

Michael Callaghan · Chetan Ghate
Stephen Pickford · Francis
Xavier Rathinam *Editors*

Global Cooperation Among G20 Countries

Responding to the Crisis and Restoring
Growth

 Springer

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The Macroeconomic Policy Response to the International Financial and Economic Crisis and the G20

Alok Sheel

1 Overview

During the *Great Depression* of the 1930s, an event to which the recent crisis is often compared¹, the animosities of the interwar period prevented a coordinated policy response to what was essentially a global problem. Indeed, it is often argued that this failure resulted, inter alia, in the cascading competitive protectionism triggered by the Smoot–Hawley tariffs that may well have magnified a deep recession into the Great Depression. In sharp contradistinction, the G20 orchestrated a much acclaimed globally coordinated policy response to the *Great Recession*, in the process effectively putting in place a new institution to manage globalization.

The first G20 Summit was held in November 2008 in Washington DC under the shadow of the greatest financial crisis in the post-war era. While central banks had already taken steps to inject liquidity into a faltering global financial system, G20 Leaders now supplemented these efforts through an unprecedented concerted global policy response to prevent the global economy from falling over a cliff. At the second G20 Summit in London in April 2009, as the crisis worsened, Leaders pledged to do whatever was necessary to restore confidence, growth and jobs through concerted fiscal expansion and monetary easing. They also pledged to keep international trade and investment open, and reached an agreement to provide over a trillion dollars of additional resources through international financial institutions to counteract the spillovers on emerging markets and developing economies (EM-DEs) of a crisis emanating, rather unusually, from advanced economies. These coordinated actions are widely credited for forestalling a second Great Depression, with the G20 declaring victory at their third Summit at Pittsburgh in September 2009 (“It worked”).

¹ While the fall in aggregate national income was not as rapid and been as sharp in major countries as during the Great Depression—except in the Eurozone periphery—in several other respects parallels are quite striking.

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The focus of the Pittsburgh Summit was on strengthening the recovery and making it durable. With this end in view, the G20 launched its signature '*Framework for Strong, Sustainable and Balanced Growth*', while declaring the G20 to be the premier international forum for economic cooperation, ostensibly replacing the G7. The G20 also turned its attention to addressing other long-standing structural problems in the global economy such as setting an ambitious agenda for regulatory reform of the financial sector; phasing out and rationalizing inefficient fossil fuel subsidies; raising resources for effectively dealing with climate change; combating cross-border tax evasion and havens; bridging the development gap and making the governance of the Bretton Woods and other institutions of global economic governance more representative of tectonic shifts in the structure of the global economy.

Meanwhile, the market reaction to mounting public deficits and debt in some Eurozone countries led G20 Leaders to make commitments for fiscal consolidation at the fourth G20 Leaders' Summit at Toronto, Canada, in June 2010. By the time of the sixth G20 Summit in November 2011 at Cannes, France, it was clear that the global recovery was again in trouble. The Summit deliberations were largely dominated by the Eurozone crisis and on how to restore growth and jobs. The G20 and indeed economists and policymakers, generally, were now on the horns of a dilemma that pitted the need for austerity demanded by markets, against the need for growth and jobs demanded by electorates. This dilemma, most vividly captured in the ambiguous construct 'growth-friendly fiscal consolidation', remains as paramount as ever, having once again dominated the seventh G20 Summit at Los Cabos on June 18–19 under the Mexican Presidency, and also likely to dominate the eighth Summit to be held in St. Petersburg, Russia, on September 5–6, 2013.

With the prospects of global economic recovery uncertain, and the IMF repeatedly downgrading its forecasts for global economic growth², the initial accolades received by the G20 for having forestalled a second Great Depression have been dented by increasing scepticism regarding both its effectiveness and credibility as the premier forum for international economic cooperation. The two questions uppermost in the minds of those who have observed the G20 policy response to the crisis are, firstly, how appropriate was this response, and secondly, whether the G20 is indeed an effective forum for international economic cooperation.

2 The State of Play of Macroeconomic Policy on the Eve of the Global Financial Crisis

Any critical review of the G20 policy response to the global financial crisis needs to take stock of the broad consensus on macroeconomic management prevailing as the crisis set in, as this consensus shaped the policy response. This macroeconomic stabilization consists of monetary and fiscal policies conducted by central banks and

² See Table 1.

treasuries. Central banks generally use a combination of interest rates and monetary aggregates to stimulate or depress demand, depending on the stage of the business cycle. To ensure financial stability, central banks provide liquidity as 'lender of last resort' through their discount windows to prevent financial panic. Treasuries use taxpayer resources—fiscal policy—to bail out critical segments of the financial system that appear to be collapsing, and to substitute for the decline in private demand.

Extant policies for short-term macroeconomic and financial stability were in turn shaped by what was done, but more importantly what critics later pointed out should have been done, and was not done, during the Great Depression of the 1930s. There were, of course, some critical policy constraints, as 'fiat currency' policy tools were unavailable under the gold standard.

2.1 Milton Friedman and the Great Depression

Milton Friedman famously argued that the catastrophic economic collapse of the Great Depression could have been averted had the Federal Reserve lowered, rather than increased, interest rates in the face of deflation. Deflationary tendencies in turn arise from the rapid deleveraging following financial panic that leads to a sharp fall in the money multiplier. During the Great Depression the Federal Reserve felt compelled to raise rates to protect the value of the dollar as speculators demanded gold for currency. The Federal Reserve also failed to provide liquidity necessary for financial stability, which exacerbated deflationary tendencies, bankruptcies and bank failures. The banking system was eventually stabilized by setting up the Federal Deposit Insurance Corporation (FDIC), and abandoning the gold standard for some time. The first measure reassured depositors that their money was safe. The second measure enabled the Federal Reserve to pump liquidity into the financial system.

Temporary abandonment of the gold standard also facilitated expansionary new—Keynesian—fiscal policies (President Franklin Roosevelt's 'New Deal') that according to several economists led to a smart recovery in the mid-1930s.³ It is widely believed that premature fiscal tightening on account of worsening public deficits and debt pulled the USA back into a second dip recession in 1937. Ultimately it was the fiscal stimulus of the 'War Economy' that finally pulled the USA out of the Great Depression.

2.2 The Post-War Period and the Dominance of Keynesian Economics

Keynesian economics enjoyed a bull run in the post-Second World War period. Even Milton Friedman, who effectively sounded the death knell of fiscal policy as

³ The relative role of monetary and fiscal policy during the Great Depression is a matter of continuing debate. Rangarajan and Sheel (2013, p. 47).

a macroeconomic tool, could say that “we are all Keynesian now.” Theoretically, Keynesian demand management policies should not be inflationary, since fiscal expansion merely substitutes for the contraction in private demand to restore the economy to trend growth and full employment. When domestic demand destruction is combined with external demand shock, there may even be no alternative to fiscal expansion to restore growth. Fiscal policy works over the long run however only if used in a contra-cyclical manner, by targeting the structural rather than the nominal fiscal deficit.

This means, firstly, estimating growth potential, a hazardous exercise in the best of times, and often a shifting target as well, and secondly, creating fiscal space when output is above potential by running fiscal surpluses for use when it is below potential. Fiscal policy is however a political minefield, easy to navigate while expanding, but difficult to exit even during boom times. In practice, therefore, governments, fortified by the Philips curve that postulated a trade-off between inflation and growth, kept pushing the envelope to increase growth. Central banks, no longer constrained by the gold standard, were now in a position to accommodate the expansion by monetizing any level of fiscal deficit. Fiscal policy therefore had an inherent inflationary bias.

While some amount of financial repression may have been necessary to reduce the huge burden of the World War II debt in advanced economies, the War Debt hangover was no longer a destabilizing issue at the time of the oil price hikes in the 1970s following the oil price hike, by that time. Fiscal policies however expanded, rather than adjusted, in the face of what was a big and permanent demand shock—a steep rise in oil prices. This led to hyperinflation even as growth remained below trend (‘stagflation’), with the widely acclaimed Phillip’s curve breaking down.

2.3 The Ascendancy of Monetary Policy

Milton Friedman sounded what appeared at the time to be the death knell of Keynesian economics by placing monetary policy at the heart of macroeconomic stabilization policies. He identified inflation as basically a monetary phenomenon. It was however Paul Volcker’s dogged and aggressive monetary tightening that finally tamed the dragon of hyperinflation, although it is still disputed whether the costs in terms of growth foregone was too high a price. Be it as it may, inflation rates were brought down sharply and have been well anchored ever since in advanced economies. Over time, even though the strict ‘monetarism’ of Milton Friedman was not strictly adhered to, monetary policy tools were streamlined and became more rule bound. The US Fed has by and large followed the Taylor rule, adjusting short-term interest rates to attain targeted inflation and growth rates. Other central banks also followed variants of the Taylor rule, with single or multiple targets. The entire credit for low and stable consumer price inflation cannot of course be given entirely to inflation targeting, the Taylor rule or the US Fed. ‘Benign’ deflationary forces deriving from productivity gains wrought by globalization, especially following the

integration of large developing countries like China (for manufactures) and India (for services) into the global economy, were also at work.

