Briefing

Mina Toksöz
International Economics Department | March 2015

Policy Cooperation in the G20: The Role of Middle Powers and Proposals for the Turkish Presidency in 2015

Summary

- The G20 was more than an organizational initiative born in the 2008–09 financial crisis; it also represented a new global consensus on growth and development. Turkey's presidency of the G20 should choose its priorities to leverage this consensus on the management of the global economy.
- The priorities should include two key areas. One should be to continue the focus on infrastructure investment to boost economic growth. On this there is wide agreement among G20 members, and good progress has been made on technical issues where the G20 has shown it can deliver.
- The second priority should be to push for international coordination to reduce risks to global growth from policy 'spillovers' and 'spill-backs' – the international impacts of policies and reactions by other countries. Here the G20 consensus has frayed, and these risks will increase in 2015–16.
- The G20's ability to help coordinate an orderly response as the US normalizes monetary policy will be a key test of its effectiveness, particularly given the likelihood of more volatile capital flows and currency movements. 'Middle powers' such as Turkey can play a major role in reasserting the early G20 mission of international cooperation and in reinvigorating the forum.

CHATHAM HOUSE
The Royal Institute of International Affairs

Introduction

The third summit to be hosted by a non-G8 developing country member of the G20 will take place in 2015. The G20 emerged from the unique circumstances of the 2008–09 financial crisis as the premier forum for global economic policy cooperation between advanced economies and developing countries. Initially the G7 members seemed to remain the agenda-setters in the G20, leading some observers to suggest that the G7 had maintained a 'hegemonic' role.[1] However, this began to change as more development issues were added to the agenda. In 2010 and 2012, South Korea and Mexico hosted summits. Turkey's presidency in 2015 will be followed by that of China in 2016.

This paper will argue that Turkey should choose its priorities to try to leverage the G20 consensus between advanced and developing countries on the management of the global economy. The priorities should include two key areas. One should be to continue the focus on infrastructure investment to boost economic growth. And the second should be to push for international coordination of macroeconomic policies to reduce the risks to global growth from policy 'spillovers' and 'spill-backs'.[2] While there is general agreement on the first priority, consensus on the second has weakened. In its concluding section, this paper will highlight the constructive role that 'middle powers' – middle-income regional powers – can play in reinvigorating the G20.

The construction of the G20 growth and development consensus

> The old Washington consensus is over. Today we have reached a new consensus – that we take global action together to deal with the problems we face … A new world order is emerging and with it the foundations of a new and progressive era of international cooperation.
>
> *Gordon Brown, UK prime minister, 2009 London G20 summit*[3]

The emergence of the G20 was not just an organizational initiative that better reflected the growing importance of emerging markets. It also brought a new consensus between the advanced and developing countries regarding the management of globalization. The shift away from the Washington Consensus – the mainstream thinking on the global economy that had prevailed since the 1980s – had begun during the 1997 Asian crisis with criticism of the policies of the International Monetary Fund (IMF). The rapid growth of the Chinese economy, based on a distinct, state-led development model, also challenged prevailing free-market orthodoxy.

The G20 emerged from the unique circumstances of the 2008–09 financial crisis as the premier forum for global economic policy cooperation between advanced economies and developing countries.

The 2008–09 global financial crisis brought the positions of supporters of market-led and state-led policy-making closer together. The crisis revealed the fragility of global financial centres in contrast to the relative resilience of the main emerging markets. While the advanced economies contracted 3.4 per cent in real terms in 2009, developing economies, led by China, continued to grow. They accounted for 86 per cent of world growth in 2008–09. This bolstered their position in the G20. In multilateral policy circles, there was greater appreciation of the constructive role of state intervention. However, any opportunity for self-congratulation on the part of China was quickly dampened by the contraction in global trade in 2009. This revealed the limits of the 'China model', prompting a shift in thinking in Beijing towards more market-driven policies. The G20 became a crucial forum for discussion of difficult issues from the rebalancing of current-account surplus economies – such as Germany and China – to the risk of unconventional US monetary policy triggering 'currency wars'. There seemed to be a more open discussion of past policy mistakes, allowing a new G20 consensus to emerge.

This was codified in the Seoul Development Consensus for Shared Growth, agreed in 2010. It moved away from the G8's focus on aid, towards growth-driven development led by the private sector but with a significant supporting role for governments. The link between the Seoul development agenda and the broader G20 Framework for Strong, Sustainable and Balanced Growth, agreed

