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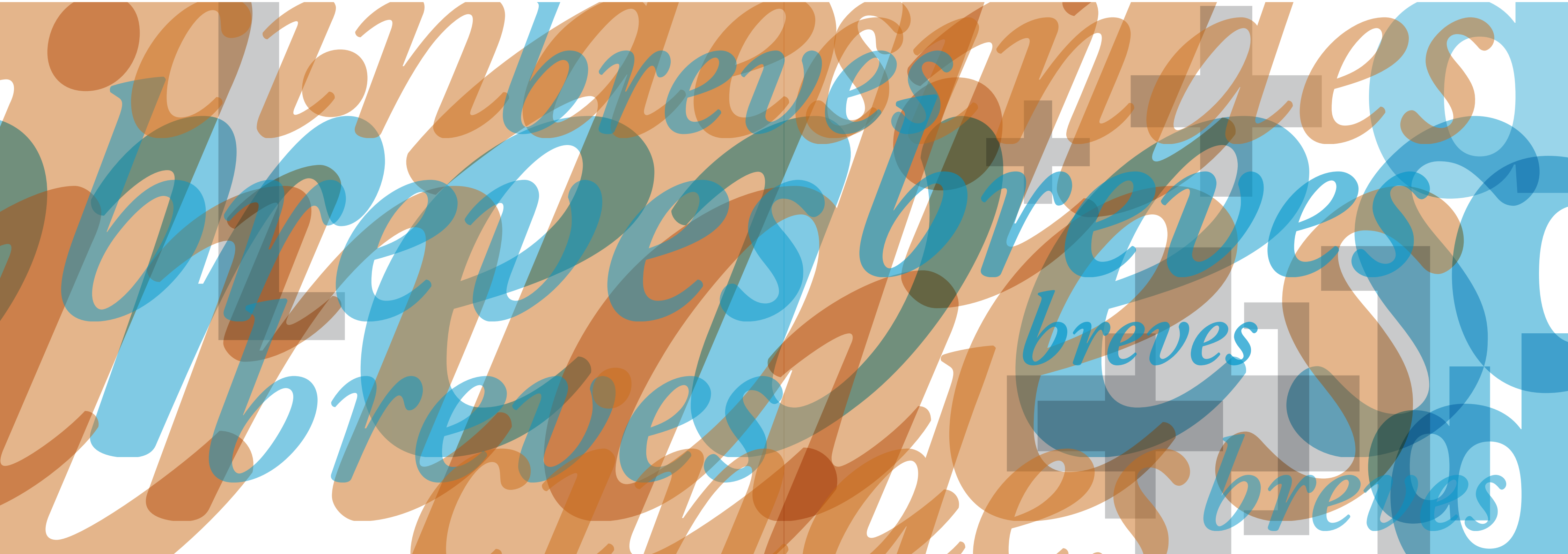

Global macroeconomic policy coordination after the 2008 crisis

Marta Castello Branco*

1. The long view: assessing G20 effectiveness

The global financial crisis that erupted in 2008 raised the profile of the G20 group overnight. Before the Great Recession, global macroeconomic policy was coordinated by a small group of industrialized countries (G5, G7, and G8). When the crisis hit, however, it became clear that its magnitude required a coordinated effort to restore global confidence, as well as a more representative model for global governance. This more inclusive approach recognized the increasing weight of emerging economies in the international economy, which they sought to translate into growing geo-political influence. Formally, the decision to establish the G20 as the 'premier forum' for international economic coordination was taken during the Pittsburgh Summit in September 2009.

G-20 Summits

Washington (November 2008)
London (April 2009)
Pittsburgh (September 2009)
Toronto (June 2010)
Seoul (November 2010)
Cannes (November 2011)
Los Cabos (June 2012)
St. Petersburg (September 2013)
Australia (2014)

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[1] The Group of 20 includes 19 (mostly large) industrial and emerging economies, plus the European Union. The group accounts for 85 percent of the world's GDP, 80 percent of global trade, and two-thirds of world population. From its creation in 1999 until the 2008 crisis, when heads of state started to participate, the G20 met at the level of finance ministers and central bank governors only.

G20 macroeconomic coordination during the peak of the crisis is generally considered successful. Faced with the threat of a global financial meltdown, during the 2008-09 summits G20 leaders set aside domestic policy concerns and united around the shared agenda, focusing on stimulating the world economy. To that end, the G20 expanded the funding base of international financial institutions (IFIs) and encouraged all members to adopt monetary/fiscal stimulus programs to help stabilize global output. This effort was especially vigorous in the large emerging countries, eager to burnish their credentials as major players in global affairs.

This sense of collective purpose started to crumble after the Pittsburgh Summit. To ensure a lasting recovery, the Pittsburgh declaration launched the Framework for Strong, Sustainable, and Balanced Growth, anchored on the Mutual Assessment Process (MAP). Through this new approach to multilateral policy collaboration, IMF staff was tasked with assessing the consistency, coherence, and compatibility of national policies with G20 objectives.[2] The idea was to highlight the role of policy spillovers and promote an understanding of the gains from cooperation in an increasingly interconnected world economy, thus helping unwind global imbalances. But the topic itself was analytically controversial and politically charged, as foreshadowed by earlier IMF attempts to conduct multilateral consultations between 2004 and 2007, amid generalized criticism of currency manipulation by China.

By the time G20 leaders met for the next summit in Toronto, the fragile consensus had fallen apart. The summit was expected to focus on the policy measures needed to keep the global recovery on track. However, the emerging sovereign debt crisis in the eurozone brought about a change of tone and purpose, with fiscal consolidation taking priority over growth. The debate about the risks of persistent global imbalances (and related policy prescriptions) exposed the cracks between the German-led 'austerians', and the advocates of Keynesian-style stimulus (notably the US government). And from then on, the G20's ability to deal effectively with global economic issues was increasingly questioned.

[2] For details about the MAP, see: http://www.imf.org/external/np/exr/facts/g20map.htm

With global rebalancing still to be achieved, the so-called currency wars took center stage in the run-up to the Seoul Summit. The focus of discussions switched to the ultra-loose monetary policies in the US, removing China's exchange rate policy from the spotlight. A positive outcome of the summit was the historic agreement on reforming IMF governance, which would expand the representation of emerging countries. Notwithstanding the new process for assessment and dialogue launched in Pittsburgh, no tangible policy results were achieved on macroeconomic coordination, which had become especially difficult under the dual-speed global recovery, with emerging countries growing much faster than the advanced world. In the meantime, the epicenter of the crisis had moved on from the US financial system to the eurozone's southern periphery.

