The New Global Economic Governance: Can Europe Help Win the Peace?

The Robert Triffin International Conference

Speech of Marco Buti

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- I would like to thank the organisers for having invited me and in particular Ivo Maes for having suggested my name. My subject today is global governance and the role Europe in it. It's a natural topic for a lecture in memory of Robert Triffin.
- The actions taken in 2008-09 by the G20 avoided an outright depression during the financial crisis. But while there was widespread agreement on what to do when the crisis broke out, this has not been the case since 2010 when governments started to have different readings of the challenges ahead and of the policy mix to adopt. Such differences have been accentuated in recent months.
- The international community should shift its focus from 'winning the war' – i.e. responding to the 2008 crisis to avoid the meltdown of the global financial system – to 'winning the peace', i.e. overcoming the legacy of the crisis and creating conditions for strong, sustainable, balanced, and, not least, more inclusive growth. Making the case for global cooperation in a multilateral context is all the more critical in the context of populism and protectionism threats.
- My presentation is about to make the multilateral system better and what the EU could do to achieve it.

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- The outline of my presentation is:
    - Long-term trends in global economy: shift of power to emerging powers; rising interdependence
    - The global governance system: a historical perspective - From Bretton Woods to a multipolar system
    - Impact of the financial crisis
    - G20 key achievements, decisions and challenges
    - A new development: G7 is not quite like minded anymore after new US administration
    - Preconditions for EU to make a difference in global governance: overcoming weaknesses and leveraging strengths
    - Moving towards the Hamburg summit (7-8 July)

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- The rise of emerging markets and developing countries in the international economy is driven by changes in growth dynamics and demographic developments.

- First, looking at broad demographic developments, advanced economies, such as the EU and the US, are declining relative to world population and are forecast to continue to do so. This reinforces the economic trends set out above:
    - in the 1960s, BRICS' population (Brazil, Russia, India, China and South Africa) was 3 times larger than the US and the EA
    - in 1990: almost 4 times
    - today: it is almost 4 times and half larger

- and 2050: is going to be 5 times larger, and the share of the BRICS themselves will be declining compared to the other developing and emerging economies.

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- Second, let me turn to GDP dynamics: in the long term, as I said, it can be expected that differential growth rates will shift global economic power from advanced to emerging and developing countries. From this graph, it is clear that the "BRICS" are expected to rise in relative economic weight from around 10% of global GDP in the late 20th century to over 45% by the middle of this century. At the same time, the relative weight of Europe, but also of the US, will decrease substantially.

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- One of the factors behind the loss of relative GDP share of advanced economies is the slowdown in productivity growth. This was already underway before the financial crisis and has continued to undermine rises in output and material living standards in recent years.

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- These long-term trends have not affected global governance until recently.
- After the Second World War, the so-called Bretton Woods system structured global economic governance. The Bretton Woods system consisted of a number of rules and institutions, most importantly the IMF and the World Bank as central institutions (both created in 1944 in Bretton Woods) and the General Agreement on Tariffs and Trade (GATT, signed in 1947 in Geneva).

- Looking at the international monetary system, the essential feature of Bretton Woods was a fixed exchange rate of all currencies vis-à-vis the US dollar. The central role of the US dollar in this system maintained and reinforced the role of the US in global governance. However, already by the early 1960s, US monetary liabilities towards non-residents exceeded US gold holdings. Hence the well-known Triffin dilemma: if the United States refused to provide other countries with US dollars, trade would stagnate and the world economy would eventually be trapped in a deflationary bias; but if the United States provided an unlimited supply of dollars, the confidence that it would convert them into gold would erode confidence in its international currency. The system eventually collapsed, as Triffin had predicted: faced with the dilemma, the system’s core country preferred not to maintain its commitment to keep the value of the dollar in terms of gold, but rather to pursue its internal needs while providing the other countries (which were not adjusting either) with its reserve currency.
- US policymakers' lack of regard for repercussions on other economies means that this was at the same time an international "non-system", and a unipolar system based on the dollar. In the long run this proved unsustainable, and the end of the Bretton Woods system started with the decision by President Nixon in 1971 to unilaterally terminate the convertibility of the US dollar into gold. Compounded by the first oil price shock, by 1973 the major currencies began to float against each other.

