RANKED AMONG THE WORLD'S TOP 10 THINK TANKS
CEPS Commentary
Thinking ahead for Europe
CENTRE FOR EUROPEAN POLICY STUDIES

A (short) to-do list for the G20

Daniel Gros

10 November 2010

The first task for the forthcoming G20 summit is to manage expectations. One year ago the global leaders got carried away with the apparent success they had experienced in formulating a common response to the acute global crisis which started late in 2008. They thus designated the G20 as the "premier forum for our international economic cooperation". They overlooked the fact, however, that it is relatively easy to agree on common measures to stimulate the economy if everybody is in the same situation. This is no longer the case, and the G20 now has little choice, but to adopt the refrain that has been so pervasive in the recent G7 gatherings: the best contribution any participant can make to a strong global economy is to put its own house in order. But that is easier said than done.

For the Chinese to put their house in order, this means continuing their rapid growth which is based on exports and investment. Putting the US house in order means something quite different, namely stimulating demand in order to reduce unemployment, which is at a politically unacceptable level (9.5%).

With short-term interest rates already at zero and fiscal policy dangerously exposed, the Federal Reserve has opted for a programme of buying $600 billion of medium-term Treasury bills with the aim of stimulating demand via lower interest rates. But will this policy work?

Buying massive amounts of T bills lowers medium- and long-term interest rates, which should lower borrowing costs of enterprises and families. But US corporations are already sitting on an enormous pile of cash. Lower interest rates will not lead them to invest more. Lowering the borrowing costs for families should help sustain house prices and consumption. But again, under current circumstances, the effect will be very limited because there are so few new home buyers. The usual transmission mechanism would be massive refinancing of existing mortgages, but this is now impossible because many are 'under water' (the value of the house is lower than the mortgage).

Most observers thus agree that QE II should have a very limited impact, but the standard models suggest that it should at least be positive. However, this line of argument overlooks the fact that lower interest rates also mean lower incomes for investors, like insurance companies and ordinary people who saved for their retirement. These 'rentiers' will now have to reduce consumption

Daniel Gros is Director of CEPS. This commentary was originally published in Handelsblatt, Germany's business and financial daily newspaper, 10 November 2010.

because their income has gone down along with interest rates. The upshot is that the net effect of QE II might be to reduce demand in the US.

This explains why the reaction to the new round of quantitative easing has been so hostile: normally the impact of an easing of monetary policy on the rest of the world should be neutral: as income in the US goes up, the rest of the world can export more to the US. At the same time, the US dollar might depreciate, but the two effects could easily be of similar size, thus canceling each other out. However, the emerging markets and countries whose economies are in a healthy state now perceive that QE II will only have a negative impact because it does not stimulate demand in the US, but will foster asset price bubbles everywhere else.

The G-20 will not be able to reconcile these conflicting national policy imperatives, but a lot could be achieved through a frank exchange on these issues so that our leaders understand the concerns of their counterparts and agree to tone down the rhetoric.