During the two latest summits in 2011-12, G20 leaders' efforts to pass the relevance test were overshadowed by the protracted eurozone crisis. With Europe in political disarray, the ambitious agenda put forward for the Cannes Summit, centered on reforming the international monetary system, was hijacked by the debate over crisis response. To avoid a repeat performance, the Mexican chair calibrated the agenda for Los Cabos in line with low expectations, attempting to re-focus on the original G20 mandate of strong, sustainable, and balanced growth. Despite these efforts, short-term crisis management continued to dominate over the longer-term objectives in the agenda: a deepening eurozone crisis, coupled with a sluggish US recovery and a marked slowdown in emerging countries stoked fears of a double-dip global recession. As a result, concerns about the global imbalances and the related currency wars were placed on the backburner.

Ahead of the upcoming St. Petersburg Summit, all eyes are on the ups-and-downs of the eurozone crisis. The latest chapter—the high-drama Cyprus bailout, including a haircut on large depositors —brought renewed focus on eurozone governance problems and fresh concerns over potential gaps in the current crisis resolution framework. In particular, fears that the Cyprus deal could become a template for future bailouts, shifting the burden from taxpayers to private investors, have created more uncertainty regarding the future treatment of crisis countries.

2. The evolving agenda in the G20: key themes

The early G20 summits focused on the immediate issues raised by the global financial crisis, while other topics were added to the agenda as the crisis eased. The original core themes (recovery and global imbalances, financial regulatory reform, and overhaul of the international monetary system) continued to be critical during the subsequent summits, but increasing policy disagreements among G20 members prevented common actions to address these issues. After a near-collapse of world trade in 2008-09, efforts to enhance multilateral trade gave way to other pressing items in the G20 agenda, most notably the eurozone crisis, which involved similar policy disagreements, but no direct G20 role.

2.1. Recovery and global imbalances

The post-crisis period has witnessed some rebalancing of global demand but also occasional threats of currency wars. Notwithstanding the analytical arguments provided by the IMF in support of collective action in the post-crisis period[3], all G20 summits to date have ended without agreement on the root causes of global imbalances, let alone the policies to fix them. With limited fiscal policy space in several advanced countries, central banks continue to do the heavy-lifting, while politicians keep postponing the hard choices.

The global imbalances debate has focused on two related issues: (i) the appropriate response to the sluggish recovery in advanced countries (the 'austerity vs. growth' debate); and (ii) the twin needs for rebalancing global demand: internal rebalancing (shifting demand from public to private sector) and external rebalancing (boosting savings in countries with persistent current account deficits and raising consumption in countries with persistent surpluses).

[3] The IMF models point to a win-win situation, with higher global growth and employment. Adam, Subacchi, and Vines (2012) also make the case for international macroeconomic policy coordination in the period following the 'Great Moderation', when lack of coordination (the 'non-system') was not a problem.

Austerity vs. growth

There is no agreement among G20 leaders on how to achieve fiscal consolidation without undermining economic recovery. At the peak of the crisis, during the London Summit, G20 leaders endorsed the use of fiscal stimulus to offset lower private demand—only to shift gears in Toronto, calling for fiscal consolidation (albeit at different paces) in G20 members. This change in mood reflected the sharp market reaction to the Greek crisis, but also expectations that growth in emerging markets would drive the global recovery.

With global growth still anemic, the debate on the wisdom of fiscal austerity is far from settled. Indeed, it has only intensified as the eurozone recession continues to deepen, highlighting the fundamental disagreements between core and periphery. Those that believe that the key problem in some countries is their unsustainable debt argue that the necessary deleveraging process in the private sector would be only slowed down, if not worsened, by Keynesian-type fiscal stimulus. In time, fiscal austerity and structural reforms would produce positive results. While acknowledging the debt overhang, others believe that the main short-term problem is lack of demand, which has generated a jobs crisis, calling for Keynesian stimulus to rekindle growth. Fighting debt with fiscal austerity is self-defeating, as it adversely impacts on growth in the short-term, making it harder to reduce the long-term debt burden. When it comes to the eurozone, the right strategy would be to recalibrate the pace of fiscal consolidation, with economic policies aimed at reviving growth in the south and stimulating demand in the north.

While both austerians and Keynesians stick to their talking points, political support for austerity has steadily eroded. The austerity backlash is especially severe in the eurozone, where creditors, led by Germany, continue to push for more belt-tightening, notwithstanding alarmingly high and rising unemployment in debtor countries, and growing hostility to the 'austerity first' approach. The anti-austerity camp has gained some ground recently on account of the deteriorating eurozone outlook, the faltering global recovery, and the unveiling of statistical and modeling flaws in well-known and influential academic research linking high debt to low growth. As a result, the G20 has dropped a proposal to set debt-reduction targets below the 90 percent of GDP threshold identified by the academic research as damaging to growth.

Current account imbalances and the currency wars

The on-and-off threat of currency wars reflects deep disagreements within the G20 about the role of exchange rates in unwinding global imbalances. Given weak global demand and slow progress in implementing pro-growth reforms, competitive devaluations are tempting, but also ineffective since clearly it is not possible for all countries to raise their growth prospects by boosting exports at the same time.

G20 members have also argued about how to measure the global imbalances. In the hope of preventing currency disputes from escalating into trade wars and a return to protectionism, the G20 adopted a two-step currency coordination process during the Seoul summit:

- The first step involved the establishment of a set of domestic and external indicators to measure global imbalances, as well as a process (or indicative guidelines) to sort out the countries subject to peer review due to their potential spill-over effects.
- The second step encompassed an IMF assessment of the policies of the selected group of systemic countries (US, China, Japan, Germany, UK, France, and India). The seven sustainability reports for these countries included policy recommendations, which were used as input in the action plans discussed in Cannes and Los Cabos.

This approach represented an incremental change to the policy cooperation framework agreed in Pittsburgh, recognizing the challenges of coordination outside the crisis period and in the absence of a formal rules-based system. Since the MAP was voluntary and consensus-based, it had to rely on mutual assessment and peer pressure to move policy positions. Given the political economy challenges to collective decision-making, the framework had to evolve gradually, drawing on interactive technical discussions within the G20 Framework Working Group to achieve international cooperation.

This 'enhanced' MAP has been widely criticized for the lack of tangible results. Although the action plans represent a commitment to enhanced accountability, without a credible enforcing mechanism to ensure policy implementation there is no guarantee of a successful multilateral surveillance process. The optimists highlight the usefulness of the information-sharing and analytical discussion within the Working Group, which may still pay off in terms of increased trust and understanding, and ultimately lead to common action.[4] They also note that, in contrast to the failed IMF multilateral consultations, the G20 has leadership in the MAP exercise, with IMF staff playing the supporting role of technical advisor. In addition, a mechanism for accountability was launched in Los Cabos to measure progress in implementing past commitments, as part of the MAP's peer review process.