[1] Robert Wade, 'Emerging World Order? From Multipolarity to Multilateralism in the G20, the World Bank, and the IMF', *Politics & Society*, Vol. 39, No. 3, 2011.
[2] 'Spillover' is typically when policy in one economy has negative effects on another (or others). One example was the sudden outflow of capital from emerging markets and ensuing currency volatility in mid-2013 in response to the announcement by the US Federal Reserve that it would start tapering its asset purchases. 'Spill-back' is the phenomenon wherein economic impacts in the spillover-affected economy subsequently create new problems for the policy-originating one. e.g. Spillover causes currency weakness in an emerging market, which is then unable to service foreign-currency-denominated debts, thus negatively impacting creditors in the originating country. The IMF defines the terms thus: 'the impact of policy actions in one country on others (spillovers) and the possible consequences for the original spillover source economies themselves (spillbacks)', http://www.imf.org/external/pubs/ft/survey/so/2014/pol072914a.htm.
[3] Quoted in Eswar S. Prasad, *The Dollar Trap: How the US dollar tightened its grip on global finance*, Princeton University Press, 2014, p. 171.

in Pittsburgh in 2009, was made explicit at the Toronto summit in 2010. The summit members agreed that 'narrowing the development gap and reducing poverty are integral to … ensuring a more robust and resilient global economy for all'.

Experiences of policy-making in various contexts have helped to shape this view. The pragmatic approach behind South Korea's remarkable economic development since the 1960s, the increase in financing options that have become available to developing countries in recent years, and the emergence of more innovative economic thinking following the global financial crisis – all have allowed a more diverse view of growth and development to emerge. The Australian G20 presidency in 2014 further integrated discussion of development into the broader global growth agenda.

The evolution of the G20 agenda since the 2008–09 financial crisis is illustrative. At the start of the crisis, which mainly affected advanced economies, there was understandably an urgent focus on restoring financial market stability and preventing a global economic depression. This resulted in the G20's introduction of massive, coordinated fiscal stimulus in 2009; and in an extensive programme of reforms led by the Financial Stability Board, the membership of which had been extended to all of the G20. However, the agenda then widened in 2010–12 to incorporate issues affecting developing countries, in an effort to strengthen the group's global legitimacy. It has since evolved to cover both the development and broader growth agendas. This has led some observers to credit the G20 for keeping globalization a going concern and forging a new 'global developmental liberalism'.[4]

Managing globalization: agreed and contested agendas

However, this consensus is increasingly being challenged in practice. Although the G20 agreed not to introduce new protectionist measures, policy-making has struggled with this commitment as domestic political pressures have risen in member countries.[5] The global economy is looking increasingly fragmented. Implementation of many priorities agreed by the G20, such as IMF governance reforms, has been delayed. This is also the case with macroeconomic policy coordination. Now that the global crisis has eased, fiscal and monetary policy coordination among G20 governments has weakened.

Despite these problems, there remain several priorities that all can agree on. In particular, infrastructure investment has been identified as a major driver of growth in advanced and developing countries alike.

Agreed agenda: the central role of infrastructure

Infrastructure investment ticks all the boxes in terms of growth and development. It helps the bigger emerging markets to overcome the middle-income trap, solves critical bottlenecks in energy and transport in the least developed economies (LDCs), and provides a counter-cyclical growth boost in advanced economies. Even in fiscally constrained economies, at times of low interest rates and negative output gaps the additional GDP growth generated from publicly financed infrastructure investment can limit the fiscal costs of such projects.[6]

Between now and 2020, global investment in infrastructure needs to rise by $1 trillion a year, according to various estimates.

Yet, despite the global savings surplus, there has been a dearth of finance for infrastructure investment. Between now and 2020, global investment in infrastructure needs to rise by $1 trillion a year, according to various estimates. The decline of bank lending, especially by European banks, since the global crisis has contributed to this funding gap. So, too, has the fall-off in projects funded as public-private partnerships since the mid-2000s.[7] In developing countries, which account for half of the $1 trillion investment gap, long-term credit remains scarce. Some 55–75 per cent of big infrastructure projects are funded by the public sector, 20–30 per cent by the private sector, and 5–8 per cent by official development finance. Globally, insurers, pension funds, sovereign wealth funds and private endowments invest only 0.8 per cent of their $50 trillion of assets in infrastructure – the result of poor project preparation, institutional weaknesses (failings in areas such as insolvency regimes, business regulation and procurement practices), and a dearth of 'bankable' projects to attract private sector long-term investment.

[4] Paul Cammack, 'The G20, the Crisis, and the Rise of Global Developmental Liberalism', *Third World Quarterly*, Vol. 33, No. 1, 2012.

[5] Since October 2008, some 1,185 import restrictions have been put in place, with about a fifth removed since. Fortunately, the remaining measures seem to affect only about 4 per cent of world merchandise imports. See *Global Economic Prospects*, World Bank, January 2015.

[6] *World Economic Outlook*, IMF, October 2014.

[7] Helena Huang, Stephen Pickford, Paola Subacchi and Davide Tentori, *Building Growth in Europe: Innovative Financing for Infrastructure*, Chatham House, September 2014.