While discretionary fiscal policy fell into disrepute, fiscal policy continued to play a role in macroeconomic stabilization through ‘automatic stabilizers’, such as unemployment benefits that automatically kicked in as economic activity fell below trend. These additional expenditures, along with the revenue decline associated with lower growth, were however expected to make fiscal deficits contra-cyclical, keeping the structural balance stable.

Till the outbreak of the recent global financial crisis, Japan stood out as the outlier in the developed world as a country that persisted with fiscal policy as a major tool for macroeconomic stabilization. Since this stabilization has still not occurred, its public debt to national income ratio has risen to unheard-of levels. In retrospect, the Japanese experience in several respects anticipated what was to happen in much of the developed world in the wake of the Great Recession. The Euro Union Maastricht Treaty imposed a ceiling of 3% on fiscal deficits on its member states, which approximated to their expected real growth rates. As a result, debt–GDP ratios in advanced countries tended to decline over time, until such time adverse demographics started affecting their balance sheets. At any rate these ratios remained significantly below those in EMDEs where fiscal discipline remained by and large lax until a big spurt in trend growth sharply increased the size of the denominator.

2.4 The Emergence of Unconventional Monetary Policies

There are apparent limits to the use of conventional rule-based monetary policy since interest rates cannot dip below zero. These limits are breached as inflation rates drop and the output gap grows, and there is little demand for credit even when the central bank discount rates are at the lower zero bound. This is the liquidity trap, into which Japan fell in the 1990s, and arguably the USA and much of the developed world in the wake of the recent global financial crisis.

In such circumstances central banks may be constrained to resort to unconventional monetary policy, expanding money supply not only through the short-term discount window, but also through purchase of long-term government (quantitative) and/or private (credit easing) assets. This can neutralize the sharp decline in the multiplier due to rapid deleveraging during a severe financial crisis. Such liquidity injections are also expected to stimulate growth by raising both investment (by keeping the cost of credit cheap) and consumption (through the wealth effect of appreciating asset prices).

The current chairman of the US Federal Reserve is closely associated with another variant of unconventional monetary policy, sometimes referred to as a money financed as opposed to a bond-financed tax cut, giving him the epithet ‘Helicopter Ben’, as this is tantamount to dropping money by helicopter. This is outright money creation, with no associated government debt. The first real-life experiment with quantitative easing (QE) was done in Japan in the 1990s. However, QE could nei-

ther prevent deflation nor stimulate growth in Japan. Ben Bernanke argued that this was because Japanese QE was far too timid to be effective⁴. A 'helicopter drop' has however never been attempted so far (Sheel 2013a).

3 The Monetary Policy Response to the Global Financial Crisis

The turmoil in US financial markets was in evidence as early as 2007, with rising defaults in the subprime housing market in the USA as interest rates rose consequent on monetary tightening by the US Federal Reserve, and a long, unprecedented bull run in US housing prices ended. The market for complex structured products that fuelled the housing boom was particularly affected, leading to a crisis of confidence in interbank markets that pushed up TED (T bills Euro Dollar) and OIS (overnight indexed swap) spreads to unusually high levels in August 2007. However, the global economy still grew at a robust 5.2% in 2007, and inflationary expectations were on the upward side. Corporate bond markets were quite unaffected. There was therefore some uncertainty regarding the extent to which perturbances in exotic financial products would spill over into the real economy.

In retrospect such speculation appears strange, because the financial system had become much interconnected. The financial system also intermediates real sector economic activity. The response time is no doubt asymmetrical, with financial markets adjusting immediately, even as the real economy adjusts with a lag, like an inverted J curve. Be it as it may, the US Federal Reserve was the first off the block to tackle what was clearly seen as an emerging financial panic. Monetary tightening had peaked on June 29, 2006, with the benchmark Fed Funds Rate set at 5.75%. From September 2007, almost as soon as the first tremors in the financial system were felt, the US Federal Reserve embarked on a rapid easing of monetary policy. At a time other central banks, such as the European Central Bank (ECB) and the Bank of England, were still concerned about inflationary pressures and rising interest rates; the direction of US monetary policy indicated that the US Federal Reserve was presciently looking beyond current inflation rates and worrying about deflationary pressures down the road. By January 2008, the benchmark Federal Funds Rate (FFR) was down to 3%, and by April to just 2%. Within 3 months of the collapse of Lehman Brothers US monetary policy was zero bound, well ahead of other central banks that followed suit (Figs. 1, 2, 3 and 4).

Alongside lowering its benchmark policy rate, the US Federal Reserve also started injecting liquidity into the financial system through its short-term discount window by selling off assets, even as its balance sheet (total assets) remained flat. At this point it was the ECB that expanded its balance sheet to inject liquidity into

⁴ The Bank of Japan has however recently embarked on a much more aggressive round of quantitative easing, comparable to what the US Federal Reserve is doing, in an attempt to defeat deflation and raise growth.

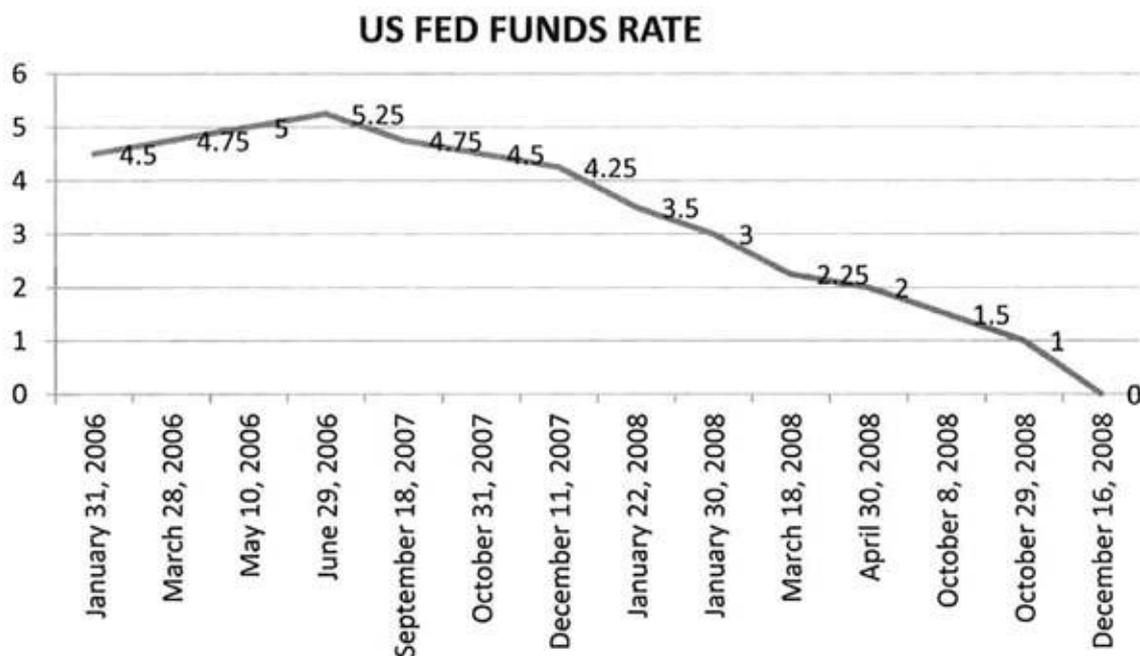


Fig. 1 US Federal Reserve benchmark interest rates. (*US Federal Reserve*. <http://www.federal-reserve.gov/monetarypolicy/openmarket.htm>)

the financial system when the Paris-based bank *BNP Paribas* ran into a liquidity problem in August 2007 with three of its funds heavily exposed to US mortgage-based securities.

The expansion of the ECB's balance sheet was relatively modest compared to what the Bank of England and the US Federal Reserve embarked upon in the wake of the collapse of Lehman Brothers and the associated credit freeze. The US Federal Reserve and the Bank of England were the most aggressive, with their balance sheet expanding in a spectacular fashion through lending to banks and purchase of long-term treasury bonds and mortgage securities. The size of central bank balance sheets continued to grow through various rounds of QE. The composition (mix of short-term liquidity facilities, treasury bonds, mortgage and other assets) and maturity profile (such as through Federal Reserve's '*operation twist*') also changed over time as they calibrated their strategies to new challenges. The ECB however started catching up with the US Federal Reserve and the Bank of England from the second half of 2011 as it stepped up to the plate to backstop sovereign debt through its long-term refinancing operations (LTRO) as the Eurozone crisis unfolded. The balance sheets of all three central banks continue to remain at historic highs. From early 2013 the Bank of Japan started charting a similar path of aggressive QE to try and beat deflation.⁵

The Federal Reserve's balance sheet has quadrupled from \$ 869 billion on August 8, 2007, to almost \$ 3.5 trillion currently (Fig. 5). In its current phase QE 3 it

⁵ A comparative picture of the expansion of the balance sheets of the four major central banks, including their composition and source of financing, can be gleaned from IMF's GFSR (2013b, p. 97).