So far, however, G20 countries have framed the global imbalances issue according to their own interests, and carry on with their own domestic priorities. The US and EU tend to point the finger at the artificially undervalued Yuan as the main reason behind China's highly competitive exports. This criticism has been muted recently by evidence of a decline in China's current account surplus and in exchange rate misalignments. In turn, China blames the US and other rich countries for increasingly relying on unprecedented levels of monetary stimulus to boost domestic demand, and for exporting hot money to emerging markets, fueling inflation and weakening local currencies. While frustrated by China's competitive edge, the other emerging countries also firmly oppose advanced countries' accommodative monetary policies. They have responded to the destabilizing inflows from advanced countries with currency intervention and capital controls, which tend to complicate monetary management.

[4] See, for example, Butler (2012).

The easy money-plus-tight fiscal policy combination seems to be here to stay, as policymakers seek to boost anemic growth in situations of political gridlock. Although the new Japanese government's decision to join the 'monetary policy plus ' club led to a fresh round of accusations of currency manipulation during a February 2013 ministerial meeting in Moscow, a change in tune away from the prevailing currency wars rhetoric was noticeable during the Spring Meetings in Washington. Going beyond the usual pledges to coordinate and avoid targeting exchange rates, the G20 communiqué included a tacit endorsement of unconventional monetary policy to support the weak global recovery.

2.2. Financial regulatory reform

Once a clear priority, financial sector reform slipped down the G20 agenda in the post-crisis period. Following the initial crisis-driven push to establish the Financial Stability Board (FSB) and strengthen financial regulation, reform implementation has been slow and uneven, with the financial industry lobbying hard to delay the translation of the new global rules into national regulation.

One of key pillars of the G20 financial sector reform agenda was a revamped regulatory system, known as Basel III. The higher liquidity and capital requirements under Basel III, endorsed by G20 leaders during the Seoul Summit with a view to increasing the resilience of banks, will be phased in gradually, becoming fully effective by 2019. Other priority areas in the agenda include a resolution framework for global systemically important financial institutions (SIFIs), over-the-counter derivatives reforms, and oversight and regulation of shadow banking.

Implementation of financial sector reform is more advanced regarding the Basel III liquidity and capital requirement framework. According to the FSB, 14 out of 27 Basel Committee's members have issued final capital regulations, and 11 of them started implementing the new requirements by the January 2013 deadline. There have been delays in the remaining 13 members (notably the US and the

EU), but they have published draft regulations, and are expected to meet the 2019 timeline for full implementation.[5]

Although the G20 can claim a certain measure of success regarding Basel III, the new standards have been widely criticized. Some of the critics argue that, under pressure from the bank industry, the new standards have been watered down significantly, while long phase-in periods apply for some of the requirements. Others point out that, since the new requirements only apply to a subset of the financial system, they may not be sufficient to prevent another financial crisis. On the other side of the debate, the banking community has warned against the adverse impact of stricter regulation on growth and the functioning of markets, in an effort to stall implementation. But several studies suggest that these fears are exaggerated, as the benefits of additional financial stability would more than compensate any adverse impact from Basel III.

Clearly, much remains to be done to complete the G20′s financial regulatory agenda. In contrast to the relatively fast moves on Basel III, implementation of the other reform priorities is behind schedule. For example, discussions on a plan to tighten supervision of SIFIs have been marred by disagreements among European and US regulators on how to design the new package of capital surcharges and other safety measures, as well as the complexities involved in cross-border supervision and regulation. More generally, the delays in the FSB work program have questioned the feasibility of multilateral solutions, increasing the risk of unilateral initiatives that could lead to regulatory arbitrage.

2.3. Reform of the global financial architecture

The key issue here is the underrepresentation of emerging countries in IFIs. Since the onset of the crisis, emerging countries have used the G20 forum to call for a comprehensive review of procedures and governance in the IFIs—notably in the IMF—to better reflect economic realities and enhance their legitimacy and credibility.

The most pressing reform is to change the current quota distribution in the IMF. Reform of IMF governance would entail a redistribution of Executive Board chairs and reorganization of constituencies to secure a representation more in line with the share of emerging and developing countries in global GDP. It would also make the selection process for IMF and World Bank management more open, transparent, and merit-based, ending the long-standing, unwritten rule that guarantees a seat to a European national at the IMF and to a US national at the World Bank.

To the frustration of emerging countries, these reforms have moved at a snail's pace, with the sense of urgency all but lost after the crisis peaked. During the Pittsburgh Summit, the G20 agreed to shift the IMF quota distribution from developed to emerging/developing countries by at least 5 percentage points. After months of foot-dragging, in October 2010 they reached agreement on a reform package, which was subsequently ratified by G20 leaders during the Seoul Summit and later endorsed by the IMF Executive Board. The agreed overhaul of IMF quota and governance structure included three main items:

- Doubling IMF quotas and reforming their distribution, by transferring more than 6 percent of IMF voting power to emerging and developing countries;
- Keeping the current size of the Executive Board, with all 24 directors elected rather than appointed;[6]
- Reducing the representation of advanced European countries: Europe would give up two Executive Board seats and the US, which holds 16.5 percent of the voting rights, would retain its veto power.

These changes were expected to enhance the IMF's legitimacy and credibility, thus facilitating the process of international economic coordination. Once the reforms

[5] See April FSB progress report: http://www.financialstabilityboard.org/publications/r_130419a.pdf.

[6] Currently, the countries with five largest quotas (US, Japan, Germany, France, and the UK) have permanent seats (and appointed directors), while the remaining 19 chairs are elected by constituencies of countries.

were implemented, the BRICS would be placed among the top 10 shareholders of the IMF, with China holding the third largest quota in the Fund.

Regrettably, the quota and governance reforms still have not been completed. The agreed timetable was not met because the US Congress had not ratified the 2010 agreement before the 2012 IMF/World Bank Annual Meetings. Although the Seoul package had been endorsed by 146 Fund members, without US approval there were not enough votes to make it effective, since the decision required supermajority. The IMF Executive Board has also failed to agree to revise the formula to calculate the voting share of members. Decisions on a new formula and on changes in country representation at the Executive Board, which are expected to reduce European voting power and number of Executive Directors, have been postponed for the next quota review, due to be completed by January 2014.

Despite reform delays, the IMF has strengthened its role in global monitoring and as a potential lender of last resort. The Fund's capacity to deal with future crises was raised with the activation of a $581 billion crisis fund (the New Arrangements to Borrow) in 2011, and a significant resource boost ($456 million) committed in Los Cabos, which is additional to the funds pledged under the 2010 quota agreement. Still, failure to complete the governance reforms threatens to undermine the credibility and the effectiveness of the IMF, even as global inter-linkages become more challenging.