The G20 focus on infrastructure began early in 2009. Policy-makers highlighted the importance of infrastructure investment to economic development and encouraged the main international financial institutions to lend more to infrastructure projects. In 2012 an Infrastructure Action Plan recommended drawing up a list of bankable projects. In developed financial markets, efforts to attract institutional investors (given the need of pension funds to match their long-term pension liabilities with long-term, revenue-generating assets) have revived interest in bond finance, especially project bonds issued by special-purpose vehicles. In Europe, the EU 2020 Project Bond Initiative – an EU and European Investment Bank joint facility of €230 million – is expected to mobilize investments of €4.6 billion, according to EU estimates.[8]

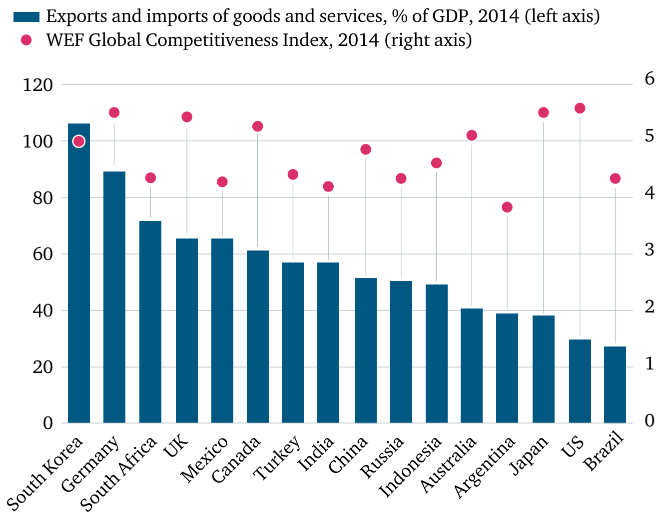
Infrastructure was also one of the highlights of the Brisbane G20 summit in November 2014, with three paragraphs out of 20 in the final leaders' communiqué dedicated to it. Noting that 'tackling infrastructure shortfalls is crucial to lifting growth, job creation and productivity', G20 leaders agreed to set up a Global Infrastructure Hub to foster collaboration between governments, development banks and the private sector to speed up investments. New guidelines were issued on improving project preparation, on the development of capital markets and pension funds, and on the introduction of institutional reforms, to reduce uncertainty and risks.

Contested agenda: policy coordination and management of spillovers

In contrast, there was little mention at the Brisbane summit of the need for macroeconomic policy coordination to manage policy spillovers and spill-backs. Yet dealing with these risks is likely to be the biggest challenge for policy-makers in 2015–16. Expected monetary tightening in the US and UK, combined with continued monetary easing in Japan and the eurozone, has already increased volatility in capital flows and currencies. This could exacerbate the global impact of slowing growth in emerging markets by generating spill-backs in advanced economies.

The lack of interest in policy coordination despite these risks reflects a number of factors. First, the largest economies do not share the same enthusiasm for global policy coordination, or appreciation of its benefits, as smaller ones. Economies with large domestic markets, such as the US, are somewhat cushioned from global shocks (see Figure 1).

Figure 1: The G20 globalizers?



Sources: World Economic Forum, IMF.

But IMF research using data from 1996 to 2013 suggests that about one-third of the policy spillovers from developed countries into emerging markets rebound into advanced economies through trade and financial links.[9] Although advanced economies mostly trade with each other, exports to emerging markets have become more important. In 2008 they accounted for 20 per cent of the advanced economies' total exports, up from 13 per cent in 1985.[10] Because of the greater integration of Asian economies, Japan could be one of the countries worst hit by an emerging-market crisis. There is the additional risk of disruption of cross-border supply chains; the foreign content of US exports has tripled since the 1970s, rising from 7 per cent to around 23 per cent today.

The second factor is that 'reserve currency' economies, even those with high debt levels such as Japan, are less exposed to market discipline as they can finance their borrowing at low interest rates. Their deep capital markets provide more resilience against external shocks. But spill-backs from emerging-market crises can still be significant, as was seen in the turbulence in US financial markets following the 1998 Russian default, which forced the US Federal Reserve to intervene with several interest rate cuts. Since the late 1990s advanced economies' exposure to emerging markets has risen sharply. The emerging-market component of rich countries' gross external assets has almost doubled, to 9 per cent of GDP in 2012. In the UK, bank claims on emerging markets represent 14 per cent of total foreign bank claims,

[8] See also the €300 billion Juncker plan, http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.htm.
[9] *Spillover Report*, IMF, 2014.
[10] M. Ayhan Kose and Eswar S. Prasad, *Emerging Markets: Resilience and Growth amid Global Turmoil*, Brookings Institution, 2010.

