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Strategy: Focus switches from exit to growth

By Chris Giles
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The Toronto summit was to be the moment world leaders could declare victory over the financial and economic crisis and announce the implementation of “exit strategies” from the extraordinary policies introduced to quell the crisis, it was hoped. Events, however, have conspired against the Group of 20 industrialised nations.

Instead of the G20 declaring victory, it has been forced to rip up its previous stimulus strategy in the face of renewed market turmoil and unco-ordinated fiscal tightening.

The summit now marks the moment when financial markets have forced an exit from fiscal stimulus before a vigorous private sector recovery is established. Central banks have also reintroduced some of their emergency liquidity measures to prevent the European sovereign debt crisis undermining the banking system, and the European Central Bank has resorted to unorthodox measures that were not contemplated at the height of the crisis.

At the G20 summit in Pittsburgh last September, national leaders committed themselves to a “strong policy response until a durable recovery is secured”. But their finance ministers, meeting earlier this month in Busan, South Korea, were forced to accept that “recent events highlight the importance of sustainable public finances” and “those countries with serious fiscal challenges need to accelerate the pace of consolidation”.

Instead of a co-ordinated exit “when the time is right” – first withdrawing the extraordinary support for the financial system, then tightening fiscal policy and finally raising interest rates – the latest market concerns have forced the G20 to tighten fiscal policy earlier than many countries had wanted and to reintroduce liquidity support for banks when they had hoped such emergency measures were a thing of the past. The chances that monetary policy will return towards normal this year have consequently receded.

The International Monetary Fund, having been the champion of fiscal stimulus, has now returned to its roots of orthodoxy. “It is now urgent to start putting in place measures to ensure that the increase in deficits and debts resulting from the crisis, mostly from the loss of output and revenues, does not lead to fiscal sustainability problems,” it says in its May fiscal monitor.

But sorting out the public finances is not easy in advanced economies. Professor Eswar Prasad of Cornell University says: “Noble intentions by advanced economies to bring their budget deficits under control are rubbing up against the political and economic difficulties of fiscal retrenchment at a time when the world economy continues to be buffeted by adverse shocks.”

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And some see the exit from crisis measures into recovery as far off. Jeffrey Sachs, director of the Earth Institute at Columbia University, argues in the Financial Times: “Now we face a world economy with weak aggregate demand in the US and Europe, bulging budget deficits, sovereign debt downgrading and consumers unwilling to borrow.”

The retreat from the exit has been particularly evident in continental Europe. The bank funding market is so sick in Europe that the ECB has been forced simultaneously to reintroduce its offer of fixed-rate unlimited funds for European banks, while also finding itself the repository of record deposits, parked overnight in its vaults. Not without reason did Jean-Claude Trichet, ECB president, say this showed “that we have a market which is not functioning perfectly – that is absolutely clear”.

By mid-June, the ECB announced it had taken the unprecedented step of purchasing €40.5bn ($49.9bn) of government bonds to stop its ultra-loose monetary policy losing traction in countries where investors have lost confidence in government paper.

Across the world, US dollar swaps have also been reintroduced to keep dollar liquidity flowing when US markets are shut. The combination of all these events suggests the declaration of exit from the crisis has been postponed, at least until the Seoul summit in November.

But all is not lost. Though many of the events of the past month have been unwelcome and have undermined exit strategies, the world economy and the recovery from crisis are neither entirely bleak nor completely derailed.

As the IMF and the G20 have noted, the world economy is recovering, and faster than expected so far. Optimists point out that though the planned exit has changed, the process towards a stronger and more stable world economy has not been derailed. “It is encouraging that there is broad agreement on the need for strong action by the advanced economies to rein in fiscal deficits and by both emerging and advanced economies to take necessary steps to rebalance global growth patterns,” says Prof Prasad.

The balance of exit between monetary and fiscal policy might have changed radically since late April, with expectations of rises in interest rates significantly delayed, but the broad return to global expansion continues.

Most important, therefore for world leaders in Toronto, is to continue on their quest for policies that foster strong and more balanced growth in the years ahead, even if the sequencing of their exit from crisis measures has had to change.