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G20: trying again in Los Cabos

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Trying Again in Los Cabos

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1. Introduction

The world economy is in a funk. Anxiety emanating from the escalating Eurozone crisis is stalling the global economy. Fretful financial markets and angry voters keep punishing policymakers' perceived lack of effectiveness in finding credible solutions to the lingering problems unleashed by the 2008 global financial crisis. With governments seen as behind the curve while the world economy continues to weaken, business confidence has dropped to new lows, spreads on public debt in Southern European countries remain sky high, and anti-incumbent sentiment has become widespread, with many European governments voted out of office (the US will take its test in November). What was previously unthinkable—the breakup of the Eurozone—has become one possible (and increasingly likely) scenario on the table.

Against this gloomy background, G20 representatives met for the 7th time at Los Cabos last June, in one more attempt to prove the group's relevance. While G20 leaders assembled in the Mexican resort, Spain finally threw the towel and requested EU assistance for its battered banking system. On the positive side, Greek voters decided to stick with the Eurozone, thus giving policymakers a little more breathing space to muddle through.

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All over the globe, the mood is definitely dark. This global pessimism reflects the perception that policymakers have ran out of options in their toolboxes. When the financial crisis hit in 2008, G20 leaders acted quickly and in concert to save the global economy from collapse. In what was perceived as a show of global unity and decisiveness, governments adopted stimulus programs to bolster growth, while central banks expanded their balance sheets and flushed markets with liquidity. However, with the worse of the crisis behind them, countries increasingly turned their focus to domestic issues, at the expense of international cooperation. Moreover, many countries shifted to austerity policies despite the obvious fragility of the global recovery. Clearly, the scope for global cooperation now is far more limited than in 2008/09, given the shrinking policy space in indebted advanced economies and the sluggish growth in emerging markets.

No wonder then, that expectations for a major breakthrough in Los Cabos were very low. Moreover, memories of the highly charged Cannes Summit in late 2011, where little was achieved, were still fresh. There was always hope, however, that the gravity of the global economic situation would focus policymakers' minds and lead to more meaningful cooperation. And perhaps some tangible—if incremental—results, to avoid a repeat performance of Cannes.

2. The Mexican agenda

The Mexican hosts attempted to calibrate the agenda in line with the low expectations. In sharp contrast with the ambitious schedule drawn by the French presidency for Cannes, they made an effort to focus on the original G20 mandate, centered on strong, sustainable and balanced growth, and predicated on coordinated and collective action. In the event, with the protracted Eurozone sovereign debt crisis dominating the scene, short-term crisis management occupied center stage, at the expense of longer-term objectives in the agenda.

While the agenda itself was uncontroversial (see Table 1), it masked long-standing policy disagreements within the group. Beyond the contentious debate on austerity vs. growth, there was a clear sense of exasperation from the non-European G20 about the unwillingness and/or inability of large Eurozone countries to solve the debt crisis. This growing frustration with Eurozone leaders was evident in a series of blunt statements by non-European G20 ahead of the summit, including an open letter from the prime ministers of Australia and Japan. The message was clear—the whole world was waiting for European leaders to get their act together and take decisive action to quick-start growth and avoid another global recession. Policy delays would only serve to increase the cost of the crisis.

Table 1
Los Cabos Agenda - Key Items

Guaranteeing financial stability and restoring growth

Improving the global financial architecture

Reforming the financial sector and regulatory systems

Enhancing food security, mitigating the negative impact of commodity price volatility

Promoting sustainable development, green growth, and the fight against climate change

The agenda also followed up on the commitment to enhanced accountability made in Cannes. Recognizing the importance of transparency and accountability to boost confidence, G20 leaders launched the Los Cabos Accountability Assessment Framework to measure progress in implementing past policy commitments. The first Accountability Report under the new framework was attached to the Growth and Jobs Action Plan, and a follow-up report is planned for next year's summit in St. Petersburg. The Los Cabos Action Plan, in turn, was informed by a set of reports for the Mutual Assessment Process (MAP), prepared by IMF staff. The reports include analyses and assessments of member's economies, policies, and progress toward their commitments. They stress the tangible benefits of collective action and reform coordination, arguing that a concerted approach would deliver much higher global growth and employment.[1]

Table 2
Policy Actions Agreed under the Los Cabos Growth and Jobs Action Plan

- Addressing decisively the sovereign debt and banking crisis in the Euro Area.
- Ensuring financial stability, including dealing with the potential impacts of deleveraging.
- Boosting demand and economic growth, and reducing persistently high and rising unemployment in many advanced economies, especially among young people.
- Ensuring the pace of fiscal consolidation in advanced economies is appropriate to support the recovery, in line with the Toronto Commitments.
- Dealing with the possibility of a sustained spike in oil prices, in an environment of limited spare capacity and modest inventories.
- Ensuring a strong and sustainable growth path in emerging countries, thus contributing to the global recovery and quality job creation.
- Resisting protectionism and keeping markets open.