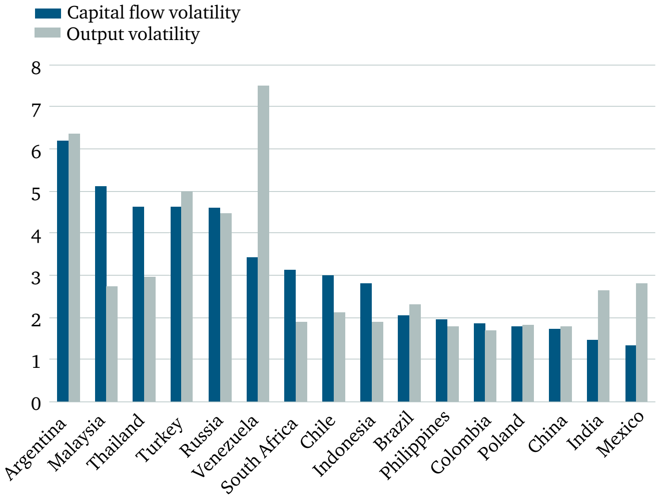
up from 4 per cent a decade ago. And this is set to grow. The World Bank forecasts that capital flows to developing countries could triple from 2010 levels to $6.3 trillion by 2030, with gross capital inflows into developing countries accounting for 47 per cent of total global inflows by that date, up from 23 per cent.

Moreover, governments and policy-makers in the leading economies have fallen out of the habit of international policy cooperation. Since the collapse of the Bretton Woods agreement in the early 1970s, there have been only brief periods of cooperation, such as the Plaza and Louvre accords in 1985 and 1987.[11] The efficient-market hypothesis and belief in free capital flows that dominated the thinking of policy-makers from the 1980s onwards reinforced the lack of interest in internationally coordinated interventions. Related to this has been the view that if the 'best' policies for each country were pursued, this would produce a near-optimal outcome globally. In this context, for better or worse it was argued that there was no need for policy coordination; international cooperation has been limited to agreeing multinational bailouts *after* crises happened.

Despite these realities of the changing global economy, and the weight of academic research, impetus for macroeconomic policy cooperation among the biggest countries in the G20 has steadily declined as memories of the global financial crisis have faded.

One of the consequences of all this is that policy thinking has primarily focused on *domestic* economic, political and institutional weaknesses in emerging markets as the main causes of crises, rather than on the impact of external shocks and spillovers.[12] Guillermo Calvo, who introduced the term 'sudden-stop' in relation to economic crises, recounts how after the crisis of 1994–95 in Mexico, which had previously been considered a star performer, '… the financial sector, particularly the central capital markets located in the United States and Europe, did not appear on the list of suspects' in many of the analyses by multilateral lenders.[13] This focus on domestic factors has had the positive effect over the past decade of enabling many emerging markets to adopt policies to strengthen their domestic economic structures, thereby providing more cushion against external shocks.

Figure 2: Exposure to capital flow and output volatility, 2000–12 (standard deviation of net non-official inflows, % of GDP)



Source: IMF, *World Economic Outlook*, April 2014.

But the risks of external shocks and spillovers are still there. In the wake of the 2008–09 global financial crisis, and the 2013 'tapering' shock, the IMF noted that '… external factors induce significant fluctuations in emerging market growth, explaining about *half the variance in their growth rates*' [author's emphasis].[14] Figure 2 shows the close relationship between capital flow volatility and growth volatility in major emerging-market economies.

Despite these realities of the changing global economy, and the weight of academic research, impetus for macroeconomic policy cooperation among the biggest countries in the G20 has steadily declined as memories of the global financial crisis have faded. Policy circles have mostly reverted to the view that good domestic policies are also 'globally optimal'. During 2013 Ben Bernanke, then Federal Reserve chairman, downplayed the role of US interest rates in triggering capital flow volatility. This was despite a World Bank study warning that a rise in bond yields in international markets by '100–200 basis points … could lead to a sharp reduction in capital inflows to developing countries by between 50 and 80 per cent'.[15]

Meanwhile, countries on the receiving end of the capital bonanzas continue to struggle with volatile capital flows. Factors such as growth differentials between advanced and

[11] Peter Temin and David Vines, *The Leaderless Economy*, Princeton University Press, 2013.
[12] For more on this, see Mina Toksöz, *The Economist Guide to Country Risk*, Profile Books, London, 2014.
[13] Guillermo Calvo, 'The Mayekawa Lecture: Puzzling over the Anatomy of Crises – liquidity and the veil of finance', *Monetary and Economic Studies*, November 2013, p. 46.
[14] *World Economic Outlook*, IMF, October 2014.
[15] *Global Economic Prospects*, World Bank, January 2014, p. 97. Bernanke quoted in Rakesh Mohan and Muneesh Kapur, 'Monetary Policy Coordination: The role of central banks', in Kemal Dervis and Peter Drysdale (eds), *G20 at Five*, Brookings Institution, 2014.

developing economies, low international interest rates and high commodity prices have been found to be key drivers of capital flows into emerging markets during global credit booms preceding financial crises and defaults.[16] There are difficulties in managing large inflows, which may result in unsustainable credit growth, inflation, overheated domestic demand and widening current-account deficits. Outflows, too, carry risks. These include liquidity crunches; sharp exchange rate depreciation and, depending on the response, erosion of foreign-currency reserves; banking sector crises; the need for government bailouts of banks; and even sovereign debt crises. These difficulties are undermining the consensus for global financial integration. Hence the stakes are high for the G20 in managing such risks. Given this impasse, three groups of measures have been debated.

