

Research Paper

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Global Risks and the Challenges for G20 Coordination

A Growth Agenda for China's 2016 Presidency

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International Affairs

Summary

- China has assumed the rotating presidency of the G20 at a time when the outlook for global growth has weakened and some emerging markets face serious difficulties. This presents policy challenges for China, but also provides opportunities for the country to show leadership on global economic issues.
- The world economy grew by just over 3 per cent last year, its slowest rate since the depths of the crisis in 2009. Many emerging markets (including China) are slowing, and some (in particular Russia and Brazil) are in recession.
- Several factors are compounding these problems. Low commodity prices are having a negative impact on global growth. Financial market volatility is making companies and consumers cautious about spending, and the risk of further financial disruption is increasing. Geopolitical pressures are rising, and political populism is visible in many countries.
- Possible explanations for the slowdown include 'secular stagnation', post-crisis deleveraging, and the effects of emerging markets transitioning from export- and manufacturing-led growth. Low growth could become the 'new normal' for the world economy.
- In response, policies need to be more supportive of growth. G20 ministers and central bank governors have pledged to use all tools of economic policy – structural reforms, monetary expansion and fiscal stimulus – to boost growth. But so far there has been little action.
- Structural policies are important for boosting growth in the longer term, but they are unlikely to have the desired effect in the short term; it is not the priority at present to boost supply when there is a global shortage of demand. Monetary policy may also have neared its limits in terms of stimulating growth, with interest rates turning negative in some countries and quantitative easing becoming less effective. Moreover, easy monetary conditions could raise financial stability concerns in the longer term.
- There is a strong case for more activist fiscal policies, especially to boost investment. Some countries have more room for fiscal expansion than others, but a concerted move to provide stimulus – coordinated by the G20 – would minimize the risk of adverse market reaction and have a bigger effect on growth.
- A more effective and fully financed global safety net is needed to reduce risks globally; work needs to start on a longer-term mechanism for allowing countries in crisis to restructure their debts. Financial risks, both country-specific and cross-border, also need to be addressed.
- The G20 is the best forum for taking forward all these issues. Much rests on the incumbent presidency country. China has its own domestic economic challenges to address, but a concerted programme of international action by the G20 would also help in this respect. China should champion agreement on a set of policies to boost growth. It should encourage the G20 to take action on financial and country risks. And it should lead by example, committing itself to 'non-aggressive' exchange rate policy, its own domestic fiscal stimulus and increased efforts to tackle problems in its financial sector.

Introduction

The global economy is in a fragile state, and requires strong coordinated action to support growth and reduce risks. This is the message that emerged from the meeting of G20 finance ministers and central bank governors in Shanghai at the end of February. Working together on multilateral approaches to economic and financial problems is important, as policy-making is becoming more fragmented globally.

Despite its self-designated status as the 'premier forum' for economic and financial affairs, the G20 has not so far been able to come up with a robust agenda to tackle low growth, weak demand and deflationary pressures – problems now gripping most of the advanced economies, especially Europe and Japan. Emerging markets are already experiencing the spillover effects of this, along with substantial domestic policy challenges of their own. Many emerging markets (including China) are slowing significantly. Some that are exposed to low commodity prices, including Russia and Brazil, are in much more serious difficulties.

The structural weakness of the eurozone, the uncertainty surrounding the United Kingdom's forthcoming referendum on continued membership of the European Union, the European migrant crisis, and the economic rebalancing of China are all adding to the challenges for policy. Political populism is on the rise across the globe – it is taking hold in many continental European countries (including Germany, France, Italy and Greece), and is a feature of the US presidential campaign and the 'Brexit' debate in the United Kingdom.

The current challenging environment makes it especially important for countries to cooperate in ensuring that the world economy stays on track towards the goal of strong, balanced and sustainable growth.

Trade and financial interdependences mean that each country has a strong interest in other countries' economic performance and policies. And yet, there is no agreement even on the nature of the problem at hand. Are the advanced economies in the grip of 'secular stagnation'? Are they still deleveraging after piling up too much debt in the pre-crisis years? Are emerging markets going through a period of adjustment from export-led to domestically oriented growth? Or is it just the case that the world is entering a 'new normal' of slow growth? The lack of a common diagnosis is making it harder to come up with an agreed strategy.

Like other multilateral institutions, the G20 faces a tension between encouraging global policy cooperation and accommodating the often-conflicting domestic priorities of its member countries. The current challenging environment makes it especially important for countries to cooperate in ensuring that the world economy stays on track towards the goal of strong, balanced and sustainable growth. If they do not, it will be more difficult to keep protectionist impulses at bay. Yet economic growth, and the policy-making to support it, increasingly seems to be perceived as a zero-sum game. At times of weak demand globally, there is an increased temptation for countries to engage in 'beggar-thy-neighbour' behaviour such as competitive monetary easing, with countries seeking to boost exports at the expense of their trading and financial partners. Moreover, in those circumstances structural reforms to increase productivity and competitiveness also risk a 'race to the bottom', simply redistributing demand rather than raising it.

