AN ACTION PLAN FOR THE G-20

Statement by
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Before the Hearing on
THE G20 AND GLOBAL ECONOMIC AND FINANCIAL RISKS

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The world economy obviously faces major risks. There are three separate though related problems: the possibility of renewed recession in the three large high-income areas (United States, European Union, Japan), the continued fragility of the global financial system and most immediately the threat of renewed crisis in Europe.

At the same time, the global economy does exhibit several significant strengths. The emerging markets and developing countries, which now account for half of all global output, continue to grow rapidly. Many of the design shortcomings and implementation failures of the previous financial regulatory regime have been reduced by the Basel III agreement and by regulatory reform at the national level, including importantly the Dodd-Frank law in the United States. World trade has continued to expand and the feared outbreak of protectionism has failed to materialize.

In this mixed setting, what should the G-20 do at its upcoming summit in Cannes on November 4-5? I recommend a three-part initiative.

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Promoting Global Growth

The most critical task is restoring economic growth throughout the world and the G-20 should act to do so at Cannes as it did at London in April 2009. The group should postpone its 2010 pledge "to cut budget deficits in half by 2013." There is no problem in the emerging markets: they continue to expand at an average rate of 6 percent and some, including China and India, are doing much better. Such growth is pervasive across all groups of these countries, including Latin America and sub-Saharan Africa as well as East Asia.

All three of the traditional global economic leaders, however, are struggling to reach even 2 percent growth. All are experiencing high and persistent unemployment. Compounding their policy problems, all simultaneously face large budget deficits and rapidly growing debt burdens that require fiscal corrections rather than the expansions that would normally be adopted in such circumstances.[2] Nor can monetary policy do very much since all three central banks are at or not far from the "zero bound" of interest rates.

The world will thus have to continue to rely – increasingly so – on the emerging and developing economies led by China, which alone accounts for one quarter of all global growth.[3] These countries should adopt new stimulus programs to strengthen the global prospect. Some, notably Brazil and Indonesia, have already begun to do so. Fortunately, almost all of them have fiscal and/or monetary policy space to deploy expansionary policies. Moreover, they are already planning to spend trillions of dollars on new infrastructure projects over the coming decade and acceleration of these efforts should be feasible as well as desirable. Their recent concerns over

[2] See Joseph Gagnon, *The Global Outlook for Government Debt over the Next 25 Years: Implications for the Economy and Public Policy*, Policy Analyses in International Economics 94, Peterson Institute for International Economics, Washington, June 2011.

[3] China accounts for about 10 percent of global output (at purchasing power parity exchange rates) and has been growing at about 10 percent per year for over three decades. Hence it contributes 1 percent to global growth, about 25 percent of the current total and 20 percent even in the boom years of 2003-07.

inflation, which justifiably have deterred some of them from shifting their policy gears heretofore, should be mitigated by the weakened prospects in the high-income countries and the leveling off of most commodity process.

In short, it is time for the emerging economies to assert the leadership of the global economic system for which their dramatic progress of the last decade or so has prepared them. China already did so to an important extent in 2008 when it acted most quickly and most decisively of any major economy to promote recovery from the Great Recession. This time the emerging markets as a group need to move with equal vigor to prevent another Great Recession.

It is also essential that the emerging markets promote global growth through the shape of their expansion strategies. China and the other countries with large reserves must provide stimulus through domestic demand and reductions, rather than renewed increases as forecast by the International Monetary Fund, in their external surpluses. This is the only way they can help the world as a whole, including a number of poorer countries as well as the high-income trio, attain renewed growth – which is of course critical to them as well.

China continues to buy $1-2 billion every day to keep the exchange rate of its renminbi 20-30 percent below equilibrium levels. It and other emerging and developing countries spent $1.5 trillion in 2011 alone to hold their currencies down, substantially increasing the trade and current account deficits of the United States (and Europe and a few others). These countries achieved much of their rapid development by exploiting demand in the rich countries and it is time for them to promote domestic consumption and social infrastructure spending and to let their exchange rates appreciate much more rapidly (which will also help counter any inflationary pressures from their new stimulus initiatives).