The extension of regional and international financial safety nets by the reserve-currency advanced economies can act as pre-crisis insurance, so reducing the need for post-crisis bailouts. Such measures could include the reinstatement of currency swap agreements established during the 2008–09 crisis.

One strand focuses on trying to tame the pro-cyclicality of the financial system by using counter-cyclical monetary and fiscal policies, alongside micro- and macroprudential regulation at a national level. This has been a major focus of the G20 recommendations, but progress has been uneven. The Basel III reforms have strengthened capital and liquidity standards, with measures including the adoption of a counter-cyclical capital buffer for banks. But it has still proven difficult to reform fiscal policy to take account of financial cycles. Nor is there yet much consensus on shifting monetary policy from its narrow goal of price stability to the broader goal of financial stability and international policy cooperation.[17]

The second strand of arguments, such as those put forward by Raghuram Rajan, governor of the Reserve Bank of India, focuses on changing underlying growth models.[18] Paola Subacchi and Paul van den Noord also suggest that structural policies need to be adjusted to enable effective international cooperation.[19] This requires advanced countries to give more weight to financial stability and deleverage their economies, while developing countries should pursue structural reforms to strengthen their financial sectors and make themselves less vulnerable to external shocks. These themes recurred at the October 2014 meetings of the IMF/World Bank. It was argued that the real challenge both in advanced economies (especially in the eurozone) and developing countries lay not so much in macroeconomic policy as in structural reforms. These would include cuts in fuel subsidies, a shifting of taxation from employment to consumption, and liberalization of the services sector. It was this message that concluded the Brisbane G20 summit.

However, structural reforms can be politically difficult to implement and take a long time to have an effect. Hence in the meantime, in the light of immediate risks, a *third strand* of measures has been actively considered. This allows for countries on the receiving end of capital flows to adopt defensive buffers, including the use of capital controls in combination with macroprudential policies.[20] However, the effectiveness of capital controls is questionable. Controls on capital inflows are more benign than controls on outflows, which can cause major distortions in the domestic economy. But inflow controls do not always work either, as they can be circumvented or avoided relatively easily. Given the difficulty of disciplining capital flows, another approach is to opt for structural policy buffers such as flexible exchange rates and high levels of foreign-exchange reserves, and to ensure fiscal and monetary policy has the flexibility to adjust to external shocks.

In addition, the extension of regional and international financial safety nets by the reserve-currency advanced economies can act as pre-crisis insurance, so reducing the need for post-crisis bailouts. Such measures could include the reinstatement of the 14 currency swap agreements the US Federal Reserve established at the height of the 2008–09 crisis (totalling around $850 billion), which were later withdrawn for emerging-market central banks. Many of these swap agreements with emerging-market central banks were ultimately not used, but studies show that their importance lies in their 'capacity to signal central bank cooperation, which seems a crucial element of restoring market confidence'.[21]

[16] See Carmen M. Reinhart and Vincent R. Reinhart, 'Capital flow bonanzas: an encompassing view of the past and present', National Bureau of Economic Research (NBER) International Seminar on Macroeconomics, 2008, Chicago; Olivier Accominotti and Barry Eichengreen, 'The mother of all sudden stops: Capital flows and reversals in Europe, 1919–1932', Berkeley Economic History Laboratory working paper 2013–07; Kristin J. Forbes and Francis E. Warnock, 'Capital flow waves: surges, stops, flight, and retrenchment', NBER working paper No. 17351, August 2011.

[17] Claudio Borio, 'The International Monetary and Financial System: Its Achilles heel and what to do about it', Bank for International Settlements working paper No. 456, September 2014.

[18] Raghuram G. Rajan, 'Currencies Aren't the Problem: Fix Domestic Policy, Not Exchange Rates', *Foreign Affairs*, March/April 2011.

[19] Paola Subacchi and Paul van den Noord, *Trade-Offs Between Growth and Financial Stability: Is Coordination Feasible?*, Chatham House, September 2014.

[20] The lower debt levels of emerging markets boosted their resilience in the global financial crisis; debt-related capital inflows had halved by 2007, from 80 per cent of total inflows in 1985. Kose and Prasad, *Emerging Markets*, 2010.

[21] Michael D. Bordo, Owen F. Humpage and Anna J. Schwartz, 'The Evolution of the Federal Reserve Swap Lines since 1962', NBER working paper No. 20755, December 2014.