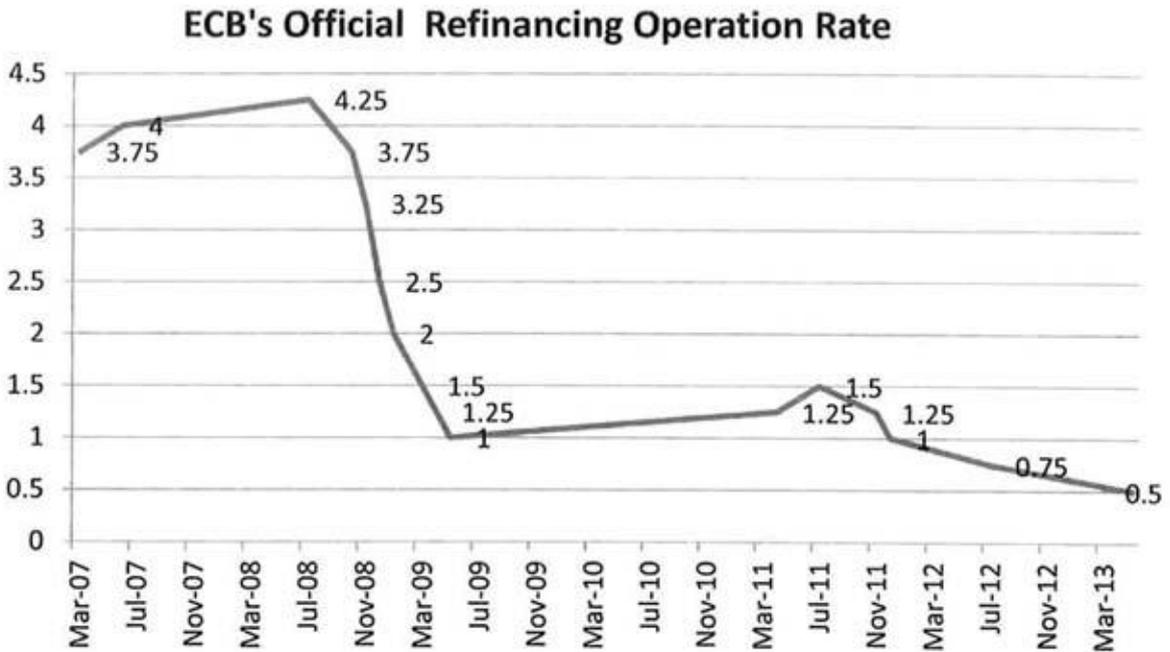


Fig. 2 European Central Bank benchmark interest rates. (Eurostat. <http://appsso.eurostat.ec.europa.eu/nui/show.do>)

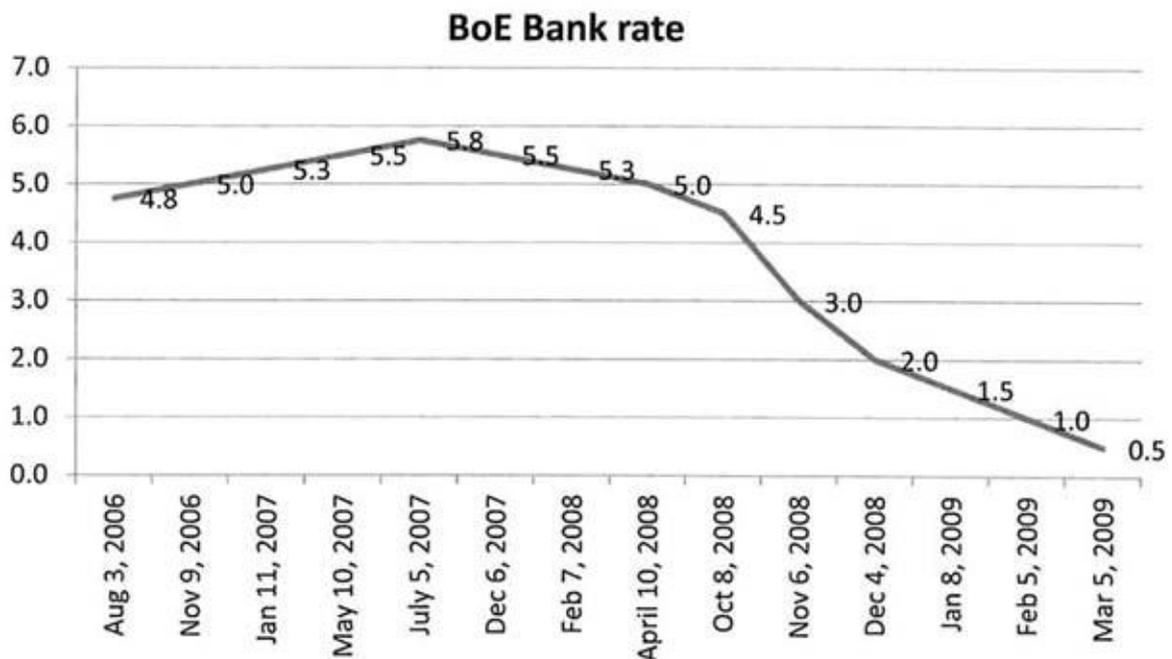


Fig. 3 Bank of England benchmark interest rates. (Bank of England. <http://www.bankofengland.co.uk/monetarypolicy/Pages/decisions.aspx>)

is expanding its balance sheet by \$ 85 billion every month, and has announced its intention to continue doing so for an indefinite period as long as conditions, chiefly the unemployment situation, so warrant. The Bank of Japan is currently expanding its balance sheet by about \$ 75 billion a month.

Conventional and unconventional monetary easing on such a scale was perhaps the reason why deflation was averted in the face of rapid private sector deleverag-



Fig. 4 US consumer price inflation. (*Bureau of Labor Statistics, US Department of Labor.* <http://www.bls.gov/cpi/>)

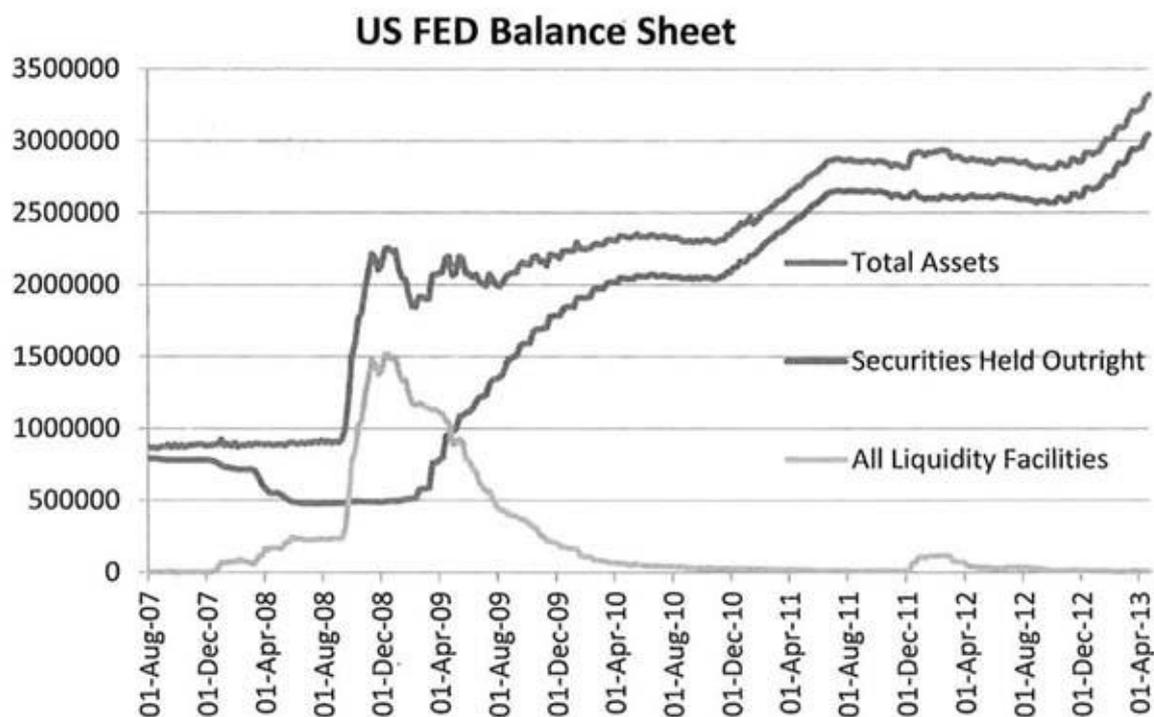


Fig. 5 US Federal Reserve balance sheet. (*US Federal Reserve.* http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

