

## G20: Significance Explained

The staffs of policy makers from around the world are preparing for the G20 meeting that will be held in Pittsburgh in a month's time. Why should it be on your radar screen now? It is timely because it is in this run-up that agenda is shaped and outcome orchestrated.

### G20, G7, Gee I'm Confused

The G20 meeting is likely to increasingly eclipse the G7 as the more important international economic policy making gathering. A person might not be able to serve two masters, but policy can. The shifting locus serves several purposes. That the G7 was no longer representative of the world economy has been true for some time. A more inclusive group may discourage solidifying of an emerging market bloc, perhaps under the leadership of China. It also buys the US and Europe time to reach an agreement on a new voting arrangement at the IMF, co-opting and stealing the critics thunder.

Another consequence of the G20 over the G7 is that it dilutes the presence of Russia, which joins G7 finance minister meetings, forming the G8, since 1997. As the only developing country to join the G7, Russia in some ways represented all developing countries. Yet in recent years, Russia's economic nationalism, weapon sales, naval exercises with Venezuela, its troublesome meddling in Ukraine's politics, and of course last summer's invasion of Georgia and its subsequent intransigence, has led many to conclude that Russia remains in the post-Soviet era an awkward and difficult member of the international community. The G20 then dilutes the special privilege of Russia being the only developing country to join the world's leading economies.

The bottom line is that movement toward giving the G20 greater significance is not a sign of US weakness, but rather under-appreciated US strength. It outflanks China and takes away a Russian privilege.

### Coordination

The economic and financial crisis continues to command the attention of policy makers. Within the confines of their own institutional and political configurations, countries addressed the crisis in various ways. The actual international coordination between the US, Europe and Japan seemed of relatively secondary significance.

Yet coordination may become more important on the other side of the crisis. The monetary and fiscal footings are on emergency settings. Some time in that not too distant future, emergency settings will no longer be deemed necessary.

The crisis produced a type of singularity. Nearly all of the major countries and many other economies contracted in sync. Now evidence is accumulating that the worst is past. If global fiscal and monetary stimulus prevented a more serious economic down turn, what happens if every one begins removing the punch bowl at the same time? It may be that coordinated rate hikes are more vital than coordinated rate cuts, for example.

Yet the political circumstances make coordination more difficult. The world's second largest economy, Japan, and third or fourth largest economy, depending on the reference, Germany, are holding national elections. Japan's election is later this month and Germany's is next month. New finance ministers are likely in both countries. The UK's Brown hardly has a popular mandate as an unelected and unpopular Prime Minister. The opposition Liberal Party in Canada appears to be trying to topple the Conservative Harper minority government.

In the US, Treasury Secretary Geithner has not yet been able to overcome his initial faux pas, like in his confirmation hearings, referring to Obama's campaign rhetoric as China manipulating its currency, and his mid-February wet-noodle of a presentation to Congress of the public-private partnership initiative to remove the toxic assets from bank balance sheets. Perhaps there is nothing Geithner could have done about it. As a prior Treasury official and NY Fed President, he is seen to be a fireman who likes to play with matches, rather than a knight in shining armor. Federal Reserve Chairman Bernanke's stock, in contrast, has risen. Polls suggest that by a 2 to 1 margin, most expect Bernanke to be reappointed, before his term expires in January 2010.

### The Dog that Didn't Bite

For many years and many forums, numerous officials, economists and journalists have bemoaned the fact that the United States was leaving beyond its means as reflected in the large current account deficit. This was said to be not only the source of America's ruin, but it was also the major challenge for the world economy.

It's a case of the dog that didn't bite. This crisis was not about a capital strike against the US. The deficit was headed lower prior to the onset of the crisis. The key feature of the crisis was not the large US trade deficit, but about the incentive structure for investors. Moreover, the crisis in H2 08 showed that rather than a surfeit of dollars, there was actually a shortage.

Among the least appreciated yet among the most successful US policy responses was the currency swap lines with a number of foreign central banks. This provided the much needed dollars. At its peak, around \$650 bln were provided (recall that before the crisis the assets on the Fed's balance sheet were a bit more than \$800 bln or that entire TARP was \$800 bln). The usage has fallen by a little more than 80%.

Global imbalances though continue to concern policy makers. Imagine Treasury Secretary Geithner looks across the table and authoritatively says, "I am happy to confirm that the US savings rate is rising and the US consumer has finally begun the long awaited de-leveraging process. The current account deficit has fallen almost in half from its peak as a percentage of GDP." He pauses for effect, and then continues, "We would be most interested to hear from the others what measures they are undertaking to address the imbalances."

Of course, there is silence. Germany's Merkel has made it abundantly clear that the German export machine will not be one of the casualties of the crisis. In Japan, the DPJ may be swept into office on August 30, but it shows no vision or desire, to undermine the only part of the economy that has shown any life—exports. The large current account surplus country, Switzerland, is intervening in the foreign exchange market to weaken its currency. Clearly China is not prepared to pursue developmental strategy driven by domestic consumption. In fact, China has moved in the opposite direction; by some measures, consumption accounts for a smaller share of GDP than five years ago. For their part, OPEC countries for the most part have failed to diversify their economies away from hydrocarbons.

### **Circles Can't Be Squared**

The crisis is of historic proportions by many metrics. Yet in some ways it was not strong enough to force a restructuring of the world economy onto a more balanced track. As momentous as it was, it is not sufficient to dissuade countries from relying so extensively on foreign growth--exports and the US consumer.

For more than a quarter of a century, US officials have argued that rather than suffer from a US current account deficit, the world suffers from a growth deficit. It is as true today as it was when it was first noted.

Yes there will be regulatory adjustments, maybe some coordination and even cooperation, but the failure to take advantage of the crisis to put economies on a more balanced footing will have far reaching consequences that will likely reinforce powerful trends. For example, if the US economy does enjoy an earlier and stronger recovery than Europe and Japan, the growth differentials alone would likely widen the US current account deficit again.

The failure to rebalance the world economy will likely drive home the lesson first learned during the Asian financial crisis 1997-1998. In the modern global economy featured by extremely volatile (some times called flexible) capital flows, countries, especially relatively open economies need more reserves than traditional analysis suggests.

Reserve accumulation appears to be already resuming after they were drawn down during the worst of the crisis on valuation grounds, but also as countries, from Russia to South Korea intervened in the foreign exchange market. The rebuilding and expanding of the reserve war chest may in turn be re-cycled and help finance the budget deficits of industrialized countries.

Sound familiar? Plus ça change plus c'est le meme chose.

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*Neither Mr. Chandler nor members of his family have investments in the companies mentioned in this piece.*

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