This paper argues that the current situation requires *more*, not less, international cooperation, and that relying on supply-side policies and structural reforms without measures also to increase demand will not be sufficient to deliver growth. Monetary policy is reaching the limits of its ability to stimulate demand, as interest rates are near or at zero (or even negative) in key economies. This paper therefore advocates that the G20 promote coordinated and substantial fiscal stimulus to rekindle demand and support growth. Indeed, at their meeting in Shanghai the G20 ministers and central bank governors mentioned fiscal policy as one of the instruments for balanced and effective economic policy, and suggested that countries ‘use fiscal policy flexibly to strengthen growth, job creation and confidence’.¹

However, more action is required. In particular, the G20 needs to:

- reach a shared diagnosis of the problem;
- agree that pre-emptive action is required now, rather than intervening later when the crisis has deepened; and
- shift the focus to fiscal policy.

As Christine Lagarde, managing director of the IMF, has argued, what is needed is a broad-based response that includes ‘supportive fiscal policies’,² especially in countries with external surpluses, fiscal space and low inflation. There is some precedent for this. One of the high points of G20 activism was the London summit in April 2009, when all countries agreed on coordinated fiscal action to support global growth. Fiscal stimulus played a key role in restoring growth – in the run-up to the summit, G20 countries announced a combined total of \$5 trillion in fiscal expansion.³ Confidence returned and the global economy grew by 1.5 per cent, 2.4 per cent and 3.8 per cent in the following quarters of 2009.⁴ However, from 2010 onwards the policy focus returned to fiscal austerity, and it was left to unconventional monetary policy to secure economic growth.

The next two sections of this paper consider the uncertain outlook for the world economy and its causes, and identify the main risks to growth and financial stability. Subsequent sections then go on to examine what policy instruments are available, from structural reform to monetary and fiscal expansion, and their relevance to current global conditions and risks. The paper concludes with a section that proposes a specific agenda for China’s presidency of the G20 in 2016.

Risks are building in the world economy

China has taken over the G20 presidency at a time when the global economy is entering dangerous waters. Forecasts for global growth are being lowered, and downside risks are mounting. In October the IMF revised down its estimate for growth in the world economy in 2015 to 3.1 per cent, the slowest rate of increase since the crisis in 2009 when aggregate GDP growth was flat (see Figure 1). And its forecasts have been downgraded again in the latest *World Economic Outlook*, published in April.

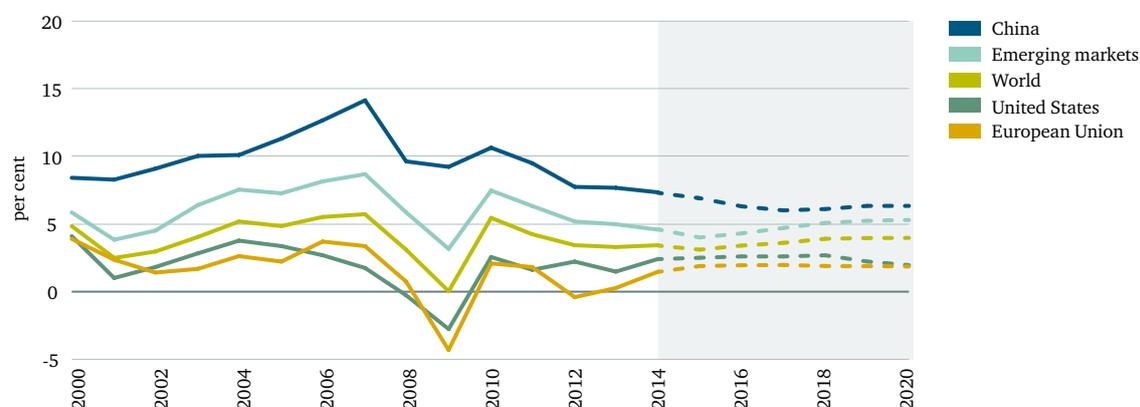
¹ G20 (2016), ‘Communiqué, Meeting of G20 Finance Ministers and Central Bank Governors (Shanghai, 26–27 Feb. 2016)’, http://www.mof.go.jp/english/international_policy/convention/g20/160227.htm (accessed 15 Mar. 2016).

² IMF (2016), ‘IMF Managing Director Christine Lagarde Calls for Bold, Broad and Accelerated Policy Actions’, Press Release No. 16/83, 27 February 2016, <http://www.imf.org/external/np/sec/pr/2016/pr1683.htm> (accessed 15 Mar. 2016).

³ Bradford, C. I. and Linn, J. F. (2010), ‘The April 2009 London G-20 Summit in Retrospect’, Brookings Institution, 5 April 2010, <http://www.brookings.edu/research/opinions/2010/04/05-g20-summit-linn> (accessed 16 Mar. 2016).

⁴ Oxford Economics via Thomson Reuters Datastream (accessed 15 Mar. 2016).