2.4. Global trade

The two main trade commitments during the early summits were to avoid the escalation of protectionist measures, and to conclude the Doha Round of multilateral trade. While largely successful at the former, the G20 has essentially given up on the latter.

After an initial wave of violations on the heels of the 2008 crisis, widespread protectionism has been avoided. While the recovery of trade was slow, reflecting weak global demand, protectionist responses by G20 countries were

limited both through increased awareness of the risks of protectionism and enhanced monitoring by the WTO, in collaboration with the World Bank and the UNCTAD. However, the worsening global economic outlook has rekindled fears of a return to protectionism.

Despite successive G20 pledges to conclude negotiations, the Doha Round continues to be stalled. Discussions broke down following opposition to the 'grand bargain' behind the Lamy package in July 2008, reflecting significant differences between advanced countries and major emerging markets. The vacuum has been filed with negotiations over regional agreements, including most recently a potential US-EU trade agreement (which would cover about 40 percent of global GDP), and the US Trans-Pacific Partnership with Asia (which would exclude China).

2.5. Additional economic and tinancial topics

With the crisis past its peak, the various rotating G20 presidencies attempted to pack the agendas with their own priorities, without making sufficient headway on the core issues. These topics have not gained traction, suggesting that only a strong sense of urgency—as in the 2008 crisis—can mobilize the G20 to take concrete policy measures. Yet, a couple of new topics will be introduced in the upcoming St. Petersburg Summit (long-term financing for investment, and government borrowing and public debt sustainability).

Global financial safety net

South Korea proposed to create a safety net for countries facing temporary liquidity problems. The new framework—still to be developed—would replace a conventional post-crisis IMF rescue package with pre-arranged financing tailored to individual countries. Although the original idea was to have central banks operate the new scheme (given bad memories of the Asian crisis), G20 leaders placed the IMF in charge, while endorsing the expansion of IMF lending facilities for countries facing a sudden liquidity crunch.

Development

Also on recommendation of South Korea, G20 leaders agreed to include development in the Seoul Summit agenda. The new framework—the 'Seoul Consensus for Shared Growth'—aimed at switching the focus of international development from financial aid to the broader factors underpinning economic growth, such as infrastructure. Nevertheless, the policy debate has continued to focus on austerity and fiscal consolidation instead of growth.

Reforming the International Monetary System (IMS)

The French Chair put forward the most ambitious of all G20 agendas, including as a center piece IMS reform. Pointing out existing systemic flaws (rising global imbalances, exchange rate volatility, destabilizing capital flows, and excessive accumulation of reserves by some emerging countries), France proposed the following actions to address them:

- Enhancing the effectiveness of macroeconomic policy coordination through the implementation of the MAP;
- Promoting alternative reserve currencies (including the SDR) to reduce reliance on the US dollar;
- Establishing a 'code of conduct' (monitored by the IMF) to avoid destabilizing capital flows;
- Increasing liquidity support from the IMF to limit precautionary reserve accumulation.

While there is G20 agreement on the broad goal of IMS reform, there is still no convergence on the means and speed to overhaul the current system. Of the proposed four actions, concrete results were achieved only regarding the increase in the IMF war chest (the $456mn pledged in Los Cabos). G20 governments remain divided on making the SDR into a global currency, not the least because it would require overcoming significant practical, political, and legal hurdles. The establishment of a 'code of conduct' for managing capital inflows runs against stiff opposition from emerging countries. And the jury is still out regarding the MAP potential to galvanize cooperative action.

Reducing volatility in commodity markets

France urged the G20 to curb speculation and reduce excessive volatility in commodity markets, so as to alleviate the social impact of high food and fuel prices. Specifically, the French proposed to tighten financial transactions regulation in commodity markets, strengthen hedging instruments against excessive price volatility, and enhance transparency for the physical commodity markets, with the establishment of a common data base for supply and demand trends. Again, no concrete agreement on these issues has been reached due to lack of consensus within the G20, with exporters and importers often on opposite sides of the argument.

3. The G20 track record: a story of diminishing returns

Beyond the occasional optimistic review, G20 post-crisis performance is generally considered disappointing. Following major achievements during the intense 2008-09 crisis period (Box 1), G20 countries increasingly turned their focus to domestic issues. As a result, the process of international cooperation lost steam, dashing hopes that the G20 could evolve into a new Bretton Woods.

Box 1

- Established the G20 as the premier forum for global economic issues
- Coordinated a large monetary/fiscal stimulus to avoid another great depression
- Introduced a new framework for multilateral policy coordination (MAP)
- Created a new institution (FSB) to coordinate and monitor progress on regulatory reforms
- Expanded the funding base of IFIs
- Avoided widespread protectionist response to the global crisis

Behind increasing criticism about the G20 is its inability to deliver on a few critical commitments. This failure contributes to dent confidence in multilateral solutions for global macroeconomic issues. Among the key commitments that have not been met are: global growth, IMF quota reform, and the Doha Round.

- The gap between global economic conditions and the G20's objective of 'strong, stable, and balanced growth' seems to widen with each summit. With the worse of the crisis behind them, many G20 countries shifted to austerity policies despite the fragility of the global recovery, pledging in Toronto to halve the ratio of budget deficits to GDP by 2013. Since then, most advanced countries have doubled down on austerity, despite disappointing growth.
- IMF governance reforms still have not been finalized. The 2010 quota and governance agreement continues to be hostage of the US ratification process. Given the tense budget environment in Washington, prospects for Congress approval of the legislation in the short term are slim, even though it does not entail an increase in IMF funding, but simply an accounting transfer from the New Arrangements to Borrow to the US quota.
- The G20 has put little emphasis on global trade during the post-crisis period. While protectionism remains a threat to the global economy, there are no current prospects to conclude the Doha Round. Instead, other trade initiatives at the regional level have taken the stage, reflecting deep skepticism about global agreements.

3.1. Main factors behind declining G20 effectiveness

Clearly, the scope for global cooperation now is far more limited than in the extraordinary crisis period of 2008/09, not the least because of reduced fiscal space in many advanced and emerging countries.

There are several reasons why the G20 has not lived up to expectations:

Lack of global leadership

The US retreat has created a vacuum in global leadership, which has not been filled by other emerging (or established) powers. Without a clear leader to push for results, the political and ideological differences within members tend to dominate the discussions, leading to communiqués filled with compromise language and empty promises. This lack of what political scientists call 'hegemonic stability' contrasts sharply with the dominating role of the US in past G7 deliberations.