[1] For the full text of the reports see http://www.imf.org/external/np/g20/pdf/062012.pdf

3. Highlights of Los Cabos communiqué

G20 leaders hit all the right notes, reaffirming their commitment to multilateralism, market-determined exchange rates, and free trade. Some observers noted the more harmonious atmosphere, compared to the high-drama Cannes summit. As usual, the communiqué was long on generalities and short on specifics, glossing over the considerable policy disagreements within the G20 and within the Eurozone members.

Nevertheless, the summit secured two important commitments (the former much more certain than the latter):

- The provision of additional funds for the IMF war chest by large emerging markets.
- The adoption of concrete measures to solve the sovereign debt crisis by Eurozone leaders, to be detailed during the end-June EU Council summit.

Eurozone crisis

The main focus of the summit was on possible ways to defuse the Eurozone debt crisis and thus avoid a double-dip global recession. The G20 welcomed the measures taken by Eurozone leaders following the Cannes summit, including the agreement on a Fiscal Compact and the strengthening of European firewalls with the establishment of the European Stability Mechanism (ESM). But the Spanish banking crisis brought a renewed sense of urgency to the discussions.

Under intense pressure from their G20 peers, Eurozone leaders did their best to make clear they were determined to act. In the communiqué, they committed "to take all the necessary measures to safeguard the integrity and stability of the [Euro] area, improve the functioning of financial markets and break the feedback loop between sovereigns and banks." This public commitment raised the expectation that far-reaching measures on further financial and fiscal integration (including a road map for a banking union), would be announced during the forthcoming European Council summit.

Guaranteeing financial stability and restoring growth

Recognizing the deterioration in the global outlook, G20 members pledged to adopt a pro-growth agenda. Formally, they agreed to make a collective effort to strengthen global growth and restore confidence, as stated in the Los Cabos Growth and Jobs Action Plan (see Table 2). Informally, there was strong pressure on European members—especially the one with deeper pockets—to relax austerity programs and to allow the European Central Bank (ECB) to open the lending floodgates. Although the communiqué supported additional spending by G20 countries with fiscal space if the economic situation deteriorated further, there was no call for less austerity in the Eurozone.

With the Eurozone crisis threatening to spiral out of control, some of the old hot topics were no longer priority in Los Cabos. In contrast to previous G20 summits, concerns about global imbalances and the related currency wars were played down, as the global financial crisis had already led to a reduction in exchange rate misalignments and in China's current account surplus. Instead of the usual criticism, this time the G20 welcomed China's commitment to reform its current exchange rate system.

Other downside risks to the global economy were not central to the debate, although they were highlighted in the IMF supporting papers. Among the key risks are the absence of a credible medium-term plan for fiscal adjustment in the US and a potential hard-landing in China. While the communiqué made a reference to the need for the US to place its public finances on "a sustainable long-run path so that a sharp fiscal contraction in 2013 is avoided", China's current downturn was not explicitly mentioned.

Improving the global financial architecture

The most important outcome under this heading was a commitment to increase the IMF's firepower. Despite delays in implementing the Quota and Governance reform agreed in 2010, during the summit the IMF received a significant resource boost ($456 million), almost doubling its lending capacity. To reassure emerging markets that the additional funds would not be used to bail out rich European countries, the communiqué specified that they would be available for all IMF members. These funds are additional to the increase under the 2010 quota reform, which G20 leaders pledged to complete on schedule by the 2012 IMF/World Bank Annual Meetings. This timetable may be difficult to accomplish, since the US has not yet ratified the 2010 agreement.
Although frustrated with the slow pace of IMF reform and Eurozone crisis resolution, the BRICS chipped in with $75 billion. With this significant contribution, these large emerging markets reaffirmed their rising economic power, hoping it would be translated into more political clout, including increased voting rights in international financial organizations (IFIs). The quota reform will make China the third largest IMF member in quota terms, placing the other BRICS among the top 10—an initial step towards aligning emerging markets' power more closely to their relative contribution to the world economy.