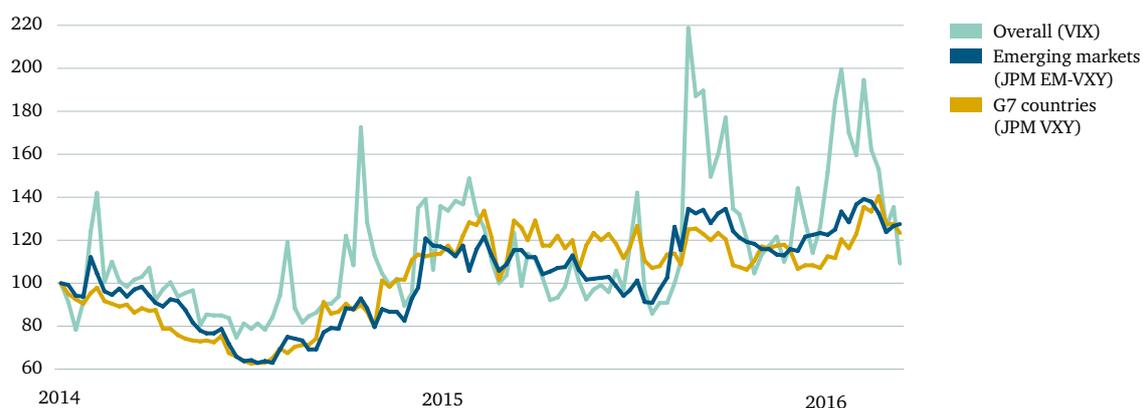
Figure 1: Real GDP growth, 2000–20



Note: 2015 data are estimates; 2016–20 data are forecasts.
Source: IMF (2016), World Economic Outlook Database, April 2016.

The IMF and OECD are still forecasting a slight pick-up in global growth this year and next. But the risk of a significantly worse outturn is increasing. Financial market volatility has risen sharply, as markets have been hit with a succession of shocks including Chinese stock market turmoil, sharp reactions to the US Federal Reserve's first hesitant moves towards monetary tightening, and plunging commodity prices (see Figure 2).

Figure 2: Selected financial market volatility indexes, 2014–16



Sources: Thomson Reuters Datastream, JP Morgan.

Good economic management, and good policies, could reduce these risks and contain their effects on global demand. But, as the IMF concludes, 'if these key challenges are not successfully managed, global growth could be derailed'.⁵

Against this background, some countries are still performing reasonably well – at least relative to the rest of the world. The US economy is continuing to grow steadily, having expanded by 2.4 per cent

⁵ IMF (2016), *World Economic Outlook Update, January 2016*, <http://www.imf.org/external/pubs/ft/weo/2016/update/01/>.

a year over the past two years. The IMF expects growth to remain at about that rate in 2016 and 2017. As a result, the US Federal Reserve was able in December 2015 to take another tentative step towards normalizing monetary policy by raising the federal funds rate target – although it has recently reined back its expectations for future interest rate rises as downside risks have increased. Lower oil prices and reduced profitability are starting to have an impact on investment in the energy sector in the United States.

In March the European Central Bank (ECB) embarked on another round of aggressive monetary easing, in which it reduced its main refinancing rate to zero, took the deposit rate further into negative territory and announced an expansion of asset purchases. Despite these measures, the EU crisis countries show little sign of improvement.

The United Kingdom has been relatively protected from global headwinds, but only in comparison with other advanced economies. UK growth fell back last year to just over 2 per cent. Economic forecasts in the government's latest budget were scaled back, with growth now expected to remain at about the same level for the next five years, as the economy faces a 'cocktail of risks' (as Chancellor George Osborne described it).⁶ Against this outlook, the Bank of England seems likely to maintain the current easy monetary conditions for some time to come. The latest minutes from the Bank's Monetary Policy Committee (MPC) meeting conclude that 'when [the] Bank Rate does begin to rise, it is expected to do so more gradually and to a lower level than in recent cycles'.⁷

Problems elsewhere are much greater. Europe seems to be stuck in a low-growth rut, even though there were tentative signs of recovery last year, with the eurozone forecast by the IMF to grow by 1.5 per cent this year and by 1.6 per cent next year. In March the European Central Bank (ECB) embarked on another round of aggressive monetary easing, in which it reduced its main refinancing rate to zero, took the deposit rate further into negative territory and announced an expansion of asset purchases.⁸ Despite these measures, the EU crisis countries show little sign of improvement. Moreover, Europe still has not fully faced up to the problem of bad debts in the banking sector – the European Banking Authority estimates non-performing loans (NPLs) at over €1 trillion, equivalent to 7.5 per cent of total EU GDP.⁹

Japan is also stuck in a low-growth situation, as domestic spending fails to respond sufficiently despite continuing fiscal stimulus, loose monetary conditions and lower oil prices. The IMF forecasts GDP growth of just 0.5 cent in 2016 and a contraction of 0.1 per cent in 2017. In January the Bank of Japan (BOJ) cut interest rates below zero, and its governor, Haruhiko Kuroda, has said that the BOJ is prepared to cut rates further.¹⁰

Rock-bottom energy prices have hit oil producers and other commodities producers hard (see Figure 3). Most are now facing fiscal and balance-of-payments problems, and many will be forced to cut public spending. In theory the effects on commodity producers could be offset by the benefits for consuming

⁶ Budget speech dated 16 March 2016, <https://www.gov.uk/government/speeches/budget-2016-george-osbornes-speech>.

⁷ Bank of England (2016), 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 16 March 2016', 17 March 2016, <http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2016/mar.pdf>.

⁸ *Financial Times* (2016), 'Mario Draghi delivers a bold expansion of stimulus', editorial, 10 March 2016, <http://www.ft.com/cms/s/0/04940bc8-e6cf-11e5-bc31-138df2ae9ee6.html>.