Dual-track recovery

The global economy recovered from the 2008 crisis at different speeds. While emerging countries rebounded strongly, growth in advanced countries remained sluggish after the crisis. Uneven recovery was also the norm within the eurozone, with core economies performing strongly, while their peers in the periphery lagged behind, dragged down by austerity policies aimed at regaining competitiveness and restoring public debt sustainability. Such uneven growth has encouraged uncoordinated policy actions.

The policy disagreements

The group's divergent views over basically all relevant global topics—from the merits of fiscal consolidation to the role of governments—limit fruitful cooperation and consensus-building. Some topics—such as the currency wars—drive a wedge between emerging countries and the rich world. Emerging countries have not yet fully taken advantage of their new position at the global table, since their interests often diverge. While they are united in pressing for governance reforms in IFIs and in their desire to challenge US dominance, emerging countries are split on several key G20 topics. Similarly, within the eurozone there is no shared vision about burden-sharing and long-term solutions for the sovereign debt crisis. It remains to be seen whether effective implementation of the MAP will result in a better understanding of the need for (and benefits of) cooperation, and thus encourage collective action.

Lack of enforcement mechanism

Given their entrenched differences, most of the time G20 members simply agree to disagree. In the absence of a formal enforcement mechanism to promote the collective interest, G20 leaders continue to address global issues at the national level. The Accountability Assessment Framework introduced in Los Cabos aims at using peer pressure to measure progress in implementing past commitments and identify policy gaps, but it remains untested.

The numbers

Such an unwieldy group is not conducive to objective decision-making. The G20 summits include not only G20 members, but several guest countries and many international organizations (UN, IMF, World Bank, WTO, FSB, ILO, FAO, and OECD). Only in extremis, when they are all hit by the same shock (as in 2008/09), it is realistic to expect this large group to deliver concrete actions instead of diluted messages and general commitments. The best that can be expected under the circumstances is that the summits provide an opportunity for leaders to exchange information and ideas on global policy issues —a point often made by G20 optimists. While there is clear value in this exchange, the large numbers contribute to cement the widespread perception of the G20 as a 'talking shop' rather than a decision-making body.

The process

The G20 agenda has been broadened at each summit, together with the proliferation of new initiatives, new working groups, and even new institutions (such as the FSB). A number of ministerial meetings (labor, agriculture, development, trade, foreign affairs, and tourism) have been added to the original setup, which included only finance ministers and central bank governors—arguably a more appropriate audience to discuss global economic issues. There is also the outreach effort—with parallel meetings of Business-20, Labor-20, Youth-20, and Think-20. The cost of this increasingly complex bureaucracy is out of sync with the current austerity environment, especially if contrasted to the few concrete deliverables. While each rotating presidency attempts to re-focus on the original mandate, in practice each summit adds more commitments, more acronyms, more participants, and longer communiqués—invariably filled with pledges to stick to multilateralism, free trade, and market-determined exchange rates.

4. The global economic outlook: from budget battles to currency wars

The world economy is still on a roller-coaster. The ride appeared a bit smoother in early 2013, after the dire predictions for the previous year did not materialize. Indeed, there was some hope that the global economy was finally turning the corner after the 2008 crisis, and financial markets rallied with (premature) optimism. But anxiety about another bout of turbulence soon settled in, amid renewed tensions in the eurozone, the prospect of significant short-term fiscal tightening in the US, and a slowdown in China.

Economic uncertainty, political dysfunction, and synchronized austerity policies are still weighing on the global recovery. Last-minute policy actions in 2012 averted an immediate fiscal crisis in the US (the 'fiscal cliff') and a breakup in the eurozone, while the feared hard-landing in China did not take place. But global growth continues to be weak and uneven. Despite robust contributions, emerging countries have been unable to completely offset the lackluster growth performance in advanced economies. As a result, the GDP of the G20 economies increased by 3.3 percent in 2012, compared to 4.2 percent growth in the previous year.[7] Growth forecasts for 2013-14 have been downgraded to match the weaker macro trends.

[7] IMF (April 2013).

The global financial crisis has evolved into an unemployment crisis in **advanced economies**, most critically in Southern Europe. With fiscal policy in austerity mode and inflation expectations low, central banks have been doing the heavy lifting to support economic activity. The unconventional monetary policies adopted by the major central banks have buoyed financial markets, but rekindled the currency wars and the exasperation of emerging countries. Importantly, given slow progress in deleveraging and implementing structural reforms, central bank activism has not translated into significant real sector growth or employment/wage gains in most advanced countries. **Emerging and developing countries** posted an average growth of some 4 percentage points above that of advanced economies in 2012, validating the decoupling theory. While faring relatively well in their efforts to compensate weak external demand with increased domestic spending, they are not expected to repeat their strong pre-crisis performance anytime soon, as their growth rates are slowing.

4.1. Main downside risks

While short-term risks have been contained, dark clouds still hang in the air. This is especially the case in the eurozone, where confidence has reached new lows and unemployment has reached record highs. Medium-term challenges remain virtually unchanged in the three major pillars of the global system—the United States, the eurozone, and China— as they call for politically-difficult structural reforms, instead of the usual quick fixes.

In the **United States** the recovery keeps hitting speed bumps. There are some signs that economic activity is gaining strength, notably through the accelerating housing market recovery, improved prospects in the labor markets, and significant progress in repairing private sector balance sheets. But recent tax increases and across-the-board government expenditure cuts could take the steam out of the fragile recovery. The ongoing recession in the eurozone and the slowdown in China are also contributing to undermine US growth prospects.

Excessive short run fiscal consolidation could derail the recovery process. The past two years have witnessed a series of self-inflicted fiscal crises, including a stand-off over the debt ceiling (August 2011), the fiscal cliff fight (end-2012), and disagreements over ‘sequestration’ in early 2013, leading to tax increases and sweeping automatic budget cuts over the next decade. These are estimated to shave some 0.5 percent off GDP and cut 700,000 jobs in 2013, working against the FED’s efforts to stimulate the economy through a massive bond-buying program. So far the stock market has shrugged off the budget battles, with both the DOW Jones and the S&P500 indices hitting new records, thus erasing Great Recession losses. However, despite an unprecedented stock of corporate cash reserves, emphasis on front-loaded deficit reduction has been a drag on growth, while uncertainty about fiscal policy is holding back investment and hiring.

Uncertainty about monetary policy is also clouding growth prospects. The current disconnect between the financial market boom and sluggish real economic activity has raised flags about the diminishing returns and the potential risks of unconventional monetary policy. A less-than-smooth exit from quantitative easing (QE) could impact negatively on financial stability (with the creation of asset/equity bubbles if monetary stimulus is withdrawn too slowly) and growth (with negative impact on economic activity if monetary stimulus is withdrawn too fast). Uncertainty about the future impact of QE and the limits to its capacity to lift the global economy from the post-2008 slump are behind the increasing criticism of central bank activism in the US and in other advanced economies.

