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The G-20's Empty Promises

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CAMBRIDGE – Talk about "exit strategies" will be high on the agenda when the heads of the G-20 countries gather in Pittsburgh a few days from now. They will promise to reverse the explosive monetary and fiscal expansion of the past two years, to do it neither too soon nor too late, and to do it in a coordinated way.

These are the right things to promise. But what will such promises mean?

Consider first the goal of reversing the monetary expansion, which is necessary to avoid a surge of inflation when aggregate demand begins to pick up. But it is also important not to do it too soon, which might stifle today's nascent and very fragile recovery.

But promises by heads of government mean little, given that central banks are explicitly independent of government control in every important country. The US Federal Reserve's Ben Bernanke, the Bank of England's Mervyn King, and the European Central Bank's Jean-Claude Trichet will each decide when and how to reverse their expansionary monetary policies. Bernanke doesn't take orders from the US president, and King doesn't take orders from the British prime minister (and it's not even clear who would claim to tell Trichet what to do).

So the political promises in Pittsburgh about monetary policy are really just statements of governments' confidence that their countries' respective monetary authorities will act in appropriate ways.

That will be particularly challenging for Bernanke. Although the Federal Reserve is technically independent and not accountable to the President, it is a creation of the US Congress and accountable to it. Because of the lagged effects of monetary policy and the need to manage expectations, early tightening by the Fed would be appropriate. But the unemployment rate could be over 9% – and possibly even more than 10 – when it begins to act. If so, can we really expect Congress not to object?

In fact, Congress might tell the Fed that it should wait until there are clear signs of inflation and a much lower unemployment rate. Because Congress determines the Fed's regulatory powers and approves the appointments of its seven governors, Bernanke will have to listen to it carefully – heightening the risk of delayed tightening and rising inflation.

Reversing the upsurge in fiscal deficits is also critical to the global economy's health. While the fiscal stimulus packages enacted in the past two years have been helpful in achieving the current rise in economic activity, the path of future deficits can do substantial damage to long-run growth.

In the US, the Congressional Budget Office has estimated that President Barack Obama's proposed policies would cause the federal government's fiscal deficit to exceed 5% of GDP in 2019, even after a decade of continuous economic growth. And the deficits run up during the intervening decade would cause the national debt to double, rising to more than 80% of GDP.

Such large fiscal deficits would mean that the government must borrow funds that would otherwise be available for private businesses to finance investment in productivity-enhancing plant and equipment. Without that investment, economic growth will be slower and the standard of living lower than it would otherwise be. Moreover, the deficits would mean higher interest rates and continued international imbalances.

In contrast to monetary policy, the US president does have a powerful and direct impact on future fiscal deficits. If the presidential promise to reduce the fiscal deficit was really a commitment to cut spending and raise taxes, we could see today's dangerous deficit trajectory be reversed.

Unfortunately, Obama shows no real interest in reducing deficits. The centerpiece of his domestic agenda is a health-care plan that will cost more than a trillion dollars over the next decade, and that he proposes to finance by reducing waste in the existing government health programs (Medicare and Medicaid) without reducing the quantity and quality of services.

A second major policy thrust is a cap-and-trade system to reduce carbon emissions. But, instead of raising revenue by auctioning the emission permits, Obama has agreed to distribute them without charge to favored industries in order to attract enough congressional votes. Add to this the pledge not to raise taxes on anyone earning less than $250,000 and you have a recipe for large fiscal deficits as long as this president can serve. I hope that the other G-20 leaders do a better job of reining in their budgets.

Finally, there is the G-20's promise to reduce monetary and fiscal excesses in an internationally coordinated way. While the meaning of "coordinated" has not been spelled out, it presumably implies that the national exit strategies should not lead to significant changes in exchange rates that would upset existing patterns of trade.

In fact, however, exchange rates will change – and need to change in order to shrink the existing trade imbalances. The dollar, in particular, is likely to continue falling on a trade-weighted basis if investors around the world continue to set aside the extreme risk-aversion that caused the dollar's rise after 2007. Once the Chinese are confident about their domestic growth rate, they can allow the real value of the renminbi to rise. Other exchange rates will respond to these shifts.

In short, it would be wrong for investors or ordinary citizens around the world to have too much faith in G-20's promises to rein in monetary and fiscal policies, much less to do so in a coordinated way.

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