⁹ European Banking Authority (2015), *Report – 2015 EU-wide transparency exercise*, November 2015, <http://www.eba.europa.eu/documents/10180/1280458/2015+EU-wide+Transparency+Exercise+Report+FINAL.pdf> (accessed 21 Mar. 2016).

¹⁰ Address to the Japanese parliament, 15 March 2016.

countries, as their real incomes are boosted. But at the moment the net global effect of lower commodity prices appears to be negative, with lack of confidence preventing commodity importers from increasing spending sufficiently to offset falls in commodity-producing countries.

Figure 3: Selected commodity prices, 2010–16

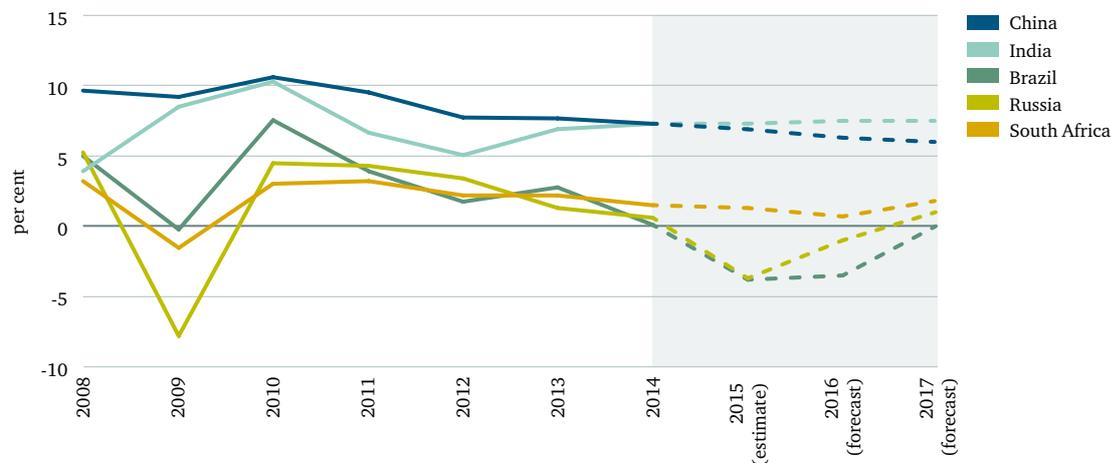


Sources: Thomson Reuters Datastream, ICIS Pricing, London Metal Exchange (all via Datastream, accessed 15 Mar. 2016).

Emerging markets

Russia and Brazil, in particular, are being badly affected by the slump in commodity prices. They are in deep recession (see Figure 4). Both countries saw output fall by around 3.75 per cent in 2015, and the IMF expects further contraction this year. On top of falling commodity prices, Russia has been hit by Western sanctions, and the Brazilian government is facing deep political problems.

Figure 4: BRICS real GDP growth, 2008–17



Source: IMF (2016), World Economic Outlook Database, April 2016.

China is facing largely home-grown difficulties – banking- and shadow banking-sector problems, asset and credit bubbles, and structural weaknesses as it makes the transition from export- and investment-led to consumer-led growth. The recent Chinese Communist Party Congress has recognized these problems, but many questions remain, in particular what policies China will undertake to increase domestic consumer demand; how state-owned enterprises will be reformed; and whether the Chinese government will be able to credibly liberalize its financial markets in the face of increasing global uncertainty.

Even if China's slowdown remains gradual and relatively orderly, the country is now such an important player in the global economy – and such a large trading partner for many other countries – that weakening demand growth is bound to have negative knock-on effects on other emerging markets, especially in Asia.

Emerging market growth has now declined for five consecutive years, according to IMF estimates. Among the BRICS, only India seems relatively unscathed at the moment. With annual growth of over 7 per cent, it is now outperforming China for the first time in decades. But India's economy is neither big enough nor strong enough to exert more than a marginal pull on other trading partners. With the general loss of confidence and headwinds facing them, a number of key emerging economies are likely to see things get worse in the short term – although it should be noted that the IMF forecasts a modest aggregate improvement in 'emerging market and developing economies' in 2016–17.

Policy pressures

Worsening growth fundamentals are interacting with financial market volatility in a vicious spiral. Markets are reacting to the emerging market slowdown, US monetary tightening, low commodity prices and greater uncertainties. The result is more volatile capital flows, rising risk premiums and large currency movements.

Last autumn the IMF identified the risk of a 'downside scenario' in which global asset markets are disrupted, liquidity in many asset classes dries up and risk premiums rise.¹¹ In such a scenario of tighter financial conditions, economic growth would stall, putting pressure on sovereign and corporate balance sheets. Emerging markets would face capital outflows, corporate defaults would rise, and the risk of a 'doom-loop' between corporate, sovereign and banking debt would emerge (as happened in the eurozone in the recent crisis). That scenario is now looking more likely than it was six months ago.

Added to these risks are uncertainty over the coming months from the UK referendum on whether to remain in the EU, and rising geopolitical tensions in many parts of the world.

