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The role of macroeconomic policy in rebalancing growth☆

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ABSTRACT

The aftermath of the global financial crisis of 2007–2009 has called the export-led growth model of many Asian economies into question. This paper describes the contribution that macroeconomic policy can make to promote a rebalancing of growth away from dependence on exports to developed economies to a more sustainable pattern of growth centered on domestic and regional demand. This represents a significant departure from the traditional uses of macroeconomic policy to stabilize the economic cycle and achieve stable and low inflation. The evidence suggests that macroeconomic policy can successfully contribute to growth rebalancing. Policy measures not only can affect aggregate demand directly, but can also affect it indirectly via their "microeconomic" impacts on private sector behavior such as the household savings rate. Although in the long-term fiscal policy should be balanced to maintain government debt stability and avoid crowding out of private investment, there may be substantial scope to expand monetary and fiscal policy in the medium-term to offset the deflationary effects of an appreciating currency during periods of current account reversal. Previous experience suggests that most of the needed stimulus can be provided by monetary policy, with only a supplementary role to be played by fiscal policy. Moreover, Asian economies with large current account surpluses tend to have sufficient fiscal space.

1. Introduction

Although Asian economies have enjoyed high growth, rising per capita incomes and diminishing poverty during the period of export-led growth, the aftermath of the global financial crisis of 2007–2009 has called this growth model into question. First, it seems likely that Asia's traditional major export markets – the United States (US) and Europe – will experience a prolonged period of sluggish growth as they work off the excesses of the crisis. Second, policies that supported export-led growth, especially foreign exchange rate intervention to keep exchange rates under-valued, helped to widen global current account imbalances that likely contributed to global economic and financial instability that culminated in the crisis. Third, the export-led growth phase had undesirable side-effects, including, in some cases, widening income gaps and, in almost all cases, substantial environmental degradation, including rapid growth of greenhouse gas emissions. Therefore, Asian economies need to consider ways in which their growth pattern can be re-oriented away from export-led growth to one that is more balanced and sustainable. This means growth that is consistent with smaller global imbalances, more reliant on domestic and regional demand, and more inclusive and environmentally sustainable.

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This paper contributes to that debate by analyzing ways that macroeconomic policy can contribute to such growth rebalancing. This is fundamentally a departure from the traditional tasks of macroeconomic policy, i.e., stabilization of the economic cycle and, in the longer-term, achievement of price stability. Moreover, the time frame of such policies is considerably longer than is usual in the case of macroeconomic stabilization policy. Such a long period means that there is less scope for a prolonged expansion of fiscal policy, since it eventually would hit constraints of fiscal sustainability. In other words, fiscal policy should still aim to be neutral over the cycle. Therefore, rather than simply contributing directly to aggregate demand, such policies should aim to influence the overall investment-savings balance in other ways as well.

Targeting the current account balance, which is the same as the gap between savings and investment, is inherently difficult. This is because the determinants of investment and savings are many, complex, and subject to all manner of feedback loops. This point has been forcefully argued by McKinnon (2010) among others. The case of Japan is an object lesson. Although the US dollar fell by 62% against the Japanese yen between its peak of ¥260 in February 1985 to just ¥99 in mid-1994, adjustment of the current account was temporary. In fact, Japan's current account surplus in the decade following the Plaza Accord of 1985 averaged 2.7% of gross domestic product (GDP), versus only 1.4% in the period 1980–1985.

Moreover, the notion of growth rebalancing should not be limited to ways to reduce the current account balance. Asian economies need to achieve higher rates of growth from domestic and regional demand to make up for the looming shortfall of export growth to the developed economies. Therefore, policies are needed to promote the growth of domestic and regional demand, and to facilitate the supply-side adjustments that need to accompany such rebalancing. Policy measures also need to aim to promote growth that is more sustainable from the standpoint of inclusiveness and environmental sustainability. In view of these considerations, this paper examines not only broad policies for managing aggregate demand – taxes, spending, interest rates, and currency policy – but also policies with expected "microeconomic" effects, such as spending on social safety nets, changes in income distribution, changes in tax rates, deepening of financial markets, and increasing macroeconomic and financial stability.

The paper is organized as follows. Section 2 reviews the relevant literature on recommendations for achieving rebalancing via macroeconomic policy. Section 3 reviews the current state of imbalances within the region. Section 4 examines the feasibility of using macroeconomic policy to achieve rebalancing. Section 5 describes specific measures to stimulate domestic demand, including consumption and investment. Section 6 examines the contribution of improving the policy frameworks for macroeconomic and financial stability, including management of capital flows. Section 7 concludes.

2. Literature review

There is a vast literature on the traditional macroeconomic policy tasks of stabilization of the economic cycle and achievement of price stability, but the literature on macroeconomic policies to encourage growth rebalancing is still quite limited. The literature on rebalancing typically starts from the recognition of the identity that the current account surplus equals savings minus investment, so that a reduction of the current account surplus needs to be accompanied ex post by lower savings and/or higher investment. Therefore, one can consider policies either that act on net exports directly, or that act on savings or investment. Since household savings are an important component of overall national savings, policies that encourage consumption (for a given level of disposable income) can also contribute to rebalancing growth.

Eichengreen (2009) identifies four major implications of the global financial crisis for macroeconomic policy management in Asia:

- the need for policy space to be kept in reserve for future shocks;
- the desirability of increased exchange rate flexibility, both to absorb external shocks and contribute to adjustment of imbalances;
- the need to incorporate financial stability concerns more explicitly into monetary policy frameworks; and
- the desirability of having a regional pooling arrangement for foreign exchange reserves to reduce the need for individual countries to insure themselves against capital outflows by building up foreign exchange reserves.

Regarding fiscal policy, the prescription for deficit countries such as the US is straightforward – reducing fiscal deficits can contribute to reducing the current account deficit as well, although the scope for and will to accomplish such reductions will be limited as long as the economy is below full employment (Bosworth & Collins, 2010). Fiscal consolidation should also improve prospects for debt sustainability by achieving stability of the ratio of government debt to GDP, an additional incentive for deficit countries to adopt more contractionary fiscal policy. However, surplus countries have no similar incentive to adopt more expansionary fiscal policies. Fiscal expansion is less attractive, because of its tendency to worsen both the current account balance and debt sustainability conditions.

Prasad (2009) and Jha, Prasad, and Terada-Hagiwara (2009) advocate the following to promote economic rebalancing: increasing spending on the social safety net and other government insurance mechanisms to help reduce precautionary motives for saving; developing financial markets and increasing their efficiency to aid smoothing of consumption and investment by companies; promoting financial inclusion; and increasing exchange rate flexibility to promote consumption via terms-of-trade effects and creation of greater monetary policy space to promote macroeconomic stability.

Asian Development Bank (2009) argues that policies aiming to reduce the imbalance between savings and investment should focus on increasing consumption rather than promoting investment, since the evidence for under-investment in Asia