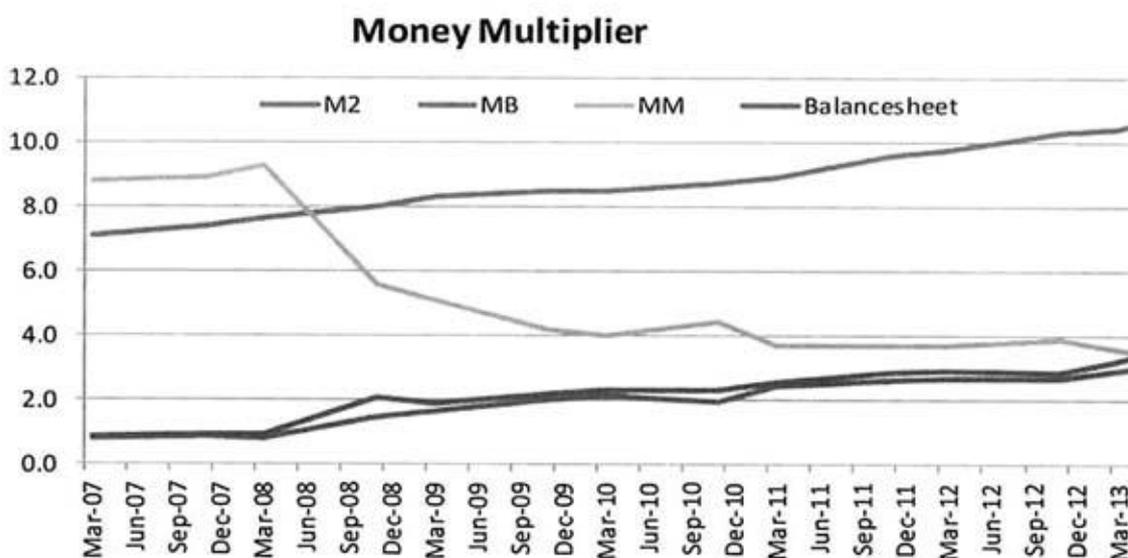


Fig. 6 US money multiplier. (US Federal Reserve. <http://www.federalreserve.gov/econresdata/statisticsdata.htm>)

ing. The massive liquidity injection, however, did not have a commensurate impact on credit expansion through the banking system (M2), as the money multiplier (MM)—the velocity of money in circulation—plunged on account of a large increase in reserve assets. Instead of lending, depositary banks started parking huge amounts of money with central banks, far in excess of mandated requirements. The monetary base is currently expanding more through the increase in reserve assets rather than through monetization. These reserve assets continue to increase in tandem with the size of central bank balance sheets, resulting in what is often called a “liquidity trap”—a breakdown of the monetary transmission channels through which easy monetary policy stimulates economic activity (Fig. 6).

4 Evolution of the G20 Macroeconomic Policy Response to the Global Financial Crisis

The financial panic came to a head with the collapse of Lehman Brothers which filed for bankruptcy on September 15, 2008. This aggravated the credit squeeze that had already tipped many advanced economies into recession by early 2008⁶, and had begun to slow growth in fast-growing EMDEs. Following the growing credit freeze in financial markets, and as it became evident that the real economy was being adversely impacted, both Europe and EMDEs were inclined to blame

⁶ The Business Cycle Dating Committee, of the National Bureau of Economic Research, has determined that economic activity in the US peaked in December 2007, and “that the subsequent decline in economic activity was large enough to qualify as a recession.” *Determination of December 2007 Peak in Economic Activity*, National Bureau of Economic Research, <http://www.nber.org/cycles/dec2008.html>.

lax financial regulation in the USA for bringing down a robustly growing global economy. President Sarkozy of France contemplated hosting an international summit where it was expected that the USA would be put on the mat. Any such initiative was pre-empted by President Bush's announcement to hold a meeting of the G20 for the first time at Summit (Leader) level in Washington DC, thereby reasserting US global leadership.

The G20 was a forum of finance ministers and central bank governors of systemically important economies, representing almost 80% of global GDP, set up in the wake of the Asian financial crisis a decade earlier. Since such a role was the traditional preserve of the G7, the move was widely welcomed by EMDEs who were full members of the G20, who had along resented sitting on the margins of G7 Summits as part of the L'Aquila or Heligendamm process.

4.1 *The Washington Summit*

The first G20 Summit was preceded by a meeting of G20 Finance Ministers and Central Bank Governors in Sao Paulo, Brazil, on November 8–9, 2008. The crisis had deteriorated to the point of warranting a coordinated policy response by systemically important economies, but the severity of its impact on the real economy was still unclear.⁷ Nevertheless, it was at this meeting that the broad contours of the G20 assessment of the problem and the policy response emerged. This was more fully articulated in the Leaders' Declaration⁸ in Washington DC a week later, and carried forward into subsequent communiqués.

At Sao Paulo, Brazil, G20 Finance Ministers identified the root causes of the crisis as global macroeconomic imbalances on the one hand, and a gradual weakening of regulation of the financial sector on the other. The suggested policy response was a fiscal stimulus to supplement action being taken by central banks, consistent with country-specific fiscal situations. Two aspects of the early policy response are especially worthy of note. First, the reference to “non-inflationary growth” is an indication that the G20 did not consider deflation as a serious danger at this stage, although the reference to an appropriate monetary response to dangers arising from “financial deleveraging” would indicate that it was not entirely oblivious of the threat. Second, while there was a close consensus on supporting the financial sector, differences between the USA and Europe on the role of fiscal policy in stimulating economic activity were already apparent, with the latter drawing attention to its automatic stabilizers that made discretionary stimulus less critical.⁹

⁷ In its *World Economic Outlook* of October 2008, the IMF was still forecasting global growth at 3%, and that of advanced economies at 0.5%, in 2009. This was subsequently revised downwards to 0.5 and –2% in its January 2009 *Update*, and further to –1.3 and –3.8% in its *World Economic Outlook* of April 2009, around the time of the London (second) G20 Summit.

⁸ *Declaration of the Summit on Financial Markets and the World Economy, Washington DC, November 15, 2008.* <http://www.g20.utoronto.ca/2008/2008declaration1115.html>.

⁹ Para 9: “ We noted that fiscal policies have served as an important instrument to address the current financial crisis, including through government support to the financial sector and have

Several other essential ingredients of the overall G20 policy response to be fleshed out in future meetings were all in evidence in Sao Paulo and Washington DC: keeping international trade open, including quick conclusion of the Doha round; insulating innocent developing country bystanders from the financial crisis through additional capital provisions for the World Bank and the IMF and reforming global economic governance by giving developing countries greater voice and representation in the Bretton Woods Institutions and the Financial Stability Forum.

4.2 *The London Summit*

Nuanced differences between the USA and Europe on the policy response were again in evidence in the run-up to the second G20 Summit in London. When G20 Finance Ministers met in Horsham, UK, on March 13–14, 2009, while there was a broad consensus on tightening financial regulation and coordinated use of fiscal and monetary policies to combat the economic crisis, the USA advocated aggressive use of fiscal policy, relatively lighter regulation, and a more far-ranging reform of the governance structure of the Bretton Woods Institutions. The Europeans rooted for tighter financial regulation, more prudent use of fiscal policy with an eye to medium-term sustainability, and a more defensive posture to safeguard their pre-eminent position in the governance structure of the Bretton Woods Institutions in the face of their economic decline.

In view of the rapidly worsening economic outlook, and with monetary policy falling into a liquidity trap, the differences on fiscal policy were however, more muted, with stability concerns now pushed to the long term.¹⁰ It appeared that the global economy was on the verge of another Great Depression. The IMF's April 2009 *World Economic Outlook* that appeared just before the London Summit on

performed an important stabilization role and in mitigating further negative effects on markets and on economic activity. Some countries are also considering additional fiscal measures to stimulate the economy and we agreed that countries must use all their policy flexibility consistent with their circumstances, to support sustainable growth, while we recognize the importance of fiscal sustainability for macroeconomic stability and growth...." *Communiqué. G20 Meeting of Ministers and Governors, Sao Paulo, Brazil, 8–9, November, 2008.* <http://www.g20.utoronto.ca/2008/2008communiquel109.pdf> The International Monetary Fund was also of the view that "In Europe, with its relatively large automatic stabilizers, the additional fiscal impulse can probably be somewhat less than in the United States," Blanchard (2008, p. 12).