The European Crisis

The most immediate problem is of course the European crisis and the G-20 should be in a position by Cannes to endorse a comprehensive action plan.

Here too, however, renewed growth is essential. Austerity alone cannot restore economic viability in Greece, Italy or the eurozone as a whole. Two steps are required on this aspect of the European problem:

- Germany, the Netherlands and the other strong countries of the European "core" should, at a minimum, postpone the further tightening of their fiscal policies that is now planned and let their automatic stabilizers play through, and preferably adopt temporary stimulus measures for the next couple of years;
- the European Central Bank, which alone in the high-income world has tightened monetary policy this year and is some distance from the "zero bound," should reduce its interest rates by at least 100 basis points.

In addition, the eurozone must deal decisively with its financial perils. The only way to do so is by leveraging the European Financial Stability Facility (EFSF), through the European Central Bank (which will remain the ultimate source of eurozone bailouts) or whatever techniques prove to be most feasible politically, to create a total reserve of 2-4 trillion euros. Such a war chest would assure markets that the zone itself could handle any conceivable contingencies, including defaults by Italy and Spain, as well as provide the financing necessary to provide the essential recapitalization of European banks and enable Greece to buy back large portions of its existing debt and thus restore national solvency.

For the longer run, the Europeans must continue with the steps toward completing their Economic and Monetary Union that have already been galvanized by the crisis. These will

include a fiscal union, a European Monetary Fund to systematize their rescue capabilities (and the accompanying conditionalities) and a comprehensive mechanism for regional economic governance. Such evolution will almost certainly require changes in the EU treaty and national constitutions. It will obviously take time, perhaps 5-10 years, but is an essential complement to the current crisis management to prevent replication of the present difficulties and restore assured stability to the European Union as the single largest component of the global economy.

If the Europeans fail to get their act together sufficiently to deal with their crisis themselves, which we should know by Cannes, it will be necessary to move to Plan B: mobilization of global resources to do so through the International Monetary Fund. The Fund is the only alternative through which such financing, along with the requisite adjustment programs, could be obtained.

The G-20 would have to play a crucial role in any such process, as it did in raising $750 billion for the Fund in 2009, because the IMF would have to raise several trillion dollars to enable it to deal effectively with the European difficulties. Such funds could only be borrowed from the emerging market economies that have built huge reserves of foreign exchange: China, Russia, Brazil, Korea, India, Mexico, Singapore, Hong Kong and several others including a number of large oil exporters.

Such investments would be attractive for these countries because almost all of them would like to diversify their reserves out of dollars. A claim on the IMF would provide them with an asset that was both diversified in terms of currency risk and paid a higher interest rate. They might also, quite legitimately, link their provision of such funds to the IMF to further substantial increases in their quotas, and thus voting rights, at that institution.

I believe that the IMF should seek to avail itself of such additional resources, with or without an immediate need in Europe, due to the ongoing fragility of the global economy and its uncertain prospects for at least the next several years. But Europe's requirements could provide a compelling case for urgent action and this issue could in fact leap to the top of the G-20 agenda in Cannes.

Global Financial Regulation

It would clearly be desirable to implement a common financial regulatory regime that encompassed all major parts of the world and all classes of financial institutions. We are still far from being able to achieve such a regime, however, as indicated by the fierce battles over key components such as capital requirements and resolution mechanisms.

The G-20 should thus agree to implement on schedule – and sooner where feasible – the minimum bank capital and liquidity requirements under Basel III including the capital surcharge for global systemically-important banks. In view of the market funding strains and contagion risks facing banking systems in some important economies, this is decidedly not the time to be heeding pleas to weaken and/or postpone these key reforms. This is of course especially the case in the Euro area, where large holdings of beleaguered sovereign bonds by banks and credibility problems with previous bank "stress" tests have increased the risk of significant spillovers from the smaller periphery countries to larger ones at the center (particularly Spain and Italy).