The pressures are mounting on policy-makers worldwide to implement measures to boost growth, but almost all countries face severe domestic constraints on economic policy. As was the case during the crisis in 2008–09, countries acting together and providing peer support and pressure could help to overcome such constraints. At their meeting in Shanghai in February, the G20 finance ministers and central bank governors recognized that 'downside risks and vulnerabilities have risen' and that global growth forecasts could be revised downwards. They also recognized that they needed to 'do more to achieve our common objectives for global growth', and pledged to 'use all policy tools – monetary, fiscal and structural – individually and collectively'. But the G20 is not yet providing the leadership to make the necessary coordination a reality, and there has been little sign of actions to back up these promises.

¹¹ IMF (2015), *Global Financial Stability Report October 2015 – Vulnerabilities, Legacies, and Policy Challenges: Risks Rotating to Emerging Markets*, <https://www.imf.org/external/pubs/ft/gfsr/2015/02/pdf/text.pdf> (accessed 18 Mar. 2016).

What is hampering global growth?

A number of explanations have been put forward for the current sluggish and uncertain level of growth in the global economy. One argument is that the world has entered a period of '**secular stagnation**'. This suggests that the relative lack of attractive investment opportunities has encouraged individuals and firms to favour saving over investment. The resultant high levels of saving and low expected returns on investment have driven down real interest rates worldwide. Consequently, despite record low borrowing costs and central banks' pursuit of unorthodox policies such as quantitative easing (QE) and negative interest rates, economic growth is likely to remain slow so long as global demand for investment remains stagnant. This lack of demand would mean that expansionary monetary policy in one country, during a period of secular stagnation, would support economic growth primarily through exports (as that country's currency weakened) rather than through any increase in investment or domestic consumer demand.

The build-up of debt and the slow pace of **post-crisis deleveraging** have also been suggested as potential drags on growth. Global debt has been estimated at \$199 trillion in 2014, up from \$142 trillion in 2007, its proportion of GDP rising from 269 per cent to 286 per cent over the same period.¹² The process of debt deleveraging has been slow, particularly in advanced economies. The public debt-to-GDP ratios of the United States, the United Kingdom and the eurozone increased by between one-third and one-half between 2007 and 2014, to 105 per cent, 88 per cent and 94 per cent respectively; moreover, the IMF projects that by 2020 these ratios will remain significantly above pre-crisis levels.¹³ Total debt in China, driven by the corporate and financial sectors, has also risen significantly. This high degree of leverage across the main regions of the world makes additional investment unattractive, and is acting as a drag on global economic growth.

Structural emerging market **growth 'transitions'**, particularly in China, have been cited as another possible cause for slow growth. After the 2008 financial crash, emerging markets became the main engine of global growth for some years. Much of this demand was generated by rapid industrial growth and investment in China. However, the rate of annual real GDP growth in China has already declined from a recent high of 10.6 per cent in 2010 to 6.9 per cent in 2015, a 25-year low.¹⁴ Even if the process is orderly, the Chinese government expects a further slowing of GDP growth as the country makes the transition to an economy that is less dependent on manufacturing, exports and fixed-asset investment, and more focused on services and domestic consumer demand. This combination of slower growth and the consequent reduction in demand for commodities will have numerous spillover effects – including on investors seeking higher returns in China; on supply chains dependent on Chinese industrial growth; and on commodity exporters exposed to Chinese demand. These spillovers mean that a slowdown in China will have economic and financial ramifications far beyond China's borders.

Finally, it is possible that the financial crisis and the response to it have established a '**new normal**' environment in which the potential capacity of the world economy, and its prospects for sustained growth, are permanently reduced. This could happen through several channels. The atrophying of skills stemming from long-term unemployment ('hysteresis' effects) could permanently reduce the potential of the economy – in the eurozone alone, for example, the percentage of the labour force that has been unemployed for over two years increased by almost 2 percentage points between

¹² Dobbs, R., Lund, S., Woetzel, J. and Mutafchieva, M. (2015), *Debt and (not much) deleveraging*, McKinsey Global Institute, <http://www.mckinsey.com/global-themes/employment-and-growth/debt-and-not-much-deleveraging> (accessed 21 Mar. 2016).

¹³ IMF (2015), *World Economic Outlook Database*, October 2015.

¹⁴ IMF (2016), *World Economic Outlook*, April 2016.

2007 and 2014. Total factor productivity also grew by less than 0.1 per cent on average across all major European economies in 2007–11, representing a significant loss in potential growth.¹⁵ As uncertainties remain about the future path of growth, business decisions by households and corporates could be adversely affected. Firms will delay investment decisions and consumers will be more cautious, as both assume lower 'baseline' rates of growth. This has the potential to become a self-fulfilling cycle as ever-lower expectations lead to increasingly anaemic growth.

These explanations are not mutually exclusive. High levels of debt and lack of investment opportunities could hobble the structural transitions in emerging markets. Equally, the shift to more sustainable growth models may diminish high-return investment opportunities, thus making saving relatively more attractive. In turn, these trends could reinforce perceptions of a 'new normal' of slower growth, leading investors to be more pessimistic about investment opportunities. However, while all of these theories may be part of the explanation for slower growth, the appropriate policy response in each case may be very different. For example, secular stagnation implies emphasis on the active use of fiscal policy, while the debt overhang theory highlights the need for public- and private-sector deleveraging. And different countries may face different problems. Nevertheless, one common theme is that international cooperation over policy responses is likely to make individual countries' responses more effective.