¹⁰ These differences were more clearly in evidence in the closed-door deliberations, than in the official Communiqués, from where these can be deduced by reading 'between the lines'. Thus in the Horsham Communiqué, while paragraph 6 makes a strong statement on strengthening financial regulation, bullet # 3 clarifies that "it is vital that capital requirements remain unchanged until recovery is assured." Paragraph 5 states that while "fiscal expansion is providing vital support for growth and jobs....we will ensure the restoration of growth and long-run fiscal sustainability." Likewise paragraph 8 tried to limit the gains of the larger EMEs by protecting the share of the poorest developing economies. *G20 Finance Ministers' and Central Bank Governors' Communiqué, March 14, 2009.* <http://www.g20.utoronto.ca/2009/2009communiquel0314.pdf>.

April 2, 2009, projected global growth in 2009 at -1.3% , with advanced economies shrinking by -3.8% , and EMDEs expanding at a very modest 1.6% . G20 Leaders now resolved to do “whatever it takes” to use the full strength of monetary and fiscal policies to pull the global economy back from an economic cliff. They put together a trillion-dollar package to cushion the impact on EMDEs through the IMF and the World Bank, in addition to committing G20 countries to taking “...unprecedented and concerted fiscal expansion, which will save or create millions of jobs which would otherwise have been destroyed, and that will, by the end of next year, amount to \$ 5 trillion, raise output by 4 per cent.... Our central banks have also taken exceptional action. Interest rates have been cut aggressively in most countries, and our central banks have pledged to maintain expansionary policies for as long as needed and to use the full range of monetary policy instruments, including unconventional instruments, consistent with price stability.... Our actions to restore growth cannot be effective until we restore domestic lending and international capital flows. We have provided significant and comprehensive support to our banking systems to provide liquidity, recapitalize financial institutions, and address decisively the problem of impaired assets. We are committed to take all necessary actions to restore the normal flow of credit through the financial system and ensure the soundness of systemically important institutions.... Taken together, these actions will constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times.”¹¹

4.3 *The Pittsburgh Summit*

IMF’s forecast for 2010 in its WEO of April 2009 was that while the global economy would grow at 1.9% , advanced economies would not grow at all. From its July 2009 WEO *Update*, however, the IMF started revising its forecasts for the global economy sharply upwards. By the time of the third G20 Summit in Pittsburgh, USA, towards the end of September 2009, G20 Leaders congratulated themselves that their unprecedented globally coordinated policy response to what was now a financial and economic crisis had succeeded.¹² In its October 2009 World Economic Outlook, the IMF now projected global growth in 2010 at 3.1% , with advanced economies growing at 1.3% and EMDEs at 5.1% (Table 1).

While G20 Leaders stated that “A sense of normalcy should not lead to complacency” (*para 8*), at the Pittsburgh Summit the focus of the G20 clearly shifted from short-term macroeconomic stabilization policies to addressing medium- to long-term structural challenges to strengthen growth and sustain the recovery.¹³ It

¹¹ *London Summit—Leaders’ Statement, 2 April 2009*, <http://www.g20.utoronto.ca/2009/2009communique0402.pdf>.

¹² *Para 5* of the Pittsburgh Declaration consisted of just two words: “It worked.” IMF’s (2010) was appropriately entitled “*A Policy-Driven, Multispeed Recovery*.”

¹³ *Para 10*: “We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature

Table 1 IMF growth projections

WEO	2008			2009			2010			2011			2012			2013		
	Wd	Ad	Em	Wd	Ad	Em	Wd	Ad	Em	Wd	Ad	Em	Wd	Ad	Em	Wd	Ad	Em
Apr-08	3.7	1.3	6.7	3.8	1.3	6.6	4.8	2.7	7.1	4.9	3.1	7.0	4.9	3.0	7.0	4.9	2.9	7.0
<i>July Update</i>	4.1	1.7	6.9	3.9	1.4	6.7												
Oct-08	3.9	1.5	6.9	3.0	0.5	6.1	4.2	2.0	6.7	4.8	2.9	6.9	4.8	2.8	6.9	4.7	2.5	6.9
<i>January Update</i>	3.4	1.0	6.3	0.5	-2.0	3.3	3.0	1.1	5.0									
Apr-09	3.2	0.9	6.1	-1.3	-3.8	1.6	1.9	0.0	4.0	4.3	2.6	6.1	4.9	3.0	6.8	4.9	3.0	6.8
<i>July Update</i>	3.1	0.8	6.0	-1.4	-3.8	1.5	2.5	0.6	4.7									
Oct-09	3.0	0.6	6.0	-1.1	-3.4	1.7	3.1	1.3	5.1	4.2	2.5	6.1	4.4	2.6	6.4	4.6	2.5	6.6
<i>January Update</i>	3.0	0.5	6.1	-0.8	-3.2	2.1	3.9	2.1	6.0	4.3	2.4	6.3						
Apr-10	3.0	0.5	6.1	-0.6	-3.2	2.4	4.2	2.3	6.3	4.3	2.4	6.5	4.5	2.4	6.6	4.5	2.4	6.6
<i>July Update</i>	3.0	0.5	6.1	-0.6	-3.2	2.5	4.6	2.6	6.8	4.3	2.4	6.4						
Oct-10	2.8	0.2	6.0	-0.6	-3.2	2.5	4.8	2.7	7.1	4.2	2.2	6.4	4.5	2.6	6.5	4.6	2.6	6.6
<i>January Update</i>				-0.6	-3.4	2.6	5.0	3.0	7.1	4.4	2.5	6.5	4.5	2.5	6.5			
Apr-11	2.9	0.2	6.1	-0.5	-3.4	2.7	5.0	3.0	7.3	4.4	2.4	6.5	4.5	2.6	6.5	4.5	2.5	6.5
<i>July Update</i>				-0.5	-3.4	2.8	5.1	3.0	7.4	4.3	2.2	6.6	4.5	2.6	6.4			
Oct-11	2.8	0.1	6.0	-0.7	-3.7	2.8	5.1	3.1	7.3	4.0	1.6	6.4	4.0	1.9	6.1	4.5	2.4	6.5
<i>January Update</i>							5.2	3.2	7.3	3.8	1.6	6.2	3.3	1.2	5.4	3.9	1.9	5.9
Apr-12	2.8	0.0	6.0	-0.6	-3.6	2.8	5.3	3.2	7.5	3.9	1.6	6.2	3.5	1.4	5.7	4.1	2.0	6.0
<i>July Update</i>							5.3	3.2	7.5	3.9	1.6	6.2	3.5	1.4	5.6	3.9	1.9	5.9
Oct-12	2.8	0.1	6.1	-0.6	-3.5	2.7	5.1	3.0	7.4	3.8	1.6	6.2	3.3	1.3	5.3	3.6	1.5	5.6
<i>January Update</i>										3.9	1.6	6.3	3.2	1.3	5.1	3.5	1.4	5.5

was widely believed at that point that, the recovery notwithstanding, a return to pre-crises levels of global growth on a sustainable basis was unlikely without a major rebalancing of the global economy, since US saving rates were rising in response to the severe mauling of household balance sheets on account of the financial crisis. The drop in US consumption expenditure would need to be countervailed by higher domestic demand in China and elsewhere. Such rebalancing was also expected to reduce the risks to the global financial system.

The institutional mechanism to achieve this—*The Framework for Strong Sustainable and Balanced Growth* based on a ‘mutual assessment process’—was launched at Pittsburgh, and was soon to be described as the ‘heart and soul’ of the G20. The *Framework* was seen by G20 Leaders as a compact that committed their Finance Ministers to consult and work together on a continual basis to assess how their policies fitted together, to evaluate whether they were collectively consistent with strong, sustainable and balanced growth, and to act as necessary to meet the common objectives of G20 countries. The compact was that G20 members would agree on shared policy objectives, which would be updated from time to time as conditions evolved; they would set out medium-term policy frameworks and work together to assess the collective implications of national policy frameworks for the level and pattern of global growth and to identify potential risks to financial stability. G20 Finance Ministers would subsequently present the results of their mutual assessment to Leaders at each Summit, who would in turn agree on actions to meet these common objectives.

To an extent the *G20 Framework* could be seen as another attempt to augment IMF’s bilateral macroeconomic ‘*Article IV*’ surveillance system with multilateral macroeconomic surveillance which was more suitable to an age of enhanced globalization and policy spillovers IMF (2007). Two features of the G20 Framework exercise are particularly relevant: it is firstly, a mutually consultative process, rather than driven by the IMF¹⁴, and secondly, any commitments/targets are country driven rather than imposed externally. While this makes the exercise uniquely democratic and inclusive, it is also less likely to result in rules-based outcomes.

4.4 *The Toronto Summit*

By the time the fourth G20 Summit was held in Toronto, Canada, on June 26–27, 2010, the global recovery was unexpectedly robust, considering that the general view at the time, based on the work done by Rogoff and Reinhart, (Rogoff and

withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way, maintaining our commitment to fiscal responsibility.” *Para 11*: “Even as the work of recovery continues, we pledge to adopt the policies needed to lay the foundation for strong, sustained and balanced growth in the 21st century.” *G20 Leaders Statement: The Pittsburgh Summit, September 24–25, 2009, Pittsburgh*. <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

¹⁴ IMF’s official role in the *G20 Framework* exercise is to act as ‘technical advisor’.