In this connection, it is instructive to note that, in the latest (September 2011) IMF Global Financial Stability Report, bank leverage (defined as the ratio of tangible assets to tangible common equity) in the Euro area is over twice as high as in the United States (26 versus 12) with particularly high leverage for German, Belgian, and French banks (32, 30, and 26, respectively).

Concerns that efforts to increase bank capital ratios will result in a fire sale of bank assets (by lowering the denominator of the bank capital ratio) can be countered either by requiring banks to meet the higher capital requirements in absolute terms (that is, by raising a specific amount of capital without regard to risk-weighted assets) or by picking a benchmark for the capital ratio that uses a level of (risk-weighted) bank assets prior to the required increase.

The G-20 should also redouble its efforts in two other reform areas. First, it should underline further the importance of the FSB and national authorities monitoring carefully the build-up of risks in the "shadow banking system" so that tougher capital and liquidity standards in the banking system do not merely result in a shifting of risk to less regulated but increasingly systemically-important non-bank entities. Second, it should press the FSB to make further and faster progress in securing G-20-wide agreement on a cross-border resolution regime – especially for the 28 globally active banks that have been identified as global systemically-important institutions. This should be a priority since such global institutions typically have hundreds or even thousands of majority-owned subsidiaries in other countries and resolution cannot take place effectively without such a cross-border agreement.

<u>What Role for the United States?</u>

The United States must obviously play a central role in galvanizing such a G-20 program at Cannes if it is to eventuate. It can make five major contributions:

- agreement between the President and Congress to adopt <u>a new stimulus program to enhance US economic growth</u> for 2012; we can hardly expect China and Germany to take responsibility for maintaining global expansion if we continue to be paralyzed in moving similarly;

- tangible progress toward credibly reining in the US budget deficit over the remainder of this decade, going far beyond the procedural legislation passed on August 2, to stabilize our debt buildup and thus restore global confidence in our economy and the dollar;
- a commitment to eliminate our current account deficit, which would create 3-4 million new US jobs and carry out previous G-20 pledges to correct the large global imbalances in order to achieve sustainable world growth;[4]
- House passage and Presidential signature of the China currency bill recently passed by the Senate, to emphasize our seriousness concerning the rebalancing issue and thus increase the incentives for China to both stimulate world growth via domestic demand and let its exchange rate strengthen more rapidly; alternatively, or in addition, the numerous G-20 countries concerned by China's currency manipulation could file a joint case against it in the World Trade Organization; and
- support for augmenting the reserves of the IMF as suggested above, including a commitment by the Senate and House leadership to enact the pending IMF reform legislation once it is sent to the Congress by the Administration and an expression of US willingness to increase the weight of the emerging markets at the Fund (primarily at the expense of the Europeans, who would be gaining directly – indeed rescued – from the new funds provided by those countries).

The United States has a massive national interest in successful revival of the world economy, especially as a large part of our own recovery will depend on our success in expanding sales to external markets. We must exercise a new style of leadership to catalyze action by the still-new, and diverse, G-20 but a good start has been made over the past three years and the

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[4] C. Fred Bergsten, "An Overlooked Way to Create Jobs," *The New York Times*, September 29, 2011. Copy attached.

stakes are so high that we must place the highest priority on utilizing the institution effectively over the coming months and years.

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An Overlooked Way to Create Jobs

By C. Fred Bergsten

WASHINGTON

BY virtually ignoring trade, President Obama and Congressional Republicans are missing a major opportunity to create jobs. The United States runs an annual trade deficit of about $600 billion, or 4 percent of our entire economy. Eliminating that imbalance would create three million to four million jobs, according to Commerce Department estimates, at no cost to the budget.

It is clear that our economy can no longer rely on consumer borrowing, housing bubbles, government deficits and super-low interest rates. The United States must start selling much more to other countries, especially China and other emerging markets that are growing at 6 percent or more per year.

