

Summary: As American consumers retire from serving as the engine of world growth, the major surplus economies will have to pick up the slack. This is why global rebalancing is a key item on the G20 agenda in the 2010 Toronto and Seoul Summits. The United States requires a plan for fiscal consolidation, and China should implement its domestic rebalancing goals to see a rise in household incomes and domestic consumption as well as exchange rate appreciation. Other East Asian nations will need to reduce their reliance on export-led growth by importing and consuming more while Germany, as the main European surplus economy, should stimulate domestic demand and lead structural reforms in the eurozone.

Rebalancing Global Growth: The G20's Difficult Challenge

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What should be expected from the June 26-27 G20 Summit in Toronto? Leaders have set a heavy agenda for both Toronto and for the Seoul Summit in November. A central item is the framework for strong, sustainable, and balanced growth adopted at the Pittsburgh G20 Summit in September 2009, which involves restoring growth and achieving more balanced global consumption. The leaders will also focus on reforming financial regulations and the international economic architecture and on addressing trade and investment, energy security and climate change, and global poverty.

Growth remains at the top of the agenda because of Europe's troubles and worries about a double-dip recession. In April, the International Monetary Fund (IMF) projected 4.2 percent global growth for 2010. But growth is multi-speed, with China and India leading at 9-10 percent rates and the United States rebounding at a painfully slow rate. Japan's growth is sluggish and Europe is now a major source of uncertainty as questions grow about the solvency of southern member states and as investors flee the euro for the dollar.

These dramas underline the G20's central challenge: to rebalance global growth in order to place the world economy on a sustainable long-term

path. Global imbalances peaked in 2006, and according to IMF projections, they will markedly rise again as global trade and financing recover. The composition of global demand needs to be changed, which in turn will require the major economies to change domestic and exchange rate policies. The G20's Mutual Assessment process, supported by the IMF and other international institutions, is examining the global consequences of countries' domestic policies and identifying opportunities for governments to do things differently — or do different things — to contribute to a positive global outcome. If the process works, countries will adopt reforms that are in their own and the global interest.

Heavily-indebted governments in advanced countries are seized with the need to exit the extraordinary fiscal and monetary measures taken in the depths of last year's crisis. The IMF projects their aggregate public debt in 2015 at 110 percent of GDP compared to 30 percent in the emerging and developing economies. Two concerns are whether the advanced nations maintain their resolve as growth momentum is restored and whether they link exit strategies and rebalancing. Tighter fiscal policy by itself will be insufficient. Public spending should also shift toward supporting job creation and future growth by investing

in education and green infrastructure, upgrading physical infrastructures, and reducing distortionary taxes.

The Central Challenge in 2010 and Beyond: Addressing Unsustainable Global Imbalances

Rebalancing is important because global growth will not be sustained unless its composition changes. The United States, with its large current account deficit, should consume less and save and export more. China, Germany, and Japan, the largest current account surplus countries, should consume and import more. Central to the G20's medium-term success will be a credible 5-10 year fiscal consolidation plan in the United States that signals that the U.S. consumer has retired as the engine of global growth. Clearer moves are needed from China to rely more heavily on domestic demand for growth, aided by nominal exchange rate appreciation. Germany and Japan should also stimulate domestic demand. Yet, the IMF's April 2010 numbers show global trade bouncing back in 2010-11, and exports from emerging economies rising. This could mean that too many governments are still relying on exports — and the U.S. consumer — to restore growth momentum.

Rebalancing will be both a technical and political challenge. Take the United States. A credible plan is required to achieve a 3 percent deficit-to-GDP ratio, which is considered sustainable. In contrast, the Obama administration's optimistic 2011 budget projects a deficit-to-GDP ratio of nearly 11 percent in 2010 (down from 13 percent in 2009), which declines only to 4 percent between 2015 and 2020. Private-sector projections are less optimistic, with the ratio above 5 percent of GDP for the next decade. The IMF projects that gross debt/GDP in 2014 will be 108 percent, while the administration estimates net federal debt in public hands will be close to 80 percent by 2020.

The administration's 2011 budget proposals rely mostly on expenditure restraint, suggesting that Americans are asking for more government services and transfers than for which they are willing to pay. Despite the simmering populist anger about big government, a sustainable fiscal position will also require revenue-raising. Ideally, such policy shifts the burden of taxes away from income and property and

toward consumption. Since no politician will propose such measures in the current polarized atmosphere, only a bipartisan congressional commission, with all expenditure and revenue items on the table, has a hope of changing these attitudes of denial. Or a loss of market confidence and credit tightening will force change.

China, the main actor on the other side of global imbalances, can only reduce its current account surplus if it consumes and imports more. The central short-term question is whether China's spending patterns will change when the stimulus is withdrawn, with more consumption and less investment-driving growth. While the Chinese leadership is clear about relying more on domestic demand, it will take time and political capital to change institutions and incentives. In efforts to reduce incentives for household saving, for example, China increased public spending on education, health care, and pensions three-fold between 2002 and 2008.