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- With the end of the Bretton Woods system, global economic governance has since evolved towards a more multipolar system. The international monetary system is no longer solely centred on the US dollar, but instead is increasingly built on several pillars, including an important role for the euro and the yen, and a renminbi which is growing in significance.
- But has this put an end to the Triffin dilemma? The way in which the international monetary system works has changed and thus the modalities through which the dilemma operates have changed considerably; but the fundamental tension between short-term domestic policy incentives and the stability of the international monetary system has not.
- Key issuers and holders of reserve currencies pursue domestic objectives independently of what would best serve the global system and even their longer-run interest. To the extent that these policies pay insufficient attention to negative externalities for other countries and longer-term macroeconomic and financial stability concerns, they tend to produce unsustainable imbalances and fuel vulnerability in the global financial system. Hence the Triffin dilemma is, in its essence, unfortunately, still alive and well.

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- The financial and economic crisis that broke out in 2008 demonstrated the high degree of global interdependence and the importance of effective global governance. The crisis led to recognition of the importance of international cooperation as Triffin advocated already in the 1960s. ["Gold and the dollar crisis"; 1960; New Haven; CT: Yale University Press]. Three major points:
    1. Global spillovers transmitted via financial markets can have dramatic consequences. For example, the Greek debt crisis had a direct impact on other economies in Europe and beyond.
    2. Financial and monetary stability were shown to have a global dimension. The exchange rate does not insulate national economies in a world of free capital movements. For the past few decades, international macroeconomics has postulated the so-called "financial trilemma": with free capital mobility, independent monetary policies are feasible if and only if exchange rates are floating. Helene Rey argued recently that widespread co-movement in capital flows, asset prices, and credit growth across countries – a global financial cycle – makes the trilemma moot. She declares the death of the trilemma, writing that this financial cycle, "transforms the trilemma into a 'dilemma,' or 'irreconcilable duo': independent monetary policies are possible if and only if the capital account is managed." Her conclusion is that countries with open capital markets must choose between monetary autonomy and exchange-rate management.
    3. In a post-crisis world, close cooperation between policy makers is essential to avoid zero-sum 'beggar-thy-neighbour' policies. The term 'currency war' was coined in 2010, in the context of the G20, by then-Brazilian Finance Minister Guido Mantega to depict competitive devaluation, i.e. countries competing against each other to achieve relatively low exchange rates for their own currencies to reach competitive advantage.

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- In addition to its economic impact, the financial crisis also had major consequences at the institutional level: the perception of the relative decline of advanced economies accentuated by the crisis boosted the confidence of emerging powers. Emerging and developing economies called for faster reform of global institutions, especially the IMF and World Bank. Although reforms have been implemented the pressure for additional reforms continues.
- A number of global institutional innovations took place to address the challenges of the crisis: most importantly, the G20 was elevated to the level of Heads of State and Government.

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- At the 2009 Pittsburgh Summit, the G20 was designated the premier forum for international economic and financial cooperation. The G20 has emerged as an informal forum that promotes cooperation between advanced and emerging-market countries on key challenges related to global economic growth and stability. It represents almost 90% of global GDP, two-thirds of the world's population, and 80% of world trade.
- The G20 has proven an effective forum for bringing together advanced and emerging economies. It has demonstrated that it can take swift and decisive action when dealing with the global financial crisis in 2008-2009.
- In addition, the G20 has helped to reduce the mistrust between advanced economies and emerging markets for the benefit of all. Countries have indeed been looking for a platform to exert some

influence on those policies of partner countries that were producing negative spillovers.

