Macroeconomic Policies: New Issues of Interdependence
By Helmut Reisen, Martin Grandes & Nicolas Pinaud
OECD Development Centre

- Summary -

This paper, prepared for the OECD horizontal project on policy coherence for development and to be published later this year as an OECD Development Centre Policy Brief, surveys three novel macroeconomic policy challenges: the macroeconomic implications of China’s emergence; the implications of the intensifying financial integration; and the interaction of Asia’s foreign exchange regime with monetary policy in the OECD area.

1) The prospective slowdown in China is currently one of the key sources of uncertainty in the world economy. China may now be regarded as a price-maker on some international commodity and energy markets. Its global impact nowadays stretches importantly not just into good and commodity markets, but equally into world financial markets. The acquisition by the Chinese official sector of large amounts of foreign assets has raised the country’s global cyclical, financial and macroeconomic importance. Hence, China should not just be perceived as a producer of low-priced goods, but likewise of ‘cheap savings’.

So what impact would a slowdown of China’s growth have on the world economy? This paper argues that the growth nexus is probably far from linear, but will depend on the severity of China’s expected slowdown. Should the Chinese authorities manage to engineer a soft landing of the economy, a very limited impact on global growth is to be expected and it could even be positive overall.

2) The wave of financial globalisation since the mid 1980s makes nationally oriented macroeconomic analysis increasingly meaningless and policies ineffective. Moreover, the prospective rise in institutional savings, fed by demographic trends and switches from PAYG to funded pension systems, joint with the need to achieve decent capital returns despite the headwinds of shrinking labour forces in the OECD area, can be expected to intensify the macroeconomic effects of business cycles in both OECD and non-OECD areas. Faced with low returns, pension fund strategy committees and individual investors have been increasingly turning to hedge funds, searching for uncorrelated asset classes with a focus on absolute (rather than benchmark oriented) return. These new actors may require policy attention as they have probably introduced amplifiers to global credit cycles, with potentially harmful effects to both capital-importing countries and investment returns in capital-exporting countries.

3) Asia is unlikely to drop the dollar peg – explicit or implicit - as long as China does not. As a result, East Asian central banks are among the biggest net foreign purchasers of US Treasury bonds. Sizable current account surpluses have translated into a massive build-up of US dollar reserves or a sustained increase in US Treasury bill purchases on the part of East Asian central banks. The pairwise interaction between the Asian producer and the American consumer, with Asia delivering ‘cheap’ goods (keeping US consumer price inflation down) and ‘cheap’savings’ (keeping US interest rates down), has permitted an accomodative US monetary stance, with the Euro as the ‘residual’ degree of freedom in the global monetary system. In turn, exchange-rate pegs have clearly been causing problems in Asia, not only through trade friction, but also by exacerbating the country’s accelerating liquidity growth/overheating economic growth problems.

Asia’s high-reserve policy and limited exchange rate flexibility have relevant implications and certain repercussions for main OECD countries. If, for example, Asian central banks rebalance reserves away from the dollar, private investors will require a fall in the dollar against the euro and the ECB might feel forced to stabilise the euro/dollar rate. If, by contrast, East Asia is not set to allow more flexibility in exchange policies, either the Euro zone will have to bear the brunt of the adjustment in global imbalances through a strengthened Euro or the US will be bound to implement a set of corrective fiscal and monetary measures.