In the long run, the gloomy fiscal outlook remains the main downside risk for the US and for the global economy. Long-term fiscal sustainability remains elusive, with high public debt and an unsustainable path for old age entitlements. Negotiations on a fiscal adjustment program that tackles rising health-care and pensions costs continue to be crippled by partisan politics. In principle, the recent improvement in the fiscal deficit should give politicians the window of opportunity to tackle the long-term challenges. But in the current dysfunctional political system, it may simply serve to delay the day of reckoning.

In the **eurozone**, the picture is a lot gloomier, with a lingering political crisis on top of the ongoing economic distress. At the same time, structural reforms to boost competitiveness in labor, product, and service markets seem to have lost momentum. An immediate currency crisis was averted after the ECB promised to do 'whatever it takes' to save the euro and launched its Outright Monetary Transactions program (in September 2012). But downside risks re-emerged in early 2013, following the inconclusive Italian elections and the controversial Cyprus bailout. In the meantime, real activity had weakened throughout the 17-nation economic bloc, with Southern Europe's recession threatening to spread to the north. The eurozone economy contracted by 0.6 percent in 2012—its worst performance since the 2008 crisis—and is likely to shrink again in 2013.

Underneath the higher levels of uncertainty, the key problem for the eurozone as a whole is low growth and high unemployment. The fiscal austerity imposed on the Southern periphery has not been offset by more expansionist policies in the German-led core countries, raising the odds of a deeper and prolonged recession. And there are growing doubts about the effectiveness of the current bailout programs to rebalance competitiveness across the euro area. Despite some impressive fiscal adjustment in the periphery and significant steps in solving its banking problems, the perverse link between weak banks and weak sovereigns has not yet been broken. Following a December 2012 agreement to make the ECB the common bank supervisor for the eurozone, little progress has been made to complete the necessary steps to set up a full-fledged banking union. As a result, high financial fragmentation persists, with borrowing costs in the periphery much higher than in the core, despite ECB's efforts to boost credit through refinance rate cuts.

While the monetary transmission mechanism in the eurozone is broken, the economic and social gaps between creditors and debtors have only widened. Record unemployment levels in the south have led to increasing social unrest, as debtor countries demand a shift of emphasis from austerity to growth. Following a stream of bad economic data in the spring of 2013, the anti-austerity camp has gathered some strength, raising speculation that a potential shift in the eurozone stance toward pro-growth policies and closer integration will take place after the fall elections in Germany.

The short-term risk of a hard-landing in **China** has been reduced by government measures aimed at stabilizing the real estate market and reining in the fast-growing shadow banking system. While these policy actions contributed to the lowest GDP growth in the past decade (an annualized 7.7 percent in the first quarter of 2013), a lower growth trajectory is to be expected as China catches up with advanced economies. But the recent slowdown could also be seen as a prelude to a 'middle-income trap' (the risk of stagnation before graduating to the ranks of advanced economies), as the new leadership negotiates the transition to a new growth strategy.

While its economic model is clearly unsustainable, the resilience of the Chinese economy keeps surprising critics, as it generates high growth year after year, though at less spectacular rates recently. But these achievements have come at the cost of significant internal imbalances, including regional disparities, surging income inequality, environmental degradation, and growing financial risks. The credit boom that powered the Chinese economy through the global financial crisis resulted in highly indebted local governments, under-capitalized banks, and real estate bubbles.

These vulnerabilities complicate the transition to a model based on domestic consumption and labor-intensive activities. Tangible progress has been made in reducing external imbalances, with domestic consumption accounting for more than half of GDP growth during 2011-12. But the rebalancing process is far from complete. Managing this transition, while avoiding an investment collapse and financial disruption, is the key medium-term challenge for Chinese policymakers. Whether China will be able to avoid a hard-landing remains a hot debate topic; the skeptics remind everyone that investment booms typically end up in investment busts.

5. Alternative scenarios for the post-crisis global economy

The 2008 financial crisis put a stop to an era of unprecedented global prosperity. The debt-financed boom of the previous years—the so-called Great Moderation—gave way to a period of deleveraging, low growth, and high unemployment in advanced economies. Importantly, the financial excesses of the past decades and the policy dilemmas they created have increased uncertainty and thus dented global growth prospects. Low economic growth has become the new normal for the developed world in the post-crisis period. Going forward, the interaction between the 2008 crisis and some key long-term trends will impact significantly on global growth prospects.

5.1. Global growth prospects

Globalization

Thanks to globalization, the 2008 crisis was transmitted rapidly around the world through the global financial systems. In the hyper connected world economy, domestic growth strategies have become more vulnerable to external shocks, notably to fast-moving financial spillovers. The crisis, in turn, negatively affected the financial globalization taking place in the previous decades. As a result of the ongoing deleveraging process and regulatory pressure, both financial deepening and financial integration have stalled, with adverse implications for global economic recovery and growth.[8]

In parallel, the long-term deterioration of income distribution and labor force participation brought about by globalization-induced technological change was exacerbated by the crisis. The lackluster performance of advanced countries in the post-crisis period has contributed to consolidate a category of globalization losers (the 'new poor'), including low-skilled and/or young unemployed in economies that increasingly require a qualified workforce. Some countries, such as Germany and its Northern European neighbors, have been successful in arresting the decline in labor force participation through effective job retraining. But in many others, including the US, globalization has left a lot of people behind.

Demographic change and inter/intra-generational transfers

Long-term demographic shifts that significantly raise life-expectancy imply a transfer from the young to the old, given existing welfare benefits. This transfer is taking place at a time when several advanced economies are not creating enough well-paid jobs for young people, and several developing countries are fighting youth unemployment. Moreover, population aging has placed an increasing burden on the budgets of countries with limited fiscal space, on account of the financing of public pensions and health care programs.

The crisis-related increase in public debt brought additional fiscal headwinds. The resolution of debt crises implies a transfer from creditors to debtors within the current generation. With inflation subdued and default avoided by successive government bailouts, this transfer is taking place mostly through financial repression, as savers are penalized by exceptionally low interest rates. Going forward, however, higher inflation remains a distinct possibility as a way to push the costs of the crisis to future generations, since it may be hard to reverse the extraordinary amounts of liquidity that the major central banks have been dishing out.

Multipolarity and governance gap

The 'Pax Americana' is drawing to an end. The last two decades have marked a gradual decline in US economic power, together with the steady rise of China, India, Brazil, and other emerging economies. This shift in global dynamics became evident in the wake of the 2008 crisis, when emerging countries' strong economic

[8] According to McKinsey Global Institute (March 2013), growth in global financial assets has reached a plateau, while financial deepening in many emerging markets has slowed down. Moreover, cross-border capital flows are 60 percent below their pre-crisis volumes.

performance helped stabilize global output. Moreover, if recent trends continue, we can expect to see a gradual move toward a multicurrency system, as emerging countries increasingly shift to less traditional currencies (including their own) when investing their official reserves. At the same time, hopes that the euro could displace the US dollar as reserve currency have been dashed by the uncertainties created by the eurozone crisis.