The Seoul G20 summit in 2010 agreed that pre-arrangements are essential when reacting to global financial shocks. Since then, IMF lending facilities have been enhanced and regional swap facilities in Asia and Europe have been bolstered. The missing link in this framework remains the emerging-market central banks left outside regional arrangements. The latter have to rely on IMF facilities, which have strict conditions attached, and which governments use reluctantly because of the associated stigma. Alternatively, in the midst of a liquidity crunch, governments may scramble for spur-of-the-moment credit lines from allies with cash to spare.

Challenges and priorities for the Turkish presidency

The Turkish presidency of the G20 comes at a key moment of transition, with memories of the global crisis having largely receded and attention shifting to new challenges. In 2015 the period of ultra-loose liquidity conditions to which policy-makers and investors have become accustomed will be nearing its end. The IMF, in its June 2014 *Spillover Report*, highlighted two main spillover risks for the global economy: tighter global financial conditions and slower emerging-market growth. To this can be added the risks from the recession-prone Japanese economy and the eurozone, and persistent output gaps in advanced economies due to slow progress in structural reforms and deleveraging. There is also the negative impact, particularly on Europe, of sanctions on Russia. If the G20 is to prove its usefulness, it is critical that its members cooperate to manage these risks. Effective cooperation is also crucial if the G20 is to meet the 2 per cent additional growth target agreed under the Australian presidency.

Turkey has identified inclusive growth and development as the top priority during its presidency of the G20. Given the country's open capital markets, floating currency, globally integrated banking sector and reliance on capital inflows to fund large current-account deficits, it would also represent a major achievement if Turkey could use its presidency to improve the management of spillover risks from international monetary policy tightening. Hence this must be a key focus of the Turkish presidency in 2015. In addition, during its term at the helm of the G20 Turkey should continue the forum's policy emphasis on infrastructure investment to support growth, and on defensive structural measures to strengthen international financial safety nets against capital flow volatility.

Infrastructure finance

In this context of increased downside risks to global growth, the infrastructure work-stream is an obvious focus for the Turkish presidency. As the analysis above has argued, in current global conditions infrastructure investment can support growth in advanced economies, middle-income developing countries and LDCs.

Infrastructure is in any case a domestic priority for Turkey. The government's 2014–18 five-year development plan projects infrastructure spending of $250 billion, with around 30 per cent to be privately funded. Among the high-profile projects under way are a third Bosphorus bridge and connecting highways, a third Istanbul airport, half a dozen more regional airports, two nuclear plants, harbours, and a high-speed rail network. Many of these plans reflect the country's growing role as a transport and energy hub. Infrastructure investment will be a major driver of growth in the rest of the decade leading up to the centenary of the Turkish republic in 2023.

The work of the G20 has focused on a number of related goals that could be developed further by the Turkish presidency. These are to:

- *Optimize the use of the public balance sheet*. G20 countries could give more attention to budgetary tools such as counter-cyclical fiscal rules that spread the burden of public investment over several years and protect investment spending during economic downturns.[22]
- *Increase the supply of private long-term finance*. Countries could expand the use of innovative financing techniques. Developing economies could promote reforms to encourage growth of local bond markets and allow institutional investors to mobilize private savings. This would require institutional reforms such as strengthening the rule of law and improving transparency in procurement to create a level playing field for investors and to avoid cronyism.
- *Increase the efficiency of infrastructure investments*. Countries could draw up priority lists of bankable projects at national and regional levels, and exchange information at the G20 level. They could improve project preparation.[23] They could also create national and/or regional infrastructure agencies such as a European Infrastructure Agency – an idea advocated in a Chatham House report last year – to coordinate national plans and cross-border projects with the G20.[24]

[22] *World Economic Outlook*, IMF, October 2014.
[23] Global Agenda Council on Infrastructure, 'Accelerating Infrastructure Delivery: New Evidence from International Financial Institutions', World Economic Forum, 2014.
[24] Huang et al., *Building Growth in Europe*, September 2014.

Support for LDCs is another priority for the Turkish presidency. It is an agenda that overlaps with the UN LDC review conference, to be held in Istanbul, focusing on the OECD's guideline on development aid of 0.7 per cent of G20 countries' GDP.[25] In keeping with the approach of choosing mutually reinforcing priorities, a specific portion of this aid could be committed to funding infrastructure. This would mark a shift from traditional aid to growth-enhancing measures.

Financial safety nets

Tasks for the Turkish presidency could include the following:

- Given the G20 consensus that pre-arrangements are essential when reacting to global financial shocks, Turkey could push to put in place currency swap agreements between the reserve-currency central banks and major emerging-market central banks (a measure proposed at the Seoul summit back in 2010).
- New ideas could be explored for managing capital flow volatility, such as 'global liquidity insurance', wherein each country would sign up to a liquidity facility with premiums reflecting its vulnerability.[26]

Rebuilding policy buffers and 'leaning against' the build-up of financial bubbles

The above measures cannot help if *domestic* economic vulnerabilities are not addressed. Swap lines and other short-term liquidity loans are likely to be extended only if a country is able to put its own house in order. The IMF report to the meeting of finance ministers and central bank governors in Cairns in September 2014 listed several policy buffers for countries on the receiving end of capital flows. The Turkish government should lead the way by implementing policy recommendations that apply to Turkey and encouraging other countries to follow suit. The recommendations could include:

- Building up foreign-currency reserves, exchange rate flexibility and macroprudential policies as the first lines of defence against fluctuations in capital flows.
- Rebuilding fiscal and monetary 'policy space'. For example, in Brazil, this could include winding down policy lending and cutting public debt; in India, more efforts to reduce inflation and the fiscal deficit, including subsidy reforms; and in Turkey, re-establishing a nominal inflation anchor and tightening fiscal policy while promoting national savings and competitiveness.

