that consolidation is necessary simply because the current public sector deficit is so large that public debt will continue to expand, even in the presence of such consolidation. In Japan, there is a similar worry about the level of public debt.

How to increase global expenditures and demand at a time of worry about the growing size of public debt?

The St Petersburg Declaration of the G20 argued for the importance of long-term investment as a means of creating sustainable growth, and advocated the creation of conditions that could promote long-term financing for investment, including investment in infrastructure. Such infrastructural investment would increase the levels of global demand, partly offsetting the effects of fiscal austerity. The more such investment increased in any country, the less need there would be for accommodative monetary policy in the form of QE,
and the fewer pressures towards currency depreciation. Action of this kind would thus moderate the international policy tensions described above.

Infrastructural investment would clearly also increase the supply-side capability of the economy, enhancing the prospects for longer-term growth at the same time that it increased global demand. There is a very significant need for improved infrastructure in many advanced economies. The G20 has established a Study Group on Financing for Investment to examine how such investment could be financed.

One way of financing such investment in infrastructure would be through the issue of public debt. Acceptance of increased public debt may be viewed as possible if this debt is backed by assets owned by the public sector. An alternative means of financing such investment would be through PPPs, through, for example, partly privately funded toll roads, railways, ports and airports. Recent experience has shown a need for careful risk-sharing, since there is a risk in such partnerships that the upside accrues disproportionately to the private sector, while the public sector bears the risk of the downside. But such issues can be dealt with, and will presumably be examined by the G20 Study Group examining this subject.

**Connecting the objectives of the G20 MAP with the financing of investment**

There is an opportunity here to connect the agenda of the G20 economic/finance process with the objective of increasing the financing of investment. The G20 MAP is designed to strengthen international cooperation in the making of macroeconomic policies, by encouraging countries to pursue objectives which have positive spillovers. It appears that, in present circumstances, the MAP could encourage countries both to increase public investment in infrastructure, and to make possible an increased private financing of infrastructure. This would help increase global demand and lessen the tensions which are at present being created by the policies of fiscal austerity.

**Notes**

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