The G20 Summit -- I

The G20 Summit earlier this month took place in the background of major domestic economic problems in G3 – the U.S., the European Union and Japan – with slowing economies and huge fiscal deficits. President Obama had been weakened politically also as the mid term elections, held just a few days before the Summit, had led to major gains for the Republicans who now have majority in the lower house of the U.S. Congress. At least in theory, the Republicans are committed to simultaneously pursuing lower taxes and a balanced budget – which, prima facie, seem contradictory: in fact, the last 30 years' history (Presidents Reagan and the two Bushes) suggests that, when in power, they manage to achieve the first but end up substantially increasing the fiscal deficits. The October 2010 *Global Economic Outlook* report of the IMF has argued "*fiscal consolidation needs to start in earnest in 2011*". The advice is perhaps more relevant to the U.S. than to Europe; in the latter, fiscal consolidation has already begun in many countries. And, amongst the G3, the Japanese economy seems immune, in terms of both growth and inflation, to both fiscal and monetary stimuli!

With little room for fiscal stimulation, the U.S. Federal Reserve announced, in mid-October, another major program of Quantitative Easing (QEII): since interest rates are as low as they can be, pumping money by purchasing government paper in the market is the only weapon left with the monetary authorities. The idea is to pump $ 600 bn in the market. Many analysts felt that QEII may lead to a fall in the external value of the dollar; the Chinese authorities criticized the U.S. policy as a pre-Summit tactic to put pressure on China to allow its currency to appreciate more rapidly. Ironically, since the announcement of the QEII program, the dollar has appreciated against both the euro and the yen. And, the 10-year treasury security, which yielded just 2.5% a month back, is now yielding 2.9%!

Both these developments could (more than?) take away whatever positive impact QEII was expected to have on growth and output.

Indeed, this strongly manifests the limitations of monetary policy in impacting macro-economic variables in the desired direction. To be sure, most modern central bankers acknowledge the limitations, and claim that they aim at shaping “expectations”; at dousing or rousing the “animal spirits” of the economic agents. It is obviously not easy! The fact is that monetary policy can be far more effective in bringing inflation down by pulling the monetary string hard (as Paul Volcker demonstrated in the late 1970s/early 1980s), if only at the cost of recession. Pushing the string to get the opposite result is far less effective! The Federal Reserve’s problems have been compounded after the Republican victory: they are opposed to QE II as they believe if will ignite inflation -- if only the cause and effect relationships were so consistent and predictable! One basic assumption underlying monetary theory – namely the constancy of the velocity of money – is certainly weak.

Meanwhile, the last few years have witnessed a sharp rise in the size of the balance sheets of central banks in the U.S. the eurozone, Japan and England. Much of the increase has come through purchase of assets in the market in support of the banking system (and/or to expand money supply). Surely, the quality of some of these assets – mortgage bonds, for instance – is highly questionable, even as the gearing of central bank balance sheets has gone up sharply. Some day, will the Fed and the ECB themselves need a bailout?

In the pre-Summit weeks, the President of the World Bank brought back the question of using gold price as an indicator of inflation. (One had thought that the ghost had come back to haunt policy-makers for the last time during the Reagan era, only to be reburied forever – but No!) It is strange that the issue has been brought up now – when the gold price has gone up so high even as, in the rich countries, there are far greater worries about deflation than inflation! And, what happens to demand in the rich economies would also affect the prospects of the developing countries, whatever the “de-coupling” thesis may say.

The major pre-Summit U.S. proposal was a limit on external imbalances. The earlier meeting of the G20 finance ministers could not reach any specific agreement on the issue. The proposal did not find much support – even India opposed it – and seems, for all practical purposes, dead. But its fate is a manifestation of the much lower prestige and weight the U.S. now enjoys in global fora.

To come back to the exchange rates, the recent rise of the dollar is yet another example of the inability of analysts to predict market movements, and the lack of correlation between domestic monetary policy and the external value of a currency, a point I would revert to while discussing global imbalances and the now off-the-table U.S. proposal to limit them.

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