

Why G20 leaders will fail to deal with the big challenge



By Martin Wolf

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The summit of the Group of 20 leading high-income and emerging countries in London on Thursday seems set to achieve progress. But achievement must be measured not just against past performances, but against “the fierce urgency of now”. Unfortunately, it will come up short.

The Organisation for Economic Co-operation and Development now **forecasts** a 4.3 per cent contraction in the economies of advanced countries this year, followed by stagnation in 2010. In advanced member countries, **joblessness** may rise by 25m by 2010. Meanwhile, the **International Monetary Fund forecasts** that the global economy will shrink by between 0.5 and 1 per cent this year. This would be an increase in the “output gap” (gap between actual and potential output) of some 4 per cent.

Will the G20 rise to these exceptional challenges? No, is the answer. What is needed is both a large increase in aggregate demand and a shift in its distribution, away from chronic deficit countries, towards surplus ones. On both points, progress will be far too limited.

The **OECD argues** that the discretionary stimulus measures taken by governments in response to the crisis will on average boost gross domestic product by just 0.5 per cent in 2009 and in 2010. In addition, the extra demand is coming at least as much from deficit as from surplus countries. This is not a recipe for resolution of global imbalances, but for their indefinite prolongation.

Unfortunately, no consensus exists on the underlying causes of this crisis or on the best ways to escape from it. The US and UK agree that the excesses of the financial sectors have their roots not just in deregulation, but also in the massive excess supply of surplus countries, of which China, Germany and Japan (with respective current account surpluses of \$372bn, \$253bn and \$211bn in 2007) are the most significant. But China and the continental European countries, led by Germany, argue it is all the fault of profligate deficit countries. Yet China also hopes that the world will soon be able to absorb its excess supply again.

In last week’s **FT interview with Angela Merkel**, the German chancellor said that: “The German economy is very reliant on exports, and this is not something you can change in two years.” Moreover, “It is not something we even want to change.” To paraphrase: “The rest of the world needs to find a way of absorbing our excess supply, but sustainably, please.” Yet what happens if that cannot be achieved for the excess potential supply of all surplus countries together? In 2007, the three countries ran current account surpluses of \$835bn (€629bn, £585bn). Logically, counterpart deficit countries must spend that much more than their incomes. Yet today deficit countries have run out of willing and creditworthy private borrowers.

That change is what this crisis is all about, as the charts show. Between 2007 and 2009, the crisis-hit private sectors of the US, UK and Spain will, on these forecasts, shift their financial balances (the difference between their incomes and expenditures) massively towards surplus, as savings rise and spending is cut. In Spain, the shift is forecast to be 11.7 per cent of GDP. The main offsets in these deficit countries will be huge jumps in fiscal deficits, although the current account deficits are also, inevitably, shrinking.

Surplus countries, which relied on the private sectors of deficit countries to do their irresponsible borrowing for them, show a very different pattern: their private sector balances will change rather little and, in all cases, will be in large surplus throughout: big current account surpluses nearly always mean private sector excess savings. But, as their external surpluses shrink, fiscal deficits will grow, partly because of deliberate policy but also because of the automatic consequences of recessions.

So fiscal positions are deteriorating and current account surpluses and deficits are dwindling everywhere, as the

private sectors of deficit countries cut back their spending dramatically. But the expected fiscal deterioration is bigger in the deficit countries than in the surplus ones. With the exception of Japan, the fiscal deficits will also be bigger in the deficit countries. The small size of the expected shift in China's fiscal deficit, the modest level of its 2009 fiscal deficit and the persistence of the massive surpluses of its private and state-owned enterprise sector are striking. This is a country expecting (or at least hoping for) a recovery in external demand.

What this analysis is telling us is quite simple: next to no adjustment in underlying structural imbalances is occurring. In particular, the non-fiscal sectors of the three big surplus countries are expected to continue to run huge surpluses. The change – temporary, the surplus countries surely hope – is that domestic fiscal expansion is modestly offsetting the decline in demand coming from deficit countries with over-leveraged private sectors. But that decline in private demand is also offset by massive fiscal boosts in deficit countries.