Reinhart 2009a) was that a recovery from a financial crisis is slow and protracted. Following the contraction (-0.6%) in 2009, the WEO of April 2010 projected global growth in 2010 at 4.2% , with advanced economies growing at 2.3% (not far below the average of 2.8% between 1992 and 2001), and Emerging and Developing Economies growing at 6.3% , far higher than the average of 3.8% between 1992 and 2001.

The global recovery, however, was accompanied by a storm brewing in the Eurozone, with the focus of financial instability now shifting from the USA and UK. Whereas financial instability in the first phase of the financial crisis centred on the banking system, with treasury bonds providing a safe haven, the second stage of the crisis was marked by sovereign debt risks in the Euro area when markets discovered the flaw that was always known to economists: that sovereign debt in these countries did not have a central bank backstop on the one hand, and their tax base was too small to bail out their pan European banks on the other (Table 2).

A protracted and tepid recovery severely mauled budgetary revenues, while the need for stimulus and supporting the financial sector kept expenditures high. As a result, there was a dramatic rise in budget deficits, the lagged effect of which was a steep rise in debt-GDP ratios unheard of in peace time in advanced economies. This once again opened fissures within the G20 on fiscal policy, with European countries arguing for front-loaded fiscal exit in the face of market revolt, and the USA and UK (right up to the dramatic shift in stance with the defeat of the Labour Party in the May 2010 elections) for fiscal exit calibrated to the recovery. The final outcome, reflected in the Toronto Leaders' Declaration¹⁵, was to make the fiscal consolidation mix 'growth friendly', albeit 'date' rather than 'rate (of recovery)' contingent, with advanced G20 economies agreeing measures to halve deficits by 2013 and to stabilize or reduce government debt-to-GDP ratios by 2016. The unstated assumption was that the heavy lifting was now left to monetary policy which was, however, still in a liquidity trap on account of continued deleveraging and dysfunctional transmission channels. The G20 has been living with this dilemma ever since.

At Pittsburgh the G20 had turned its attention to medium- to long-term macro-economic policies to raise and sustain global growth through its *Framework for Strong, Sustainable and Balanced Growth*, to be conducted through a consultative *Mutual Assessment Process*. The first MAP exercise was undertaken by the Framework Working Group which was co-chaired by Canada and India, with technical advice from the IMF, and its results presented to G20 Leaders at Toronto. The overall assessment was that when the G20 country frameworks were combined into a global framework the outcomes appeared unrealistic, as all countries expected to export their way out of low growth. Leaders were therefore of the view that "we can do much better," with advanced deficit countries committing to take actions to boost national savings and enhance export competitiveness, and surplus countries committing to reforms to reduce their reliance on external demand and focus more on domestic sources of growth and keep exchange rates flexible. Therefore both

¹⁵ *The G20 Toronto Summit Declaration, Toronto, June 27, 2010.* <http://www.g20.utoronto.ca/2010/to-communique.html>.

Table 2 General government fiscal balance and gross debt

% of GDP	2007		2008		2009		2010		2011		2012 ^a		2013 ^a	
	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt	Bal	Debt
<i>Advanced</i>	-2.7		-3.5	81.3	-9.0	94.9	-7.8	101.5	-6.6	105.5	-5.9	110.2	-4.7	109.3
France	-2.8	64.2	-3.3	68.2	-7.6	79.2	-7.1	82.3	-5.2	86.0	-4.6	90.3	-3.7	92.7
Germany	0.2	65.4	-0.1	66.8	-3.1	74.5	-4.1	82.5	-0.8	80.5	0.2	82.0	-0.3	80.4
Greece	-6.8	107.3	-9.9	112.5	-15.6	129.3	-10.7	147.9	-9.4	170.6	-6.4	158.5	-4.6	179.5
Iceland	5.4	29.1	-0.5	70.4	-8.6	88.0	-6.4	90.6	-5.0	102.3	-3.0	99.1	-1.3	91.9
Ireland	0.1	25.0	-7.4	44.5	-13.9	64.9	-30.9	92.2	-13.4	106.5	-7.7	117.1	-7.5	122.0
Italy	-1.6	103.3	-2.7	106.1	-5.4	116.4	-4.3	119.3	-3.7	120.8	-3.0	127.0	-2.6	130.6
Japan	-2.1	183.0	-4.1	191.8	-10.4	210.2	-9.3	216.0	-9.9	230.3	-10.2	237.9	-9.8	245.4
Portugal	-3.2	68.3	-3.7	71.6	-10.2	83.1	-9.8	93.2	-4.4	108.0	-4.9	123.0	-5.5	122.3
Spain	1.9	36.3	-4.5	40.2	-11.2	53.9	-9.7	61.3	-9.4	69.1	-10.3	84.1	-6.6	91.8
UK	-2.9	43.7	-5.1	52.2	-11.4	68.1	-10.1	79.4	-7.9	85.4	-8.3	90.3	-7.0	93.6
USA	-2.7	66.5	-6.7	75.5	-13.3	89.1	-11.1	98.2	-10.0	102.5	-8.5	106.5	-6.5	108.1
<i>BRICS</i>	0.3	39.3	-1.2	37.9	-5.6	40.4	-4.3	42.8	-2.9	41.6	-3.5	42.3	-3.3	41.6
Brazil	-2.7	65.2	-1.4	63.5	-3.1	66.9	-2.7	65.2	-2.5	64.9	-2.8	68.5	-1.2	67.2
Russia	6.8	8.5	4.9	7.9	-6.3	11.0	-3.4	11.0	1.5	11.7	0.4	10.9	-0.3	10.4
India	-4.8	75.0	-8.6	73.3	-10.1	75.0	-8.7	68.5	-8.4	66.4	-8.3	66.8	-8.3	66.4
China	0.9	19.6	-0.7	17.0	-3.1	17.7	-1.5	33.5	-1.3	25.5	-2.2	22.8	-2.1	21.3
South Africa	1.4	28.3	-0.4	27.8	-5.5	31.3	-5.1	35.8	-4.0	39.6	-4.8	42.3	-4.8	42.7

IMF, Fiscal Monitor April 2013 Bal: General Government Nominal Balance

^a Projections

internal and external rebalancing were envisaged. G20 Leaders recognized “that these measures will need to be implemented at the national level and will need to be tailored to individual country circumstances. To facilitate this process, we have agreed that the second stage of our country-led and consultative mutual assessment will be conducted at the country and European level and that we will each identify additional measures, as necessary, that we will take toward achieving strong, sustainable, and balanced growth.”¹⁶

4.5 *The Seoul Summit*

By the time of the fifth G20 Summit in Seoul a few months later on November 11–12, 2010, the global recovery was in full swing. Global growth was forecast by the IMF in its WEO of October 2010 to expand by 4.8% in 2010. Although economic activity appeared to be slowing from the second half of 2010, global growth in 2011 was nevertheless projected to be at a relatively healthy 4.2% in 2011. The recovery was ‘two-speed’, with developing countries recovering more strongly. The focus at the Seoul Summit, therefore, remained on medium- to long-term issues, namely the ‘Framework’ exercise and ‘Development’, a new G20 stream injected by the Summit Chair, Korea.

The second-stage MAP Framework exercise was expected to be at the country level on the basis of forward-looking projections given by each G20 country. This quickly brought into the open dormant fissures within the G20 apparent, reflected in the careful choice and balancing of words in G20 Communiqués. These fissures were exacerbated by IMF’s technical assessment to the G20 that after putting together G20 country submissions it appeared that countries were again overoptimistic in projecting growth through reliance on external demand. While fiscal rebalancing seemed to be on track, external rebalancing was not happening, and there was little clarity on structural reforms.

The USA and some other advanced countries were of the view that China’s exchange rate continued to be substantially undervalued. China was not ready to accept this, accusing the USA of causing global imbalances through large current account and fiscal deficits, and also causing currency (dollar) devaluation through large QE. There were also concerns that monetary easing on a large scale, combined with financialization of commodity markets, were distorting commodity prices.¹⁷ Other emerging markets, led by Brazil, also complained about volatile capital flows appreciating their currencies consequent on continuing loose monetary policies in

¹⁶ Ibid.

¹⁷ The G20 Study Group set up to study the issue however did not come up with conclusive evidence of this, pointing instead to the steep rise in physical demand for commodities in recent times, especially in emerging markets. These conclusions were keenly debated in G20 meetings, especially since there was continued pressure on commodity prices despite a collapse in global demand. *Report of the G20 Study Group on Commodities under the chairmanship of Mr. Hiroshi Nakaso*, November 2011 <http://www.cmegroup.com/education/files/G20Nakaso-November202011.pdf>.

advanced economies.¹⁸ Germany was very touchy about any attempt to discuss intra-zone imbalances in the G20, and any mention of staggering fiscal consolidation in the short term in the Eurozone. By now the UK had also started leaning towards fiscal austerity following the victory of the Conservatives in May 2010, leaving only the USA and Japan as the major advanced G20 countries who fully agreed with the IMF's advice to backload fiscal consolidation in view of worsening economic conditions. Global consensus on policy actions to deal with the new headwinds now became increasingly difficult.