Reforming the financial sector and regulatory systems

The regulatory to-do list mandated by the G20 is long and challenging. Following the initial crisis-driven push to establish the Financial Stability Board (FSB) and design new global rules, implementation (at the national level) has been slow and uneven. G20 leaders expressed support for the ongoing work of the FSB and endorsed recommendations to strengthen the FSB's capacity, governance, and resources. The FSB reported on progress in the priority areas: the Basel capital and liquidity framework; the framework for global systemically important financial institutions; resolution regimes, over-the-counter derivatives reforms, shadow banking, and compensation practices. While implementation is more advanced with respect to Basel III requirements for bank capital and liquidity, other reform areas are behind schedule.

With the global agenda dominated by the deteriorating global outlook, regulatory policy issues have taken a back seat. The regulators are under increasing pressure from the banking industry to water down and delay the new global rules. During the summit, the B20 (the group of businesses that advises the G20) argued that, since the capital and liquidity rules under Basel III were designed for US and European institutions, their implementation in emerging markets and developing countries would be detrimental to growth. The FSB's report on potential "unintended consequences" from reform implementation did not find strong evidence of any significant adverse effects, noting that many of the concerns identified by these countries are being addressed by the relevant international bodies during policy development and implementation. Nevertheless, pressure to delay translating global rules into national regulation is likely to continue.

4. Recent developments and outlook for the global economy

Even the optimists agree that the downside risks for the global economy have risen sharply. As aptly put by a notorious pessimist[2], the bullets are coming from all sides—and there is nowhere to go for cover. The Los Cabos summit took place against the backdrop of a deepening Euro area crisis, a marked slowdown in emerging markets, a looming recovery crisis in the US, and continued instability in the Middle East, with its potential adverse impact on oil prices.

The challenges for policymakers are indeed daunting. While the two-year long Eurozone crisis has been in the center of the global crisis of confidence, the US medium-term fiscal outlook is equally if not more worrisome, while a hard landing in China could have widespread negative spillovers. In this globalized world, the economic woes of the major international payers are feeding into each other and dragging the world economy down. The contagion from the Eurozone is already visible in the recent weakening of the US economy, and in the slowdown of emerging markets, leading the IMF to trim its global growth forecasts for 2012-13, while ringing the alarm bells on the rising downside risks.

Yet the overall sentiment is that policymakers are not up for the task. Indeed, while the current problems are clearly global, politicians continue to be guided by the old adage that 'all politics are local'. In the US, there is little hope that the continuing political gridlock could be resolved in this election year, while in the Euro area a solution to the major disagreements between creditors and debtors is not yet in sight. To top it up, China is going through a delicate leadership transition.

Despite IMF warnings about the counterproductive impact of austerity policies, there is little sign that an effective coordinated macroeconomic response to the weakened global outlook is in the offing. With limited fiscal space in several advanced economies and little appetite for counter-cyclical fiscal policy, central banks have been expected to do the heavy lifting, while politicians put off the long-term strategies. Despite skepticism about the effectiveness of their actions, central banks around the globe have been actively easing their policies to boost growth, using unconventional tools (as in the case of the US FED and the Bank of England) or cutting interest rates wherever there is room (as in the case of several emerging markets). With is main interest rate now below 1 percent, the ECB is under continuous pressure, and is often criticized for holding back.

2 See 'A Global Perfect Storm' by Nouriel Roubini, June 15, 2012, in Project Syndicate (http://www.project-syndicate.org/commentary/a-global-perfect-storm).

Political gridlock in the United States

Until recently the bright spot in the global economy, by summertime 2012 the US economy had lost its momentum. Earlier enthusiasm over the recovery of manufacturing has been dampened by a string of weak jobs reports. Output growth has been tepid and unemployment remains stubbornly high. Weak job creation reflects insufficient economic growth, in turn the result of continued uncertainty. While clearly related to the eurozone crisis and the state of the global economy, to a large extent this uncertainty reflects self-inflicted factors, notably the political paralysis preventing a sensible compromise to avoid falling into the so-called 'fiscal cliff'-—a poisonous combination of tax increases and across-the-board expenditure cuts (of about 4 percent of 2013 GDP) scheduled to become effective next year under current legislation. With fiscal policy on ice, the probability of another round of quantitative easing (Q3) in the second half of the year has increased, notwithstanding possible diminishing returns.