The global financial crisis exposed a widening governance gap in the new multipolar world. The rise of many different powers without a clear 'hegemon' to provide global public goods and steer the global economy has resulted in shifting alliances, growing economic nationalism, and political stalemate. Despite the global nature of most economic problems in an increasingly interconnected world, country leaders continue to search for domestic solutions, at the expense of durable global strategies. This leadership gap is evident in the successive episodes of crisis mismanagement in the eurozone, with national interests clearly trumping those of the union, exacerbating the economic downturn.

5.2. Illustrative medium-term scenarios

The proposed medium-term scenarios are based on alternative policy developments in the key global players—United States, eurozone, and China. A number of 'game changers' could alter the dynamics of the baseline scenario discussed below.

Baseline scenario: muddling-through and low growth

This scenario assumes the continuation of current trends and uncoordinated macroeconomic policies, which would deliver only modest and uneven medium-term growth, and high unemployment. Given the unchanged configuration of risks and vulnerabilities, advanced economies would carry on with the ongoing deleveraging process in order to improve debt sustainability, basically sticking to their austerity agenda. As a result, they would continue to grow below trend, making it harder for China and other emerging countries to power the world growth engine.

The global economy would depend mainly on the growth dynamics in the US and China. The eurozone would continue to struggle to solve its sovereign debt crisis and regain growth momentum, and thus would prove unable to contribute meaningfully to support the global recovery. Advanced countries would continue to rely on monetary policy to stimulate growth, given their continued inability to reach political consensus on fiscal policy and to implement structural reforms. China would be dealing with the side-effects of its credit boom, while trying to avoid an investment bust.

With the eurozone in no-growth mode and China slowing down, the **United States** would remain the brightest spot in the global economy. Despite high unemployment and the fiscal drag from tax increases and sequester-related cuts, the recovery is likely to proceed steadily (albeit slowly), supported by accommodative monetary policy, robust corporate profits, improving housing market, and increased consumer confidence and spending.

Some growth momentum would be added by the ongoing shale gas and oil boom, which could support a comeback in US manufacturing. Unconventional technology (horizontal drilling and hydraulic fracturing, or 'fracking') has already led to an impressive increase in gas production and a sharp fall in gas prices. The impact on employment would be limited, however, since manufacturing does not generate as much job creation as in the past.

The current recession in the **eurozone** could turn into a prolonged stagnation. Caught between austerity fatigue in the periphery and bailout fatigue in the core countries, eurozone politicians are unlikely to make fast progress on a banking union or on the structural reforms needed to achieve union-wide durable growth. As a result, growth prospects are likely to remain subdued for the next few years. Expectation of a bounce later in 2013 had to be revised in light of weak economic data in all 17 countries, which added to the lingering political tensions and to uncertainties regarding crisis resolution. Following the botched Cyprus bailout, a new approach for dealing with crisis countries is in the works, with the balance shifting from moral hazard to financial stability concerns. The new strategy would transfer the costs of banking crisis resolution to private investors and away from taxpayers, putting an end to the current implicit bargain between creditors and debtors. This is likely to affect bank funding in periphery countries, intensifying the current credit crunch. At the same time, their high debt burdens and fiscal contraction would continue to dampen domestic demand, while slow growth would exacerbate the debt crisis.

Pressure is mounting in the periphery to break this vicious circle and shift from austerity toward pro-growth policies. While this may lead to some marginal adjustments to the current policy stance (such as giving all eurozone countries more time to meet fiscal targets), no major change to the status-quo is expected. In practice, a more gradual fiscal consolidation effort would not be feasible for vulnerable eurozone members, since creditor countries no longer have any appetite for providing additional funding, even as they seem intent on pursuing their austerity-first approach. Therefore, a shift in policy toward slower deficit reduction would lead at most to a small improvement in employment and growth prospects for 2014 and beyond.

The transition to a new growth model in **China** would be complicated by a slowdown in its main export markets and its own debt sustainability problems. Still, the Chinese leadership would manage to engineer a soft landing, as current policies would create enough employment to avoid a social crisis, while pushing through enough financial sector reforms to avoid a banking crisis. However, the need to restructure or write off debt accumulated by state-owned enterprises and local governments would be a drag on growth, while concerns with inflation and banking weakness would limit policymakers' capacity to implement another round of stimulus. Although a slower growth trajectory could be a more sustainable medium-term strategy for China, it would reduce its ability to drive the global recovery.

Rebalancing would proceed only gradually in this scenario. In order to shift away from investment and exports, and stimulate domestic consumption, policymakers

would continue their strategy of gradually raising wages and strengthening the social safety net, while mitigating the current inequalities in income distribution, and tackling corruption. To avoid a hard-landing, they would continue to address the vulnerabilities accumulated during the high-growth period, notably the rapid credit growth in the shadow banking sector and the real estate bubble, through financial reforms and measures to cool down property markets. But given the magnitude of the bad debts accumulated during the boom, local governments would need to start deleveraging and thus reduce infrastructure investment. With consumption insufficient to offset the fall in investment, GDP growth would drop below 8 percent per year.

Box 2

Grand bargain in the US: agreement on a fiscal grand bargain could provide an important impetus for growth in the US and significantly boost global growth. The grand bargain would be a bi-partisan deal that would restore US long-term fiscal sustainability. It would include tax and entitlement reform, a reversal of the sequestration cuts, and an increase in the debt-ceiling. Market reactions to such an agreement are expected to be significant, given the improved balance sheet positions in the private sector and the availability of funds for immediate investment.

Grand bargain in the eurozone: this would entail a relaxation of austerity policies in exchange for a strong commitment to structural reforms, together with a move toward deeper integration, notably via a banking union. By removing the fear that taxpayers would have to bail out banks, the new approach to crisis resolution would reduce resistance to a full-fledged banking union, including a common supervisor, a single resolution mechanism (with its own fund), and a single deposit insurance scheme. Agreement on a banking union would boost confidence and significantly lift growth prospects in the eurozone.

Transatlantic trade agreement: negotiations on a trade agreement between US and EU are still in the initial stages, and would have to overcome difficult roadblocks to secure an ambitious and inclusive deal. However, if successful in eliminating tariffs on goods, enhancing customs facilitation, and harmonizing competing safety and technical standards, such an agreement would have very clear economic benefits, including the creation of millions of jobs and higher global growth.