In the event, the G20 continued to reiterate constructive ambiguities such as committing to 'growth friendly fiscal consolidation' and 'exchange rate flexibility and avoiding competitive devaluations'. An alternative proposal, attributed to the USA, for an indicative quantitative cap of 4% of GDP on current account imbalances was turned down largely on account of strong resistance by China, Brazil, Germany, Australia and Japan. There was however an agreement that "persistently large imbalances, assessed against indicative guidelines to be agreed, would warrant an assessment of their nature and the root causes of impediments to adjustment as part of the Mutual Assessment Process."¹⁹

4.6 *The Cannes Summit*

Following the 'dead cat bounce' of 2010, the global recovery started fading away in 2011 and 2012, with Europe falling into a second dip recession, US growth weakening and the strong recovery in emerging markets and developing economies stalling. The smouldering crisis in the Eurozone erupted once more, this time in Greece, just prior to the (sixth) Cannes Summit on November 3–4, 2011. However, another grand global rescue comparable to the 'trillion dollar' London Summit was quickly ruled out since, unlike London, policymakers went into the Summit with empty

¹⁸ These developing country concerns were carried forward into subsequent Summits leading to a debate within the G20 on external spillovers of monetary policies in reserve currency issuing countries which basically respond to domestic business cycles. At the next Summit at Cannes, G20 Leaders agreed to *G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences* (<http://www.g20.utoronto.ca/2011/2011-finance-capital-flows-111015-en.pdf>) that were earlier endorsed by G20 Finance Ministers and Central Bank Governors on October 15, 2011. While there were several constructive ambiguities in this agreement, reflecting sharp differences between G20 countries on the issue, this nevertheless endorsed the view that as a last resort countries could put in place 'capital flow management' measures to insulate them from the volatility in cross-border capital flows inherent in the shifting monetary policy stance in reserve issuing currencies. The real significance of this agreement was that it pressured the IMF into abandoning its long-held view that the final objective of all countries should be to move towards full convertibility on the capital account. While re-iterating the benefit of capital flows, the IMF now concluded that there was "no presumption that full liberalization is an appropriate goal for all countries at all times" IMF (2012c).

¹⁹ *The G20 Seoul Summit Leaders' Declaration, Seoul, November 12, 2010*. <http://www.g20.utoronto.ca/2010/g20seoul.html>.

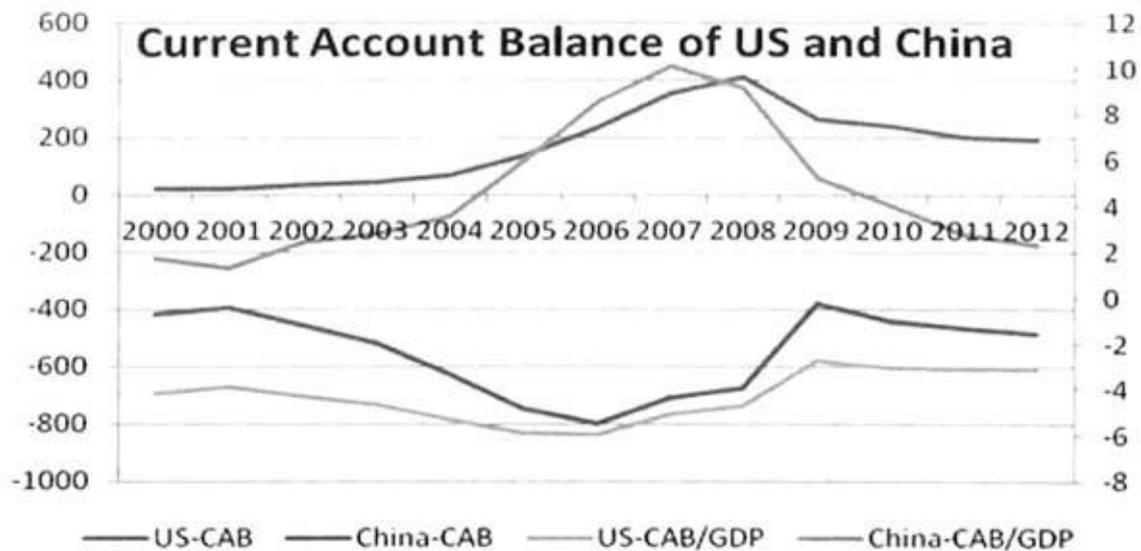


Fig. 7 USA and China current account balance. (IMF 2012b)

pockets and depleted policy instruments. There was nevertheless a resolve to garner more resources for the IMF for short-term macroeconomic support, although no number could be put on the table.

The gravity of the situation compelled G20 Leaders to turn their attention once again to short-term macroeconomic management to stabilize the global economy, with the growth–austerity dilemma now taking centre stage. These concerns were reflected in the way the Framework exercise panned out, with specified countries committing to specific short-term policy actions, in addition to long-term objectives such as demand rebalancing that retreated into the background.²⁰ Long-term objectives also lost focus on account of some appreciation of the Chinese currency, the sharp reduction in China’s current account surplus (Fig. 7) even as those of oil-exporting countries rose, China’s own resolve in its 12th Five Year Plan to increase domestic consumption so as to reduce external vulnerabilities to its growth and a new narrative on trade developed by the World Trade Organization (WTO) that highlighted the growing importance of processing trade that had the effect of sharply reducing China’s bilateral trade surpluses with the USA.²¹ While it can plausibly be argued that pressure within the G20 forum also influenced Chinese policy, other

²⁰ In its *World Economic Outlook* of September 2011 the IMF observed that “While imbalances decreased during the crisis, this was due more to a large decrease in output in advanced relative to emerging market economies than to structural adjustment in these economies. Looking forward, the forecast is for an increase rather than a decrease in imbalances.” Its tune had changed, however, by the time of its next *World Economic Outlook* in April 2012, where it stated that “latest developments suggest that global current account imbalances are no longer expected to widen again, following their sharp reduction during the Great Recession.”, and by July 2012, in its *Staff Report* for the Article IV Consultations with China it assessed the Chinese currency as only “moderately undervalued.” IMF (2012d).

²¹ WTO (2011). If the same exchange rate that led to rising trade surpluses with the US—and could therefore be considered undervalued—also led to rising trade deficits with East Asia, what, then, was the equilibrium exchange rate?

imbalances, such as those of oil-exporting countries, are taking its place. At best this could be seen as an illustration of discretionary, rather than rules-based policy coordination.

At Seoul G20 Leaders had resolved to develop indicators for identifying large imbalances that require corrective action. Following this, more stringent surveillance criteria were developed at Cannes for seven G20 countries found to be systemically important as their individual share of aggregate G20 GDP exceeded 5% at either market exchange rates or purchasing power parity. These included the USA, Japan, Germany and China (both criteria), UK and France (MER criteria) and India (PPP criteria).

The irony, however, was that just as the focus of the Framework was shifting to systemically important economies, the world was confronted with a crisis emanating from a relatively small economy, namely Greece. While the subprime housing crisis showed how a problem in a small market in a large economy could be systemically magnified by financial markets, the Eurozone crisis now showed that large imbalances even in a small economy in a large currency union can be similarly systemically magnified through the same transmission channel. The new surveillance criteria developed by the Framework Working Group therefore appeared flawed from inception, and in any case did not go very far. At Cannes²², following the adoption of the indicative guidelines, G20 Leaders commissioned an 'Accountability Framework', which has in effect meant country-led presentations and justifications of their own policies, of which other countries and the IMF were wary of being too critical.

By this time the Eurozone imbroglio had clearly supplanted global imbalances from the G20 centre stage. The Eurozone had moved to address the problem by first setting up the EFSF, subsequently rolled into the ESM to provide fiscal support to troubled governments and banks, and in March 2011 Eurozone governments agreed to reform their Stability and Growth Pact through a 'six pack' reform to penalize countries that failed to comply with fiscal rules, as a prelude to a more comprehensive new Treaty on Stability, Coordination and Governance one year later.

The market response to the outcome at Cannes was not kind. The Eurozone problem had not only not been addressed to its satisfaction, but also there was no acknowledgement that structural flaws—monetary union without a fiscal and banking union, and the absence of a mechanism to deal with intra-EMU imbalances—needed to be fixed quickly. There was also no clear strategy of how the Eurozone could get back to a path of sustainable growth from a situation where countries were being forced into austerity at a time of collapsing growth. The message that appeared to go out was that Europe did not take too kindly to the G20 meddling into what it saw to be intra-Eurozone issues.