Yet many outsiders focus on exchange rate appreciation as China's "silver bullet." It is often asserted that yuan appreciation will reduce China's trade surplus with the United States. It is conceptually correct that a surplus country's exchange rate will appreciate, making exports more expensive to foreigners and reducing the cost of imports. But China's huge trade deficit is with everyone, not just the United States, and its imports are also enormous (it is now Japan's largest trading partner). China manages its exchange rate. And of all the changes China recognizes it must make, yuan appreciation is the most politically difficult one because of powerful entrenched interests and uncertainties about the size and distribution of job losses that might result. This is part of an intense debate in Beijing about the future of China's growth model.

A more flexible yuan is only one part of the package needed to rebalance demand, shift growth to be less capital-intensive and less polluting, and raise household incomes. These shifts are possible if household incomes are raised through higher wages, and by creating more labor-intensive jobs in the services sector and raising productivity in industry with more knowledge-based production. Households would also earn more from their savings if interest rates were deregulated.

lated — but first China needs a deposit insurance system. China's investment-driven growth can also be moderated if artificially low input prices for energy, land, and capital are determined by the market, and environmental and intellectual property regulations are enforced.

Other East Asian surplus countries should promote a similar shift toward domestic and regional demand and reduce reliance on exports by shifting resources to nontradables like services and infrastructure. Such policy adjustments would be less damaging than market-driven changes in recent years — even if they are politically difficult.

Policy Recommendations

The fact that rebalancing is desirable does not mean it will happen. Some of the required measures will not be popular at home as they impact consumer and trade interests that are vested in the unsustainable status quo. Yet, with Europe a drag on world growth and the U.S. consumer no longer the engine of demand, a determined rebalancing effort is essential to pick up the slack. What needs to be done?

The United States: The best strategy to ensure the momentum for coordination in the G20 is for the largest countries to lead by example. A credible medium-term plan of fiscal consolidation would make the United States the natural leader of the Mutual Assessment process. Such a plan seems unlikely until after the November 2010 midterm elections, which also happens to be when the report of the bipartisan National Commission on Fiscal Responsibility is due. All options should be on the table, including a broad-based consumption tax, a carbon tax, and spending cuts. The alternative is a renewed crisis, triggered by rising long-term real interest rates.

China: The Chinese authorities have indicated a rebalancing strategy that includes support for domestic consumption and job generation in labor-intensive services and manufacturing. It is also recognized that exchange rate appreciation will aid these goals. China needs to follow through. However, the euro's recent depreciation has placed unanticipated pressures on the margins of exporters in China, as has the recent labor unrest. Further delay in nominal

appreciation will be inflationary and renew international tensions. External pressure to remind China of its global responsibilities is best provided through quiet diplomacy from other developing countries like Malaysia, Vietnam, and Bangladesh, which face rising price competition from China in their export markets.

Europe: The European stabilization fund and unprecedented central bank intervention have bought Greece time to restructure its finances. But serious questions remain about economic governance in the eurozone. Deeper coordination is required to restore and maintain fiscal prudence. Future economic growth will have to be sought by raising productivity through politically difficult and long-delayed structural reforms in a slow-growth environment. Germany as the large surplus economy should stimulate domestic demand in order to facilitate such changes.

G20 Co-chairs Canada and South Korea: Both countries have successes from which others can learn. Canada completed a major fiscal adjustment in the mid-1990s when it moved from a deficit of 8.7 percent of GDP to a small surplus helped by public support for consolidation, a growing world economy, and a flexible exchange rate. Canada is now a paragon of fiscal and monetary prudence with an effective system of financial regulation. South Korea is a graduated emerging market economy that recovered from severe crises a decade ago. Others can learn from South Korea's strategy to reduce export dependence through domestic investments in human capital and technology and the "Green Korea" strategy of energy conservation, clean energy R&D, and energy-efficient transportation.

Other East Asian countries: Other East Asian countries should contribute more to global demand by reducing export incentives and increasing domestic competition; increasing domestic demand by deregulating services and encouraging green and other needed infrastructure projects; and supporting household consumption as the economies adjust by creating social safety nets.

Conclusion

None of these recommendations is a slam dunk because most imply painful macroeconomic and structural adjustments. But the G20's credibility to restore global growth is on the line. The risk is that governments opt for quick fixes and declare success at Toronto and Seoul. The worst nightmare for 2011 is heightened financial volatility stemming from a renewed recession in Europe and further euro depreciation, lack of U.S. action on fiscal consolidation, a yuan appreciation in China that is too little too late, and renewed global imbalances that threaten global stability.

Another risk is protectionism and backlash against globalization in the heavily-indebted advanced countries. Few nations have much room to maneuver in the face of high unemployment. In countries that had large credit bubbles, interest rates are now at historic lows and central bank balance sheets in an uncharted territory.

Hosting the November Summit in Seoul may turn out to be extraordinarily fortuitous if South Korean President Lee Myung-bak achieves progress by persuasion and example.

The deadlock and inertia of Doha and Copenhagen cannot be continued. To prod governments to act and to prevent backsliding, the IMF's Mutual Assessment analysis should be published. Name-and-shame tactics helped mute protectionist actions in the heat of the crisis. Such tactics, or a high-profile, independent wise persons group, may be necessary to rally public support.

The stakes for the G20 are high. There must be forward momentum on rebalancing or the group's credibility and effectiveness will ebb away. And the burdens of global financial crises on future generations will only grow.

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