This global game of ‘pass the parcel’ cannot end well

By Martin Wolf

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Was the summit of the Group of 20 leading economies in Canada over the weekend a step forward towards co-operation or a step backwards towards disagreement? The answer seems to be both. The call for “growth-friendly fiscal consolidation plans” provides something for everybody. But it assumes what is to be proved: that rapid fiscal consolidation will now support growth, rather than undermine it.

Yet, instead of examining the outcome in detail, I asked myself a broader question: where have we got to? When I did so, I found myself thinking of the British children’s game of “pass the parcel”. In this game, a package is passed around until the music stops. Thereupon, a player removes a piece of wrapping paper and the game restarts. The winner removes the last piece of paper and secures the prize.

Our adult game of pass the parcel is far more sophisticated: there are several games going on at once; and there are many parcels, some containing prizes; others containing penalties. The games would be better played co-operatively, as the International Monetary Fund notes in its background paper on the “G20 mutual assessment process” for the summit. But this is very hard to do. For all the fine words, unco-operative outcomes are far more likely.

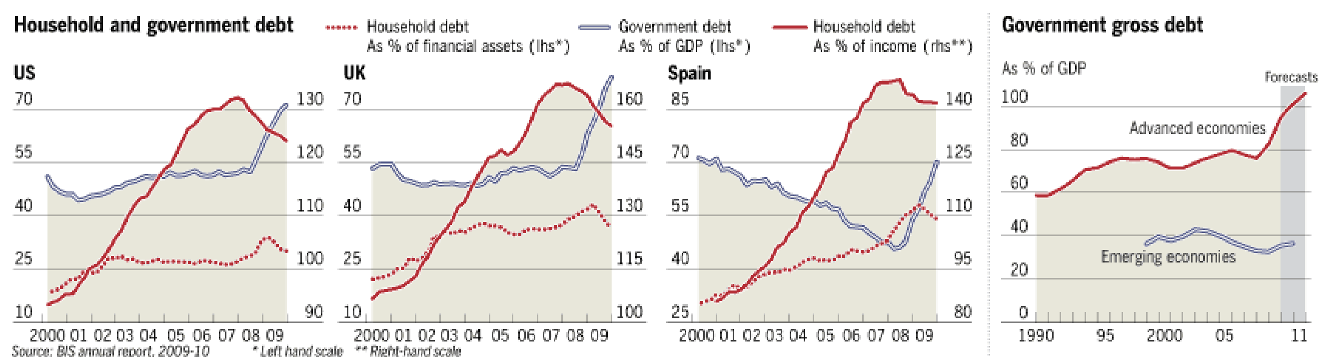
So here are four such games. The first is played within the financial sector: the aim of each player is to ensure that bad loans end up somewhere else, while collecting a fee for each sheet unwrapped along the way. The second game is played between finance and the rest of the private sector, the aim being to sell the latter as much service as possible, while ensuring that the losses end up with the customers. The third game is played between the financial sector and the state: its aim is to ensure that, if all else fails, the state ends up with these losses. Then, when the state has bailed it out, finance can win by shorting the states it has bankrupted. The fourth game is played among states. The aim is to ensure that other countries end up with any excess supply. Surplus countries win by serially bankrupting the private and then public sectors of trading

partners. It might be called: “beggaring your neighbours, while feeling moral about it”. It is the game Germany is playing so well in the eurozone.

What have these four games to do with the G20 summit? In a word, everything. The first game scattered toxic assets across the financial system. The second left the non-bank private sector with a debt overhang and deleveraging. The third duly damaged the finances of states. The fourth helped cause the crisis and is now an obstacle to recovery. Above all, these games are all linked to one another and so have to be changed together. The G20 does understand this, but only up to a point.

As Talleyrand is supposed to have said of the Bourbons, policymakers have learnt nothing and forgotten nothing, not least about the private financial roots of the present fiscal crises. Too often, the debate treats fiscal consolidation in isolation. But this is a huge mistake. What matters is not public debt alone, but all debt.

The latest [annual report] from the Bank for International Settlements makes the point clearly: it shows that three important deficit countries – the US, UK and Spain – had what appeared to be well-contained public debt positions, so long as household debt was exploding relative to gross domestic product. In the case of Spain, the government debt even consistently improved. The ratio of household debt to financial assets also gave a misleadingly good impression of the healthiness of the underlying debt. Then, with the financial crisis and the bursting of asset bubbles, came household deleveraging and fiscal leveraging.



These are mirror images: if the private sector runs a financial surplus (an excess of income over spending), there has to be either a fiscal deficit or a current account surplus (or both). The bigger the private surplus, the bigger the fiscal deficit or current account surplus must be. If, in reverse, fiscal deficits are to fall, the private sector must spend more relative to income or the current account must improve. Evidently, this needs to happen with higher spending, not lower incomes, particularly after a deep recession.

What has this to do with the G20 decisions on fiscal policy? In the years prior to the financial crisis, three groups of countries had large excesses of income over spending: a few mature industrial countries, notably Germany and Japan, China – which was in a category of its own – and some commodity exporters. Meanwhile, with most emerging market economies scarred by financial crises, the offsetting deficits were run by a number of advanced countries, notably the US, as well as central and eastern Europe. Then, when the crisis broke, the surpluses of the

surplus countries shrank as external demand collapsed. But their external demand was also supported by the soaring fiscal deficits, particularly in deficit countries: thus, public leveraging partially offset private deleveraging. Now, with the involuntary tightening in peripheral Europe and voluntary tightening elsewhere, comes yet more austerity.

There is a widely held belief that this retrenchment will, via confidence effects, lead to a burgeoning of private spending. But, as the BIS annual report also shows, deleveraging tends to be deep and prolonged in post-crisis economies. When such a large part of the world economy is affected, the adverse legacy is likely to last still longer.

In sum, excess supply parcels went from surplus countries to the private sectors of deficit countries and then, after the crisis, on to the public sectors of the latter countries. Assume that many of the latter now retrench. Where will they go next?

This is unclear: maybe, the surpluses will be absorbed in bigger external deficits in a range of emerging countries, as financial markets, seduced by these countries' relative solvency, are seeking to achieve; maybe, as US officials fear, particularly with the eurozone moving into external surplus, these surpluses will end up in higher deficits for good old Uncle Sam; maybe, the surpluses will shrink, with China leading the way; and, maybe, they will be deflated away in a prolonged global slump.

Yet it is quite clear that an isolated discussion of the need to reduce fiscal deficits will not work. These cannot be shrunk without resolving the overindebtedness of damaged private sectors, reducing external imbalances, or both.

The games we have been playing have been economically damaging. We will be on the road to recovery, when we start playing better ones.