Structural reforms are not the priority now

Raising productivity is the key to higher living standards in the longer term. The G20 agenda that was set out in Brisbane in 2014, calling for the identification and implementation of national-level structural reforms that can collectively add to the productive capacity of the global economy, represents a worthwhile initiative. In particular, infrastructure investment can add to countries' productive potential in the longer term, as well as giving a much-needed boost to demand in the short term.

The call to raise global output by an additional 2 per cent found resonance with the G20 membership in 2014. However, many of the national actions included in the plan were initiatives that countries were planning anyway. Incorporating them in the G20 agenda had the benefit of helping governments overcome domestic political pressures that would otherwise have made it hard to implement labour market reforms or product market liberalization. However, the assessment by the IMF and OECD in November 2015 was that less than one-half of the growth strategy measures identified as 'key commitments' in Brisbane a year earlier had been fully implemented.¹⁶

Furthermore, supply-side reforms are not the main priority for boosting growth at present. As argued above, weak or uncertain demand is a major reason behind the current problems facing the global economy. Structural reforms are likely to do little to address these problems in the short term. Indeed, because their main effect is to raise productivity, they could well end up increasing levels of saving (thus detracting from demand growth) by transferring income from sectors with a higher propensity to spend.

One exception to this could be trade. Trade reforms in the past have constituted a major driver of growth worldwide, and historically trade growth has exceeded global output growth. This pattern

¹⁵ OECD.stat, 'Multi-factor Productivity', <https://stats.oecd.org/Index.aspx?DataSetCode=MFP> (accessed 4 Mar. 2016).

¹⁶ G-20 Framework Working Group (2015), 'Antalya Accountability Assessment', <http://www.g20.utoronto.ca/2015/Accountability-Assessment-Report.pdf>.

has been reversed recently, as world trade has fallen as a proportion of global GDP. Part of the reason for this reversal is the rise in market uncertainty and financial volatility. But it is also partly due to some unravelling and disintegration of the global trading system. The 'mega' free-trade agreements currently being negotiated, especially the Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP), run the risk of fragmenting the system further.

One solution would be to reform and strengthen the World Trade Organization (WTO), which has become increasingly powerless and irrelevant in the world trading system. But trade has become caught up in geopolitics – as evidenced, for example, by the exclusion of China from the TPP negotiations. So, as desirable as a more effective WTO might be, progress on trade system reforms is unlikely in the short term.

Stretching monetary policy to its limits

Financial market volatility is seriously complicating the conduct of monetary policy. More fundamentally, as mentioned earlier, the surplus of saving over investment in major economies (including China, Japan and Germany) has resulted in a secular decline in global real interest rates. This means that global demand for capital only matches supply at low levels of real long-term interest rates.

Moreover, with the active use of fiscal policy constrained in virtually all developed economies, monetary policy by default has been required to take up the slack. This has driven short-term interest rates down to near zero or zero (and in some cases into negative territory). Many central banks have resorted to unconventional policies (such as QE, which involves purchasing financial assets by printing money) and 'forward guidance' in an attempt to lock in expectations that short-term interest rates will remain low for an extended period.

Many central banks have resorted to unconventional policies (such as QE, which involves purchasing financial assets by printing money) and 'forward guidance' in an attempt to lock in expectations that short-term interest rates will remain low for an extended period.

There are several problems with this approach. First, it can lose credibility over time. As a central bank becomes the single biggest owner of financial assets, the independence of monetary policy begins to be called into question, and unorthodox policy itself becomes less politically palatable. Second, QE policies appear to have become less effective and more distortionary over time, as the stocks of assets held by the central banks have risen. Third, the wholesale creation of liquidity increases the risk of asset price bubbles and consequent financial instability. In the past two decades there have been recurrent bouts of financial instability – the Latin American crisis in the mid-1990s, the Asian financial crisis in 1997–98, the dotcom bust in 2000, the global financial crisis in 2008–09, and the sovereign debt crisis in Europe in 2010–12. In all these cases the creation of liquidity played at least a part. And experience shows that financial markets do not recognize national boundaries. Liquidity that has been created by easy monetary policies 'travels' around the globe, causing spillovers well beyond the country of origin. Finally, as mentioned earlier, lax monetary policies can encourage competitive currency devaluation.

The need for coordinated fiscal stimulus

There is widespread agreement among G20 countries that the prospects for growth are insufficient and unsatisfactory. As finance ministers and central bank governors said in Shanghai, 'the global recovery ... falls short of our ambition'; they pointed to the risk of 'further downward revision in global economic prospects'.

With monetary policy options all but exhausted, and structural reforms likely to be ineffective (or even counterproductive) in the short term, this now leaves fiscal policy as the main tool available to G20 countries.