The capital-exporting advanced countries (in particular, the US) need to take more responsibility for policy spillovers. This needs to be combined with greater efforts to develop crisis prevention measures as an alternative to the reliance on post-crisis bailouts prevalent in the current international financial architecture. That the European Central Bank and the US Federal Reserve now give ample warning of their policy moves is a step in the right direction, but it is not enough.

The G20 should instruct financial regulators at supranational level to recruit more policy-makers from emerging markets who have experience dealing with cross-border policy spillovers, and to open more offices outside the main financial centres.

Countries need to develop counter-cyclical fiscal and monetary policies, and make greater use of macroprudential measures, to 'lean against' disruptive financial cycles and asset bubbles. These efforts could include further work by the Basel Committee and the Financial Stability Board to dampen the pro-cyclicality of capital flows, discourage short-term speculative flows, and bolster trade finance and foreign direct investment.[27]

The G20 should instruct financial regulators at supranational level to recruit more policy-makers from emerging markets who have experience dealing with cross-border policy spillovers, and to open more offices outside the main financial centres. Working with international financial institutions and other organizations, such as the OECD and Bank for International Settlements, the G20 should encourage more active monitoring and reporting of spillover risks and international financial flows. It should construct guidelines to show the costs and benefits of different types of capital flow and how best to respond to them.

[25] This focus on LDCs and aid fits in with Turkey's growing interests in Africa. Turkey's official development assistance to Africa rose to $772 million in 2012, up from only $28 million in 2006. It has also engaged with humanitarian medical projects, including the Africa Cataract Project in Niger, Somalia, Ethiopia and Sudan in 2013. See also www.mfa.gov.tr/turkey-africa-relations.en.mfa.

[26] This is a proposal by Eswar Prasad, a fellow at the Brookings Institution. See Prasad, *The Dollar Trap*, 2014.

[27] For example, the Basel accords have penalized short-term capital flows, even though these mostly consist of trade finance, which contracted dramatically in the 2008–09 crisis, with negative effects on the real economy. Measures could distinguish between short-term speculative flows and those tied to trade finance, to reduce the impact on trade and growth during financial crises.

Conclusion

Six years on from its formation as a leaders' level summit, the G20 finds its credibility weakened by the lack of implementation of many agreed measures. With the advanced economies struggling to grow and emerging-market growth slowing, domestic political trends are moving in an illiberal direction.[28] Domestic political tensions – such as those seen in the EU, Turkey, Brazil, India and South Africa – and the rise of geostrategic conflicts could reinforce protectionist trends and weaken interest in multilateral forums.

Some argue that the problem with the G20 is a lack of leadership. Another criticism is that it is too big and lacks the homogeneity needed to take collective action. It is certainly the case that G20 members have different expectations. Even among the smaller G7, there are sharp disagreements on issues such as climate change, austerity versus stimulus policies, and financial transaction taxes. The US elite's ambivalence towards multilateral institutions has delayed ratification of key reforms to IMF governance agreed by the G20.

The bigger developing countries – 'rising powers' – prefer either to work through the existing multilateral institutions or to construct their own alternatives. In the case of Brazil and India, the UN is their preferred multilateral organization because of its structure based on the sovereign equality of states.[29] China has tended to see the G20 as a transitional forum until the governance of existing multilateral agencies is reformed. In the absence of such reform, it has forged ahead with its own regional multilateral forums. Russia is in a category on its own, locked into a confrontational stance with the US. The country is rich enough to live with US and EU economic sanctions for a long time, implying a reversion to semi-autarky that would deepen the fragmentation of the global economy.

If mainstream powers such as the US, Japan and Germany, and the rising powers, have conflicting agendas and varying degrees of commitment to the G20, one group with a core interest in a well-functioning G20 runs across the advanced/developing divide: *the middle powers*. These include the 'mainstream middle' such as Australia and Canada, but also the 'new middle' such as Mexico, Turkey and Indonesia, with South Korea straddling the two. The G20 has revitalized this concept of middle powers, which are defined as states that cannot act alone effectively but can have a big impact if part of a group.[30] These countries have significant regional roles, but are seen also as having a constructive interest in the emergence of a multilateral global international order.