Mr. Obama has set a goal of doubling the nation's exports over five years. But his administration has done little to achieve that goal, which is inadequate to begin with. For one thing, the focus should not be the level of exports but the overall deficit — the difference between what we import from abroad and what we sell overseas.

This will of course require us to get our house in order: balancing the budget over time; investing in education, infrastructure and scientific research; and making taxation and regulation more efficient. But there are three steps we can take that would pay off more quickly.

First, the United States must, in effect, weaken the dollar by 10 to 20 percent. This step alone would produce one million to three million jobs. It's been done before: In 1971, President Richard M. Nixon ended the dollar's convertibility in gold, and in 1985, Treasury Secretary James A. Baker III reached an agreement with foreign countries to devalue the dollar relative to the yen and the Deutsche mark.

The bulk of our current misalignment is vis-à-vis the Chinese currency, the renminbi, and a small group of other Asian currencies. Partly in response to pressure from the United States and other countries, China has let its currency rise modestly over the past year, but it continues to intervene in foreign exchange markets, purchasing one billion to two billion United States dollars every day to prevent the value of the renminbi from rising more quickly.

Weaken the dollar to help our exports.

The artificially low value of the renminbi — it is 20 to 30 percent less than what it should be — amounts to a subsidy on Chinese exports and a tariff on imports from the United States and other countries. The United States should take China to the World Trade Organization in Geneva for engaging in illegal competitive currency devaluation, and retaliate if China does not cease this protectionist policy. Many members of Congress have urged such action, but Mr. Obama, like President George W. Bush before him, has been too timid to take this step.

Along with pressuring the Chinese, Congress and Mr. Obama should reduce the budget deficit, the Federal Reserve should continue to pursue an expansionary monetary policy and politicians should drop the "strong dollar" rhetoric of the past. An overvalued dollar only exacerbates the trade imbalance.

Second, the United States must negotiate a reduction in foreign regulations, monopoly practices and other barriers to the export of American services. Work done by American architects, engineers, lawyers and accountants for foreign customers is an export, just like Boeing planes and Caterpillar tractors. We run a $750 billion trade deficit in goods but a $150 billion trade *surplus* in services.

Services make up 80 percent of our economy, and we have a huge opportunity to serve emerging markets like Brazil, China and India. We could expand services exports by at least $200 billion a year by completing a free-trade agreement with South Korea; pursuing a trade agreement known as the Trans-Pacific Partnership; and reviving the Doha round of global trade talks, with a focus on services. The administration has not pursued these steps with enough vigor.

Third, we must get serious about defending the intellectual property rights of our companies against theft by foreign companies and governments. A recent study by the International Trade Commission suggested that Chinese companies alone, with support or at least acquiescence from their government, are stealing $50 billion to $100 billion in United States products each year. The global total is probably at least twice as large.

The theft of intellectual property cuts across such highly competitive products as Microsoft Windows, Apple iPads, groundbreaking pharmaceuticals and award-winning films. Negotiations have failed to achieve significant progress. We must take many more intellectual property cases to the W.T.O. and credibly threaten unilateral retaliation if the foreign piracy continues.

These steps are no doubt aggressive. They would require taking tough initiatives with some of our main trading partners, especially China, and giving trade a more prominent, even central, role in our overall foreign policy. To be sure, some American corporations will fret that these actions would needlessly antagonize the Chinese and threaten a trade war. Some economists worry that a weaker dollar would invite inflation and endanger the dollar's status as the dominant global currency. I believe these fears are overblown. The real threat to the world trading system is, in fact, the protectionist policies, including undervalued currencies, of other countries and the vast trade imbalances that result.

Not every country can expand its economy through exports, because one nation's smaller deficit is another's smaller surplus. But the United States has a unique claim now to pursue such a strategy, because it has run large deficits for most of the last three decades, become the largest debtor country and accommodated other countries' desire for export-led prosperity. If we want to avoid bankruptcy and raise growth, we have got to attack the trade deficit. ☐

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