- Triffin, himself, was a major critic of the international monetary system's domestically focused only on the so-called 'house-in-order' approach. As recolled in Ivo Maes' chapter on Triffin in the Architects of the Euro, Baffi (1988: 16) noted: 'Triffin's proposals are based on the well-grounded conviction that "keeping one's own house tidy" without the fulfilling additional obligations at the international level is not a sufficient condition to ensure monetary stability.' (Baffi, P. (1988), "Robert Triffin", Turin: San Paolo)

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- The G20 took a number of key decisions. The assessment in the slide is purely personal.
- When the global crisis broke out in 2008-2009, the G20 managed to avoid another great depression like in the early 1930s, through a coordinated G20 response to the global recession and the stabilisation of the financial system. The Summits in Washington (November 2008), London (April 2009) and Pittsburgh (September 2009) focused on four key issues: (a) the macroeconomic stimulus needed to avoid the repetition of depression similar to that of the 1930s; (b) the tripling of the financial resources of the IMF to strengthen global firewalls and support countries under financial stress because of the crisis; (c) agreement to implement reforms to restore the stability of financial markets in order to avoid a collapse, and to strengthen regulatory and supervisory regimes so as to avoid future crises; and (d) finally, the G20 committed to refrain from protectionism (in contrast to the 1930s)

and roll back restrictive trade and investment measures taken previously.

- The enacted macroeconomic packages were without precedents both for its size and in terms of economies involved in it. Aggressive monetary policies together with expansionary fiscal policies (amounting to several points of GDP and complemented by the work of automatic stabilisers) contributed to stem the collapse of demand and to bring global growth in positive territory already in the second half of 2009.
- At the Toronto Summit (June 2010), it was decided to start withdrawing the fiscal stimulus. From hindsight this was a premature decision.
- At the summit in Seoul in November 2010, the Leaders' most important decision was to finalise the IMF quota reform (which included a doubling of the overall quota of the Fund, a significant (6,40%) shift of IMF shares to emerging market and developing countries and a reduction of the advanced European presence in the Executive Board by two seats in favour of emerging market countries).
- Agreement on a common methodology to approach global imbalances (G20 Cannes 2011). The 'indicatives guidelines' contained a number of policy proposals to be taken in a coordinated way in surplus and deficit countries in order to put global imbalances on a downward path and in the meantime ensure a rotation of global demand that would support economic activity.
- In St Petersburg in September 2013, the G20 decided to address Base Erosion and Profit Shifting, tackle tax avoidance, and promote tax transparency and automatic exchange of tax information.
- At the Brisbane summit in November 2014, the G20 put forward structural reform measures and growth strategies to meet the

ambitious goal of lifting its collective GDP by more than 2 per cent over five years.

- Finally, at the Hangzhou summit in September 2016 G20 members agreed to use all policy tools - monetary, fiscal and structural - individually and collectively to achieve the goal of strong, sustainable, balanced and inclusive growth. It was acknowledged that monetary alone cannot lead to balanced growth and should be supported by fiscal policies and structural reforms.

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- What are the main challenges now for the G20?
- Going forward, in order to stay relevant, the G20 needs to evolve from a short-term "crisis response" forum to addressing more long-term challenges for the global economy. From "winning the war" – i.e. responding to the 2008 crisis – to "winning the peace" i.e. overcoming the legacy of the crisis and creating the conditions for strong, sustainable and balanced growth.
- For the credibility and effectiveness of the G20, it is essential that members implement their existing G20 commitments, for example on international tax transparency, and financial regulatory reform. Consistent monitoring will be key to ensure effectiveness of reform and a global level playing field.
- Given its diverse membership, the G20 needs to show leadership to identify points of common interest and new topics to cooperate on, such as anti-terrorism financing or digitalisation.
- There is also an increased focus on unfair distribution of the benefits of globalisation, which risks fuelling populism.

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- While the G20 has become the most important forum for global cooperation, the G7 in its financial track has remained internal caucus on key G20 matters: trade, financial regulation, climate change
- G7 as locus to overcome differences between Advanced economies: macroeconomic policy, tax cooperation.
- But consensus has broken down:
    - Bilateralism threatens multilateral, rules-based system
    - Traditional "exogenous" assumptions are questioned
    - Mistrust is setting in

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- The new attitude of the US administration risks changing fundamentally the global coordination game. With the new administration there is a renewed focus on bilateral relations – they seem to see the G20 as an amplifier of their bilateral agenda rather than a genuine multilateral forum.