The middle powers have fewer options in international forums. Hence they have higher expectations from the G20 and are prepared to work harder to make it effective. Canada's critical role in the formation of the G20 is a case in point. South Korea has successfully bridged the policy divide between advanced and developing economies, and has been one of the main contributors of ideas to the G20. Australia has kept up the momentum, improving the effectiveness of the forum.

The realization that the middle powers in the G20 may have a common mission has led to the formation of MIKTA, which consists of Mexico, Indonesia, South Korea, Turkey and Australia. This group first convened in September 2013 at the margins of the UN General Assembly. MIKTA's declared aim is to strengthen multilateralism, to contribute to global governance reform and cooperation, and to make the G20 more effective.

Leaders need to be reminded of the G20's achievement in forging a pluralistic and pragmatic new consensus on growth and development.

Turkey is a good middle-income representative of globalizing developing countries. The G20 is a forum almost tailored for Turkey, a country that has struggled with the transatlantic-centred IMF/World Bank, the G8, the former Soviet alliances to the north, and the crisis-gripped Middle East. By highlighting Turkey's position as a middle power, the G20 can help the country to form constructive alliances with like-minded mid-level powers. Turkey is also a fairly typical mid-level power in terms of global governance, having several regional roles and ample experience in multilateral forums thanks to long years of EU membership negotiations, membership of NATO and the OECD, and two years on the UN Security Council.

The G20 is at a critical moment. The Turkish presidency's priorities of 'three "I"s' – inclusiveness, implementation and investment – align its agenda with a commitment to continuing the efforts of the Brisbane summit to make the G20 more effective.[31] Turkey must also ensure that the G20

[28] This trend towards an 'illiberal model' was recently evident in arguments put forward by the Hungarian prime minister, Viktor Orbán. See Gideon Rachman, 'Victor Orban's illiberal world', the *Financial Times*, 30 July 2014.
[29] Rosemary Foot, '"Doing some things" in the Xi Jinping era: the United Nations as China's venue of choice', *International Affairs*, Chatham House, Vol. 90, No. 5, 2014.
[30] See Daniel D. Bradlow, 'Reforming Global Economic Governance: A Strategy for Middle Powers in the G20', paper prepared for the workshop on 'Going Global: Australia, Brazil, Indonesia, Korea, and South Africa in International Affairs', in Jakarta, Indonesia, 25–26 May 2010.
[31] https://g20.org.tr/wp-content/uploads/2014/12/2015-TURKEY-G-20-PRESIDENCY-FINAL.pdf.

reconfirms its early mission of a ‘new era of international cooperation’. Leaders need to be reminded of the G20’s achievement in forging a pluralistic and pragmatic new consensus on growth and development.

By creating a forum in which every country has an equal voice, the G20 has given space to new ideas. It has revitalized the constructive role that the middle powers, with their emphasis on cooperation, can play. It has also shown that, under severe crisis conditions, it provides a forum for encouraging cooperation and compromise, and for resisting intransigence and polarization. Its crucial role during the global financial crisis ensured that the world economy avoided the protectionism and depression that followed the 1929 financial crash. The international environment looks set to be less amenable to integration and cooperation than in the past decade. But even if the G20 remains mostly a crisis-fighting forum, at least it will be there when (not if) the next crisis strikes.

About the author

Dr Mina Toksöz is an associate fellow in the International Economics Department at Chatham House. She is currently senior consultant economist to the Sovereign and Country Risk Analysis team at Lloyds Bank Group and was previously head of country risk at Standard Bank International. She is the author of *The Economist Guide to Country Risk*.

Acknowledgments

This briefing is part of the research project ‘Towards Inclusive Policy Coordination: Turkey’s G20 Presidency in 2015’, developed in partnership with the Economic Policy Research Foundation of Turkey (TEPAV) and with a contribution from the UK Foreign & Commonwealth Office through the Global Prosperity Fund. The purpose of this project is to engage with Turkey’s G20 team ahead of the presidency in 2015 to provide recommendations to steer and advance Turkey’s agenda on inclusive G20 governance.

I would like to thank Stephen Pickford and Paola Subacchi for their comments on the earlier drafts; James Kelly, Treasury representative at the Australian High Commission in London; Dr Coskun Cangoz, Chief Economic Counsellor at the London Embassy of the Turkish Republic; and Feride Inan from TEPAV, Ankara, for their constructive input at the seminars held in London and Istanbul. I would also like to thank Myriam Zandonini, formerly of Chatham House, and Ruth Rajavejjabhisal, Economic Officer at the UK Consulate in Istanbul, for their assistance in managing the project.

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ISBN 978 1 78413 038 1

Typeset by Soapbox, www.soapbox.co.uk

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The Royal Institute of International Affairs
Chatham House
10 St James’s Square, London SW1Y 4LE
T +44 (0)20 7957 5700 F +44 (0)20 7957 5710
contact@chathamhouse.org www.chathamhouse.org

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