Muddling through in the Eurozone

The outlook for Europe is still bleak. From summit to summit, crisis resolution has remained elusive, given continuous financial market pressures and political challenges faced by some Eurozone countries. After the promises made in Los Cabos, expectations for a significant breakthrough during the EU Council summit were high. Following intensive negotiations and combined pressure from Italy, Spain and France against the more inflexible German stance, Eurozone leaders agreed on a **new intervention mechanism** (allowing the ESM to make direct capital injections on banks, among other things and deciding that ESM loans would not enjoy privileged senior-credit status), and on a €120 billion **growth package** for the Eurozone.

At the same time, the Eurozone economy continues to deteriorate. Recent surveys have pointed to a drop in business confidence and a move into recession territory, amid increasing doubts about the effectiveness of current bailout programs in rebalancing competitiveness in the Euro area. Somehow it feels like Eurozone politicians managed to turn a difficult situation into an impossible one.

Falling BRICS

Any hopes that, as the new engines of growth, emerging markets would lead the world out of recession have been tempered by the recent sluggish performance of the BRICS, notably Brazil, China, and India. After stellar performance in the aftermath of the 2008 crisis, the BRICS are now stalling. Not only are they facing an adverse external environment, but there is now less room for further expansionary policies, as policymakers have to deal with the consequences of their large post-crisis stimulus programs. The ongoing slowdown is likely to aggravate the problems related to the recent credit booms, including property bubbles, rising default rates and lower investment efficiency.

All eyes are on China's decelerating economy. The recent slowdown reveals the limits of the Chinese growth model, driven by exports and real estate. GDP growth has dropped below 8 percent on the heels of weaker exports and the property market downturn; the second quarter growth rate (7.6 percent) was the slowest since the onset of the global financial crisis. With inflation no longer a concern, the Chinese leadership has been trying to engineer a soft landing through aggressive monetary policy, including interest rate cuts and increased lending. This expansionary policy stance is likely to continue—possibly powered by additional public investment—with a view to a rebound later in the year.

The other Asian giant is facing similar challenges, but has fewer policy options. In addition to slow growth, India is battling rising inflation, widening current account deficits, flagging investor confidence, falling reserves, and a weakening currency. Given this combination of negative developments, there are few levers to pull to stimulate the economy. The loss in growth momentum during the first quarter of 2012 (when annual GDP growth dropped from 8.4 to 6.5 percent), prompted the central bank to cut interest rates for the first time in three years. But with inflation close to 8 percent, expansionary monetary policy is not in the cards, while the room for fiscal stimulus is constrained by relatively high debt and a large fiscal deficit.

Brazil's economic performance also has been disappointing. Despite a series of measures to stimulate consumption and boost investments in infrastructure, the economy is faltering, hit by weakened Chinese demand for commodities. Falling growth prospects are already taking a toll on job creation, wages, and consumer demand—the main source of growth in recent years, fueled by what is increasingly seen as a credit bubble. While the absolute level of private debt is still modest, a sharp increase in nonperforming loans during the past year has frightened banks into tightening credit. With manufacturing also lagging despite the weakening real, growth forecasts have been repeatedly revised down.

5. Assessing G20 effectiveness

Each summit invites a new round of criticism about G20 performance. Indeed, dissatisfaction with the G20 has intensified in step with the length of the group's communiqués.

The gap between the global economic situation and the G20's objective of 'strong, stable, and balanced growth' seems to widen with each summit. Despite the favorable assessment of compliance with policy commitments by the G20 Research Group (see Table 3) the gloomy global economic outlook does not provide evidence of gains from collective action. While noting progress with respect to the commitments in the Cannes Action Plan, the Los Cabos Accountability Assessment identifies important policy and progress gaps in fiscal policy, financial sector reforms, structural reforms, rebalancing, and exchange rate flexibility.

Table 3
Policy Commitments under G20 Summits

G20 Summit	Washington	London	Pittsburgh	Toronto	Seul	Cannes
Number of Commitments	95	88	128	47	156	299
Compliance	84%	62%	62%	64%	75%	77%

There are several reasons behind G20 lackluster performance:

The policy disagreements

The group's divergent views over a range of relevant topics—from the dangers of fiscal consolidation to the role of governments—limit fruitful cooperation. Although the IMF has provided the analytical underpinnings demonstrating the benefits from cooperation, there is no formal enforcement mechanism to promote the collective interest, since the G20 works by consensus.

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 views informally at the sidelines of the meetings—a point often made by G20 optimists.

The process

The G20 agenda has been broadened at each summit, together with an increase in the number 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. A more focused agenda, anchored on the original G20 mandate, would have a better chance to deliver tangible results.