The G20 summit in London in April 2009 temporarily galvanized countries to commit to fiscal stimulus, but this happened in the exceptional circumstances of the global financial crisis. This stance was reversed the following year, and since then an austerity agenda – aimed at reducing high levels of public debt and absorbing the costs imposed by the crisis – has taken priority. Governments in many countries have continued to face domestic political and ideological resistance to more activist fiscal policy, based on beliefs that the public sector is too big or on concerns that relaxing fiscal policy would lead to higher interest rates or credit downgrades. This is problematic for global growth. David Vines argues that countries following fiscal austerity policies when interest rates hit zero will not only experience falls in demand and output, but will also impose output losses on other countries.¹⁷

Given the current circumstances – in which most economies are demand-constrained, there are big shortfalls in investment, and borrowing costs are historically very low – there is a strong case for governments taking on more debt to finance investment. For example, it has been estimated that Germany has a shortfall of infrastructure investment totalling €6.5 billion a year.¹⁸ The fact that infrastructure investment has a high domestic content also means that it is particularly well suited as a form of stimulus for domestic demand.

Given the possibility of adverse market reactions to higher budget deficits in individual countries, it makes sense for governments to act together. Only the G20 is capable of coordinating fiscal actions internationally, in order to offset deflationary pressures at a global level. But G20 action relies on an active and involved presidency to achieve agreement on concerted policy action.

China – which holds the rotating presidency of the G20 in 2016 – will face difficulties in playing this role. It has its own domestic priorities and economic problems to address, which could limit its capacity to spend time and political capital brokering a deal in the G20. The country is also seen in some quarters as part of the wider problem. It has been criticized heavily in the past by the United States for holding the renminbi down in order to boost exports. (Although this criticism has become more muted recently, China has responded to market pressures pushing the renminbi lower by spending some of its massive foreign-exchange reserves to slow the decline – see Figure 5.)

Nevertheless, in the absence of leadership from the presidency, it is likely that countries will continue to act individually. This would be sub-optimal for the global economy as a whole.

¹⁷ Vines, D. (2016), 'On Concerted Unilateralism', in Bayoumi, T., Pickford, S. and Subacchi, P. (eds) (2016), *Managing Complexity: Economic Policy Cooperation After the Crisis*, Washington, DC: Brookings Institution Press.

¹⁸ Kunert, U. and Link, H. (2013), 'Transport Infrastructure: Higher Investments Needed to Preserve Assets', *DIW Economic Bulletin*, 10.2013, http://www.diw.de/documents/publikationen/73/diw_01.c.429361.de/diw_econ_bull_2013-10-3.pdf, quoted in Subacchi, P., Pickford, S., Tentori, D. and Huang, H. (2014), *Building Growth in Europe: Innovative Financing for Infrastructure*, Chatham House Report, London: Royal Institute of International Affairs, <https://www.chathamhouse.org/publication/building-growth-europe-innovative-financing-infrastructure>.

Figure 5: Chinese gold and foreign-exchange reserves, 2001–16 (US\$ billion)



Source: People's Bank of China, via Thomson Reuters Datastream (accessed 31 Mar. 2016).

De-risking the global economy

Even with a substantial action plan to boost global growth, risks remain. It is likely that as growth continues to slow, vulnerable countries will edge closer to crisis. In order to prevent these difficulties from spreading and causing contagion, there needs to be an effective and well-financed global financial safety net.

The IMF has the task of helping countries in crisis, and during the 2008–09 financial crisis it substantially updated its toolbox and policies for carrying out this role. It also received a significant increase in financial resources to ensure that it had the firepower to do so. At the peak of the crisis, the IMF had nearly 30 programmes in place (not including concessional programmes for low-income countries) – covering about 15 per cent of its total membership.

Although IMF resources were tripled following the agreement at the G20 summit in 2008, much of this financing (around \$500 billion) was borrowed from member countries, either in the form of bilateral loans or through bond issues. Some of these loans are due to start expiring at the end of 2016, at a time when the need for IMF financing may start to rise again.

The experience of rescue programmes in recent years has highlighted a problem in their design. Countries facing sovereign debt crises often need substantial debt write-downs before their debts become serviceable and sustainable. Argentina has struggled for many years to achieve write-downs; and even when country creditors reached agreement on this, private bondholders tried to resist taking a haircut on their debt, often through legal actions. Greece also needed substantial write-downs on debt owed to private and official creditors in Europe; the problems it faced in getting agreement from other EU countries and institutions is well documented.

There have been attempts to revisit these issues from time to time. The Paris Club of official creditor countries has reasonably well-established guidelines to follow in these cases. Some progress has also been made in coordinating the actions of private creditors, through structures such as collective-action clauses in sovereign bond issues. But as cases such as Argentina and Greece show, these measures are far from perfect.

In 2000 the deputy managing director of the IMF, Anne Krueger, proposed a sovereign debt restructuring mechanism that would have given the IMF the responsibility for deciding when sovereign debts needed to be written down, and by how much. These decisions would have been binding on both public and private creditors. However, the proposals went nowhere, so that the international community still has no firm rules for these situations and is instead forced to 'muddle through'. It would no doubt take years to reach a comprehensive agreement on this issue. But given the possibility that more countries will go into crisis and require debt write-downs, now would be a good time to restart the discussions. The G20, which includes most of the major creditor countries, is the appropriate forum for these negotiations.

Urgent action is needed to de-risk financial systems, build defences against volatile capital flows, and tackle growing asset bubbles.