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- Along with recent developments, a number of challenges to multilateralism are emerging.
- Not only, there is a risk of an increased shift to bilateralism for trade agreements, but also a (possible) US disengagement may be looming for what concerns the international monetary system (the crisis management, the IMF), competitive tax shifts may emerge and there is a risk of rolling back on Financial Regulation. Cooperative solutions are lacking to effectively tackle the migration challenge.

- Last but not least climate change: it is heartening that the decision by the US administration to pull out of the Paris agreement has been followed not only by an uprise in Europe and in the rest of the world, but also by the commitment by US states, majors and large corporations to abide by the Paris agreement.
- G7 Taormina: <u>nuanced on Trade</u>: commitment to fight protectionism, support rules-based international trading system, walk together to improve functions of WTO.

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- In this challenging environment, the rise in global imbalances may be the trigger ending multilateral cooperation.
- External imbalances may be problematic if they are excessive and entrenched. Disorderly unwinding of large current account surpluses/deficits can have high costs in terms of output and employment and could have significant spillovers on trade and financial partners.
- Evolution of global imbalances (as illustrated by current account movements) over pre-crisis periods. CA Balance as share of GDP in peak year:
    - United States (2006): almost 6% deficit
    - China (2007): 10% surplus
    - EA: historically globally balanced (overall less than 1% surplus)
- After having reached a peak in the run-up to the crisis global imbalances as illustrated by current account surpluses/deficit in % of GDP went through an important correction, mainly on the side of emerging economies.

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- In recent years the roles have changed CA Balance as share of GDP in 2016:
  - United States : -2,5% deficit
  - China : almost 3% surplus
  - Euro Area (19) : +3,4%
- Positions are being reversed: emerging market economies and developing economies as a whole are expected to run small deficits, while advanced economies register surpluses.
- The global imbalances challenge becomes more an advanced economies problem rather than an emerging market economies one.
- When we dig deeper into the EA situation we can see that Germany and the Netherlands have the highest current account surpluses in the EA. Previous deficit countries have started reducing their deficits and/or even turned deficits into surplus as part of the adjustment process. Thus, the overall EA CA surplus attained historically high levels.
- What are the risks going forward? We need to avoid that asymmetric adjustment drive the EA Current Account surplus up. Unbalanced policy mix in the US combining an increase in fiscal spending together with sharper than expected rise in interest rates could affect the dollar/euro exchange rate and drive the US deficit further up also increasing protectionist pressures.
- This may be coupled with risks of hard-landing (disorderly adjustment) in China. China's growth model fuelled by corporate (namely SOEs) indebtedness is subject to important hurdles to be managed carefully.

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The rise of renewed global imbalances can be easily represented by the so-called Swan diagram that illustrates the combination of demand and exchange rate that ensure internal equilibrium (i.e. OG=0) and external equilibrium (i.e. CA equal to the level determined by structural factors).

The risk is that an over-expansionary fiscal policy in the US going hand in hand with more rapid normalisation of monetary policy would lead to an appreciation of the US dollar and larger CA deficit. Conversely, over-reliance on monetary policy would imply the continuation of historically high CA surplus in the EA. The desirable policy directions are shown in the graph.

Let me add that the spillovers of an unbalanced policy mix in the US would be sizeable, in particular for Emerging Economies having a large share of dollar-denominated debt (Brazil, Turkey, Mexico, Indonesia).

In political economy terms, if a "bilateralist" reading of trade flow prevails, the rise in the US CA deficit may trigger protectionist pressures.

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- In order for the EU to make a difference in global governance going forward, it will need to meet a number of preconditions.
- **First**, projecting strength externally requires internal strength, which means we need a higher degree of internal EU cohesion. In particular, this means the EU must complete the single market and become a genuine Economic and Monetary Union – including through a stronger economic and fiscal governance framework and a fully working Banking Union. The Commission RP on EMU published last week indicates the possible way forward. We also need to overcome political challenges, in particular the migration crisis and Brexit.