Lack of global leadership

The American 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 differences tend to dominate the discussions, leading to communiqués filled with compromise language and meaningless commitments.

Impact on resolution of theEuro crisis

It was clear from the Los Cabos summit that the G20 group had limited leverage over the Eurozone turmoil. The subsequent end-June EU Council summit was viewed as a more important forum for managing the crisis. Nevertheless, the significant pressure applied by the US and other non-European members put European leaders on the spot, resulting in a public commitment to find concrete ways to save the euro. Moreover, the commitment to additional IMF resources contributed to bolster the Fund's ability to step up emergency lending if needed.

The G20 formally welcomed the decisions taken in the summit, looking forward to their 'expedited implementation'. In their view, the agreed measures constituted "major steps [to solve the crisis] and demonstrate that Europe is delivering on its commitments."

Financial markets disagreed. While the initial reaction to the commitments was positive, the market rally following the summit was short-lived. Bond spreads on Italian and Spanish debt quickly reverted to pre-summit levels, as the implementation challenges of the agreement became evident, suggesting that the key objective of breaking the negative feedback between banks and sovereign was not yet within reach. ESM bank recapitalization will have to wait until a banking union is established (most likely a lengthy process), and bond purchases will be limited to the €500 billion firepower of the rescue funds. At the same time, delays in ratifying the ESM have added to market uncertainty, with growing fears that Italy or Spain may need an international bailout.[3] Finally, the growth package (about 1 percent of Eurozone GDP) is too small to make a difference, but reflects the change in the balance of Eurozone power after the French elections and the recognition of increasing popular resistance to austerity at all costs.

Cementing BRICS

The BRICS left Los Cabos more energized with the prospect of gaining more influence in the IFIs. Their significant contribution to the recapitalization of the IMF was evidence of their increased importance as rapidly rising powers, and their determination to have an enhanced role in the institutions of global governance.

The BRICS have often lost strength in the global negotiating table by failing to express unified positions. To remedy this situation, they have attempted to coordinate their positions in the G20 forum by holding their own summits to discuss issues of mutual interest to BRICS economies. The last summit took place at end-March, in India. The associated Delhi Declaration articulates the BRICS' positions in a wide range of topics of G20 interest, such as reform of global financial institutions, improving crisis response, trade and development, food security, and intra-BRICS cooperation.

The BRICS also met in Los Cabos, ahead of the G20 summit. For the first time in that setting, they issued a statement, in an attempt to translate their political vision into concrete actions. The short statement included three clear commitments:

3 In mid-July the German constitutional court postponed its ruling on the ESM/fiscal treaty for two months. Italy, also, had not ratified the ESM by that time.

Solidarity with the Eurozone

Recognizing its threat to global financial and economic stability, BRICS leaders committed to finding cooperative solutions to resolve the Eurozone crisis.

Imf reform and resources

The BRICS pledged to contribute to increase the IMF firewall, with the understanding that all reforms agreed in 2010 (including a comprehensive reform of voting power and reform of quota shares) would be implemented on schedule, and that the new resources would be called upon only after existing funds were used.

Future cooperation arrangements

The leaders agreed to consider reserve pooling and intra-BRICS swap arrangements. The BRICS agreed to begin a process of building a financial safety net similar to the Chiang Mai Initiative in Asia, by creating a joint pool of reserves. In addition, Brazil and China took concrete steps in the direction of a strategic partnership, as they agreed on a $29 billion currency swap to support efforts to promote the Yuan as a reserve currency during the Rio+20 summit.

The BRICS statement in Los Cabos also called for increasing the resource base of multilateral development banks. BRICS leaders stressed the need for investments in infrastructure and in the social sectors in developing countries, an area that, in their view, deserved priority in the G20 agenda.

6. Concluding remarks

As European policymakers head to their obligatory summer holidays, the prospect of a Japanese-style ‘lost decade’ will be haunting the developed world. With their fortunes closely interlinked, emerging and developing countries also will be watching with trepidation as policymakers respond to the rising downside risks to the global economy: a possible breakup of the Eurozone, a possible hard landing in China, and a possible recession in the US, if the economy falls over the “fiscal cliff”.

The most likely scenario is a bit more of the same muddling through. Amid the increasingly gloomy global outlook, the advanced economies will continue to grapple with economic fragility and political dysfunction, making it hard to agree on policy actions that could restore confidence and strengthen global growth.

The G20 will need to try harder to pass the relevance test. Their record is not encouraging, however, providing little hope that the factors hindering G20 effectiveness will be addressed in time for a successful St. Petersburg summit.