Post-crisis efforts to clean up financial systems also remain a work in progress. The efforts by the Financial Stability Board (FSB) to agree international rules and norms for capital standards, liquidity requirements and resolution mechanisms for failing banks have been big improvements. These changes are making the financial system more stable, both in individual countries and internationally. The framework for macroprudential policies is also being developed, but countries are at different stages in implementing these.

The recent increases in financial volatility are a reflection of how much still needs to be done. The lack of reform is weighing on growth. Urgent action is needed to de-risk financial systems, build defences against volatile capital flows, and tackle growing asset bubbles. The financial regulation agenda has been a key part of the G20's work since the first leaders' summit in Washington, DC in 2008, providing political oversight to the actions of the FSB (and its predecessor, the Financial Stability Forum) and the IMF in these areas, so again these are issues on which the G20 needs to continue taking a lead.

An agenda for the Chinese G20 presidency

So what does the G20 need to do in 2016? The analysis in this paper points to seven key actions that China should champion during its presidency of the G20:

1. **A shared diagnosis.** One essential condition for a cooperative approach is that all G20 countries should agree on the diagnosis – that the global economy is suffering from a deficit of demand, and is in need of strong and concerted stimulus to address the deficiency. What is needed is a 'summit moment' when leaders agree on the political imperative to act.
2. **An economic 'non-aggression pact'.** Countries need to agree not to act in ways that will exacerbate the situation. So all G20 countries should commit to a new 'non-aggression' pact on trade and monetary policies. This would require them not to introduce new protectionist trade policies, and to refrain from monetary policies designed to drive down their exchange rates.
3. **A fiscal compact.** G20 members should agree to do what they can to apply fiscal policies countercyclically. Countries with room for fiscal manoeuvre should use that room to the full. Acting together will increase countries' confidence that fiscal expansion need not risk adverse market reaction. Ideally the G20 should agree a numerical target for an overall fiscal stimulus as a proportion of total G20 output, a timetable for implementation, and a monitoring mechanism (with the IMF independently assessing progress by countries towards their commitments).

4. **Crisis resolution.** Contingency plans need to be made for addressing the difficulties that many countries could face should growth weaken and capital flows dry up. In the short term, the IMF needs to have the ability and resources to provide countries in crisis with adequate financing packages. A stronger system of global safety nets, with the resources to support them, is an urgent priority if the risk of contagion from crisis countries is to be minimized.
5. **Sovereign debt restructuring.** In the longer term the problem of unsustainable sovereign debt has to be addressed. Most crisis countries require some form of debt write-downs, but there is no systematic structure for achieving this. Developing an appropriate and effective structure will take time, but a start needs to be made now on building a permanent mechanism for sovereign debt restructuring.
6. **Financial-sector de-risking.** Many countries face major risks because they have not comprehensively tackled weaknesses in their financial systems. The G20 should (through the FSB and the IMF) identify the major risks faced by its member countries and put pressure on them to address these vulnerabilities. The experience of the global crisis showed only too clearly the dangers of ignoring such problems.
7. **Leadership by example.** Finally, China as the presidency country needs to lead by example. Committing to 'non-competitive' use of monetary policy, fiscal policy stimulus, and early action on NPLs and the problems in its domestic banking system would send a powerful signal to other G20 countries that China is serious in seeking cooperative and collective action on an agenda for growth.

Many of the actions outlined above must be undertaken by individual countries. Aspects of these reforms will be politically difficult domestically, especially while the active use of fiscal policy remains controversial in many countries. For example, it will not be easy to secure commitment from the United States given the practical and ideological constraints as the country approaches its presidential election. Yet collective impacts are strengthened if they are pursued in a joined-up manner across the world. The G20 is one of the few institutions with the expertise to be credible in advocating reforms, the visibility to achieve impact in domestic contexts, and the geographical scope and membership to provide a truly global solution. By moving together under the auspices of the G20, countries can overcome their domestic difficulties while maximizing the beneficial impact of their policies on global growth.

About the author

Stephen Pickford is a senior research fellow with the International Economics Department at Chatham House. He has worked on economic policy issues for most of his career. In 2010 he retired from HM Treasury in London, where he was managing director (international and finance), and G7 and G20 finance deputy. Prior to this he held posts as both director for Europe and director for international finance in HM Treasury, with responsibility for international finance issues. From 1998 to 2001 he was the United Kingdom's executive director on the boards of the IMF and World Bank. Previous posts included leading the team responsible for Bank of England independence in 1997, and the 1988 Cabinet Office review of economic statistics. He also worked in the New Zealand Treasury between 1989 and 1993 on macroeconomic policy and forecasting. He studied economics at Cambridge University, England, and at UBC, Vancouver.

Acknowledgments

This paper forms part of a joint research project with the Shanghai Institutes for International Studies (SIIS). The project aims to strengthen cooperation between UK and Chinese think-tanks on global economic governance, and to develop policy proposals informing China's G20 presidency in 2016.

Financial support for this project has been provided by the UK Foreign & Commonwealth Office through its Prosperity Fund, and is gratefully acknowledged.

Special thanks are extended to Paola Subacchi, research director, and Paul van den Noord, associate fellow, in the International Economics Department at Chatham House for their valuable contributions to this paper, and to Michele Bazzano and Matthew Oxenford for research assistance.

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ISBN 978 1 78413 138 8

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