Exit of one or more countries from the eurozone: the dramatic twists and turns of the debt crisis have raised fears that the current firewalls will not be strong enough to save the monetary union. Given the current fragile situation, it is not difficult to imagine a scenario where something goes wrong, for instance, the failure of one or more program countries to deliver on their commitments. The resulting market reaction could lead to exit from the eurozone and trigger a financial crisis, affecting the global economy.

Negative market reaction in the US: a sudden change in market assessment could precipitate a crisis in the US and drag the global economy along. The likely candidates for a change in sentiment in bond markets are another standoff over the debt ceiling and/or a troubled exit from quantitative easing.

Optimistic scenario: global rebound

This less likely scenario is predicated resolving the current political impasses. Global growth prospects could be significantly improved if political leaders managed to set aside their differences and put in place credible strategies for the resolution of the sovereign debt crisis in the eurozone and the long-term debt crisis in the US. Instead of relying only on monetary policy to manage demand, policymakers would use other economic policy tools, notably agreeing on a combination of slower fiscal adjustment and faster structural reforms that would boost confidence and generate a virtuous circle of strong growth, rising employment, and falling debt. In parallel, Chinese leaders would be successful in rebalancing the economy while keeping growth sufficiently robust to avoid social tensions.

Agreement on a grand bargain in the US would be the most likely catalyst for this optimistic scenario. If US politicians manage to avoid another debt-ceiling showdown in mid-2013 and agree on a credible medium-term fiscal package while canceling the automatic budget cuts under sequestration, the economy could be poised for a takeoff. Given the size and importance of the US economy, a strong US rebound would significantly boost global demand, helping the eurozone to get out of the current slump and facilitating agreement on governance changes. China's growth prospects would also improve with the increase in global demand, raising the chances of a soft-landing and a smooth transition to a consumption-led growth path.

A higher-growth global scenario could also launched by a grand bargain in the eurozone and/or a transatlantic trade agreement between the US and the EU. But the probability that either agreement could be reached anytime soon is low.

Pessimistic scenario: another global disaster

This scenario (often called 'the perfect storm') would result from policy failures in all major global players, leading to protectionism and global economic stagnation. Political gridlock in the US and in the eurozone would prevent agreement on 'grand bargains', while Chinese leaders would not be able to avoid a hard-landing.

The most likely catalyst for this scenario would be the (partial of full) breakup of the eurozone. With increasing cracks in political and social cohesion, and declining support for crisis resolution in the core countries, investor confidence would decline, and the eurozone firewalls would no longer manage to stop fragmentation. One or more vulnerable countries would default and exit from the union, precipitating a financial crisis, which would spread to the rest of the world economy.

The situation would be aggravated if, at the same time, there was another debt ceiling standoff in the US or a troubled exit from QE. The bond markets would turn against US fiscal (or monetary) policies, leading to another banking crisis and pushing the US (and the global economy) into recession.

The perfect storm would be complete with a hard-landing in China. A collapse in property prices would lower household wealth, reduce employment, and trigger a series of defaults, while the deterioration in local governments' balance sheets would lead to a sharp slowdown in investment. In this scenario the government would not be able to fully bail out the banks and avoid a recession. Unemployment would become a severe problem without a social safety net completely in place, causing social unrest.

The perfect storm is a low-probability event. But a global slowdown could also result from a change in market sentiment in the US, without a breakup of the eurozone or a hard-landing in China. And a hard-landing could happen in China while the advanced economies would be stuck in the low-growth baseline scenario, weakening global growth.

6. Implications for global economic governance

Global economic governance has proven robust in the face of a global financial crisis, but seems unable to assert itself under less pressing circumstances. The global community's immediate response to the 2008 financial crisis is generally considered effective, but there are profound doubts about the effectiveness of global economic governance during normal times and, more importantly, its ability to avoid future crises. Notwithstanding well-articulated analytical arguments in support of international financial cooperation, divergent diagnostic views and contrasting interests stunted effective global policy coordination once immediate crisis symptoms receded, thus increasing the risk of another crisis. In particular, key countries—even among the close-knit eurozone bloc—seem unwilling to delegate sufficient sovereignty to global institutions or super-national structures. Effective global economic governance has remained a bad weather concept.

The existing multilateral system, with the IMF at its center, is not coping well with the new tensions. Global international institutions are trying to adapt to the new reality—notably to the declining economic power of Western democracies—but the reform in their governance structures is proceeding too slowly, reducing their legitimacy. In particular, the IMF's reputation has taken a hit. While the IMF's role in macroeconomic coordination was strengthened during the Great Recession, its credibility was damaged by its perceived lack of influence in the eurozone crisis, when political considerations (the euro being 'too important to fail') trumped unbiased economic advice. With respect to global trade, the WTO system of dispute settlement risks being overtaken by the proliferation of regional trade agreements.

Given the present cast of characters, it is hard to see how effective global economic governance could be revived without a major global shock. The G20 has clearly lost momentum, as it failed to coalesce around a set of common values and principles that could support and encourage joint action. Despite its limitations, however, it does not face obvious competition. The G7, sitting on a mountain of debt, have lost their high moral ground. The BRICS, accounting for 25 percent of world GDP in 2012, are trying to deepen cooperation through frequent meetings and proposed initiatives, such as a BRICS development bank, but have yet to find common cause for global governance. Their failure to support a single candidate for the top position at the IMF in 2011 is a glaring example of lack of common purpose.

Some analysts argue that, while multilateralism has served the global economy well in the last several decades, it is not up to snuff to meet present global challenges. Dani Rodrik (2012) suggests that the current futile attempts to strengthen global governance should be replaced by efforts to establish a 'thinner set of rules that recognize the diversity of national circumstances and demands for policy autonomy.' To break the gridlock, Moisés Naím (2009) recommends abandoning the large meetings in favor of a more targeted approach, which involves gathering the smallest number of countries necessary to make a major change to the way the world addresses a particular issue ('minilateralism'). This 'magic number' would vary according to the specific problem.

In the event, some variant of these ideas may well be the only viable transition solution until the next global disaster triggers real reform. Instead of a global 'hegemon', countries would take turns in taking the lead depending on the issue. For instance, US power and leadership, though weakened, could be sufficiently robust to fill the leadership gap on financial issues, given its track record in responding rapidly to crises situations. Despite the partisan politics, the US moved quickly to address the 2008 turmoil, providing fiscal/monetary stimulus and recapitalizing the banking system—something the eurozone has yet to accomplish.

Thus, global economic governance in a multipolar world will remain challenging. In all scenarios explored above, the post-war move away from a single center of gravity for the world economy is likely to continue. But the precise configuration of the new multipolar order remains unclear, except perhaps for the probable loss of global clout by the eurozone under any of the medium-term scenarios.

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