- **Second**, to make a difference globally, Europe should overcome its "small country syndrome". The euro area consists of small countries and big countries which suffer from the "small country syndrome". Many Member States, for historical reasons or otherwise, focus purely on domestic objectives and are not ready to take up broader responsibilities.

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- **Third**, the political phenomenon of the small country syndrome also has an economic counterpart, what I call the "reverse creditor paradox".
- Historically, going back to Bretton Woods and before, creditors were in a stronger position, compared with the weaker position traditionally held by debtor countries. [cf. Keynes vs Harry Dexter White at Bretton Woods]. An asymmetry reigned in the international system, which meant that creditors ruled, as could also be seen during the euro area debt crisis.
- This political asymmetry has now been reversed. Therefore, the EU/euro area is now at risk of a sort of "reverse creditor paradox". The EA as a whole runs a large and persistent current account surplus. This is no longer seen as strength but rather as a sign of economic weakness and a source of political vulnerability. It exposes the euro area to criticisms such as not contributing to global growth and demand, and exporting deflation. The EU is subject to the risk of attracting concentric fire from the US – namely for not assuming our responsibility to boost global growth – and at the same time from emerging markets for not acknowledging the shifts of power in global economy.

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- The other crucial precondition for the EU to make a difference is that we should leverage our strengths, and we have many. This means leveraging the attractive aspects of the European model so as to enhance the 'soft power' of the EU. I think in particular about four points:

1) The European social model which attempts to combine equity with growth. This makes our model more attractive for our international partners than other systems.

2) The European environmental model, very much discussed these days. The EU has been at the forefront on many global environmental issues and on the fight against climate change. The EU was a driving force in reaching the first universal, legally binding global climate deal at the Paris COP21 conference in December 2015.

3) The EU is strongly committed to effective multilateralism. We always stand ready to work with our international partners on multilateral, win-win solutions.

4) Finally, the EU at the moment represents a beacon of stability. Whilst for a long time we were in the eye of the storm during the crisis we are now seen as an anchor point of the world. Many of our international partners emphasize that they see the integration we achieved in the EU and euro area as an "important global public good" that needs to be preserved and completed.

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- Beside strengthening own domestic governance, we should also reform our external governance. Here a new impossible trinity has emerged. It is not possible to achieve an important role in global governance if representation in multilateral forums remains that of member states alone.
- Europe, notably the EA, must be able to speak with one voice to make full use of its position: this requires a balancing act between integrated and national policies and institutions for their representation in multilateral forums.
- Representation remains dispersed in multilateral forums – such as the IMF, the G20 and the Financial Stability Board – on issues of key importance for global economic governance, such as the stability of the international economic system and the need to rebalance economies. Fragmented external representation leads to a lesser weight for the European message to the world, or it weakens the effectiveness of the multilateral global governance framework via a tangle of state-to-state bilateral agreements. Only a single external voice, at least at the Eurozone level – along the lines of the proposition of the Five Presidents' Report and the proposal by the Commission (European Commission 2015) – can be conducive to a greater influence in global decision-making.

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- Global economy: future of G20 Growth Strategies
- Trade: support for multilateral system/anti-protectionism pledge
- Climate change: react to dis-engagement by the US
- Keeping up momentum on tax transparency and financial regulatory reform
- Agreement on new *chantiers*: cybercrime, antiterrorism financing
- <u>But most important of all, clarity on G20 political relevance</u>

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- Let me finish with a sober, measured, but nonetheless insightful advice by Robert Triffin. [Triffin, R., The Future of the European Payments System, Stockholm, Almqvist and Wiksell, 1958, (pp.25-26)]
  " … the construction of a stable and freer system of world trade and payments must be conceived as a continuing and permanent effort to adjust international institutions and policies to new needs and new possibilities."
- It describes well what the Commission is trying to deliver in the G20 and other multilateral fora.
- Thank you.