This is not a path towards a durable exit from the crisis. It is a path on which the fiscal deficits needed to offset persistent current account deficits, and collapsing private spending in external deficit countries, continue indefinitely. Unless and until surplus countries recognise that this cannot continue, no durable escape from the crisis will be achieved. Understandably, but foolishly, they are unwilling to do so.

So what is to be done? That must be a central agenda item of the next G20 summit. The world economy cannot be safely balanced by encouraging a relatively small number of countries to spend themselves into bankruptcy. The answer lies partly in changing the policies of surplus countries. But it lies as much in rethinking the international monetary system. The case for sizeable and ongoing allocations of special drawing rights – the IMF's reserve asset – is powerful, as, among others, Zhou Xiaochuan, governor of the People's Bank of China, has [argued](#) in a fascinating recent paper*. I hope soon to return to this huge challenge and opportunity. In the meantime, the G20 summit is largely dealing with the immediate symptoms of the illness. Finding a longer-term cure for chronic global excess supply still lies ahead.

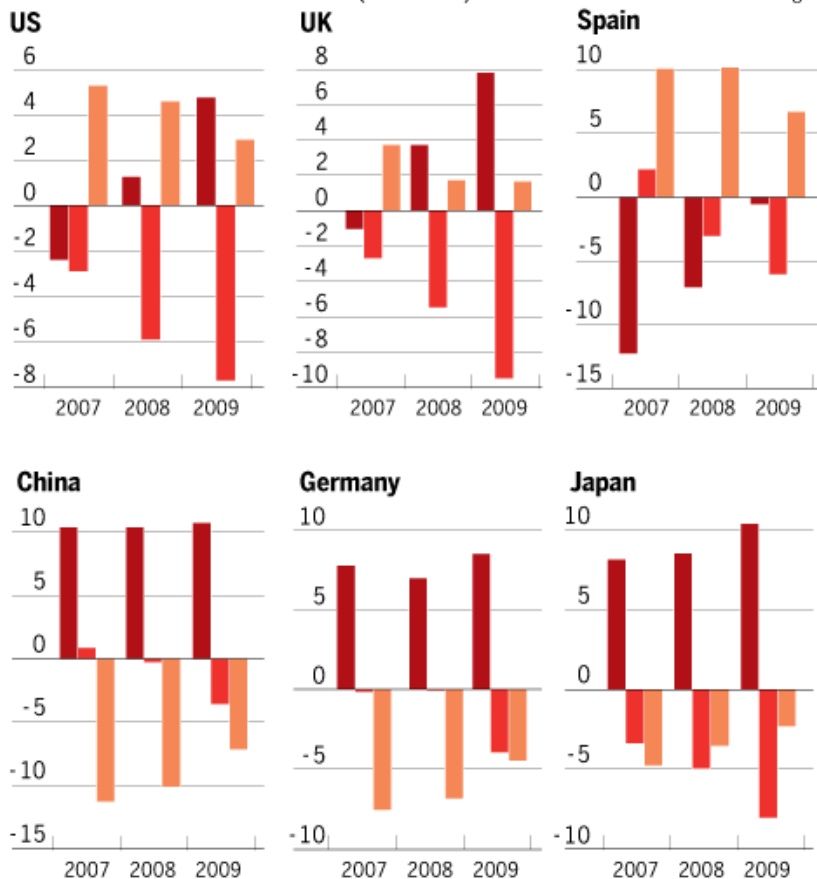
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Sectoral financial balances (% of GDP) ■ Private ■ Government ■ Foreign



Notes: The 'foreign' balance is the inverse of the current account balance. The US 'government' figure excludes estimated losses from financial sector support. The Chinese 'private' sector includes state and publically-owned enterprises

Sources: IMF; Consensus Economics; FT Research 2009= Forecast

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