The takeaway from G20's handling of the austerity-growth dilemma seemed to be that while medium-term fiscal consolidation plans were necessary, countries should continue to stimulate in the current circumstances till such point as they

²² *Cannes Summit Final Declaration—Building Our Common Future: Renewed Collective Action for the Benefit of All Cannes, November 4, 2011.* <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html>.

were penalized by markets, at which point fiscal consolidation should commence irrespective of the output gap or state of recovery. All this could hardly have been reassuring to markets. A number of Eurozone sovereign bonds went into free fall following the Summit as the contagion spread, denting the image of the G20 as the premier multilateral forum for international policy cooperation and crisis management. It was the ECB's LTRO announced in December 2011 that temporarily helped stabilize peripheral sovereign bond yields.

4.7 The Los Cabos Summit

The seventh G20 Summit was held at Los Cabos, Mexico (June 18–19, 2012), close on the heels of the Cannes Summit, with the two imminent threats confronting the global economy, to all intents and purposes, the same as what was confronted by Leaders at their last Summit in Cannes. If anything, these old challenges had become even more daunting.

First, the Cannes Summit agenda was hijacked by the gathering storm in the Eurozone, specifically the Greek question. The Summit failed to address the problem squarely. As a result, the contagion spread beyond Portugal, Ireland and Greece (PIG, all of whom had lost sovereign market access before Cannes) to the bigger Eurozone economies of Spain and Italy, and even threatened France. Their sovereign bond spreads started spinning out of control within weeks of the Summit. It was the ECB that temporarily rescued Eurozone sovereign bonds. Once 'Big Bertha' felt silent, however, sovereign bond markets went into revolt again, with the spreads of Spain breaching the dreaded 6% barrier and Italian yields in hot pursuit. Leaders now confronted a much worse situation in the Eurozone than at Los Cabos, with governments quietly planning for the exit of Greece, or even a catastrophic break-up of the monetary union. Whereas sovereign bond yields rose after the Cannes Summit, they were now rising prior to the Summit. The Eurozone once again threatened to hijack the G20 agenda at Los Cabos.

G20 Leaders agreed to augment IMF's firewall again by another \$ 450 billion at Los Cabos. Since the bigger EMDEs were already self-insured through their large foreign currency reserves, this further augmentation seemed to be directed towards the Eurozone crisis. This, however, had no impact on Eurozone sovereign bond yields, since the amount raised was too small relative to the size of the problem. It was once again the announcement by the ECB in September 2012 of its intention to buy sovereign bonds, without any limits on size or time, through its new Outright Monetary Transactions (OMT) that battered high bond yields into submission.

The second threat facing Leaders at Cannes was the faltering global recovery and the persistence of high levels of unemployment, particularly youth unemployment. The Cannes Action Plan was subtitled "Growth and Jobs" because unemployment had become a political hot potato, with the concerns over growth, global imbalances and exchange rates stemming primarily from this. If the sleight of hand in the employment data was discounted to take stock of discouraged workers who had abandoned their job search, the employment scenario had only worsened in most parts of

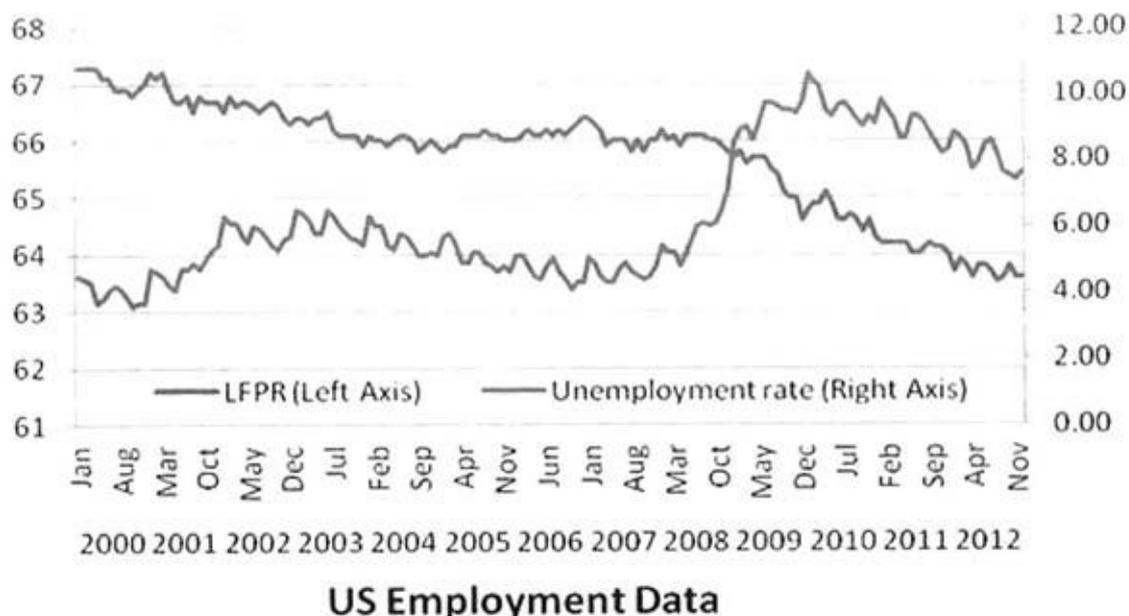


Fig. 8 US unemployment and Labor Force Participation Rate. (*Bureau of Labor Statistics, US Department of Labor*. <http://www.bls.gov/data/>)

the developed world since Cannes. While a long-term decline in the US Labor Force Participation Rate (LFPR) was discernible even before the onset of the global financial crisis (Fig. 8), it had stabilized during the boom since 2003. A true recovery is consistent only with a reversion, or at least near reversion, to pre-crisis unemployment *and* labour participation rates. Growth and jobs were, therefore, once again at the top of the Los Cabos agenda, especially with near-term economic data from the USA, the UK, the Eurozone and even major emerging markets like China, Brazil and India pointing towards another synchronized downturn.

The dilemma facing Leaders at Cannes of having to choose between austerity (market-induced fiscal consolidation) and growth (fiscal expansion to help bridge the output gap) was now compounded by the realization of a new paradox. While the flight to quality—sovereign bonds—seems to have created an illusion of fiscal space in a number of advanced countries that enabled them to continue to stimulate, or stagger their consolidation, the same process shrank the fiscal space in peripheral Eurozone countries. Capital flowed out of the latter, elevating sovereign borrowing costs. Since there was no central bank backstop, the recovery was left hostage to markets. Electorates had by now joined issue with markets, voting against austerity by unseating governments wherever elections were held. Leaders were therefore expected to devise a coordinated workable strategy to revive flagging global growth with markets and electorates revolting in different directions.

With economists divided on what was to be done, it is not surprising that there was no rabbit to pull out of the hat. On the trade-off between austerity and growth, neither the Leaders' Declaration nor the Los Cabos Action Plan went one whit beyond Cannes: continue to stimulate if you have the fiscal space, and start consolidating if you do not. In the event, the Cannes and Los Cabos Action Plans were

essentially similar in design and objectives, albeit with three significant differences. First, there was a greater willingness in Mexico on the part of European countries to let the G20 discuss and render policy advice on intra-Eurozone imbalances²³; second, the bar for what constituted fiscal space was lowered²⁴ and third, serious consideration was given to the possibility of infrastructure investment as a driver of the global recovery.

4.8 The St. Petersburg Summit

Up to this point infrastructure was seen primarily as relevant to developing countries which had big infrastructure deficits. It was consequently included as one of the nine pillars on the agenda of the G20 Development Working Group injected into the G20 work streams at the instance of the Korean Chair at the fifth Summit at Seoul. At the next Summit in Cannes, the French Chair had accorded priority to infrastructure financing, but this was still seen from a purely developing-country perspective, with the High-Level Panel on Infrastructure assigning the central role to an action plan developed by multilateral development banks (MDBs). The macroeconomic policy (Framework) and Development streams proceeded on separate tracks, as infrastructure investment was not envisaged as a possible driver of the global recovery. At Los Cabos, G20 Leaders seriously considered, perhaps for the first time, a role for infrastructure investment in reviving growth and creating jobs in developed countries and subsumed the subject within the Framework Working Group dealing with macroeconomic issues.

The synergies between the 'Macroeconomic' and 'Infrastructure' streams were explored further at the next (eighth) Summit held in St. Petersburg, Russia, on September 5-6, 2013, where a work plan was adopted to improve the overall investment climate to boost economic growth, job creation and development. Country specific strategies are expected to be worked out by the time of the next (Brisbane) Summit.

²³ The G20 had for long talked about global rebalancing, but the Los Cabos Action Plan was the first G20 document that acknowledged the need for internal rebalancing in the Eurozone. Also, while no specific commitments were given, pointers to the banking union, the severance of the negative "feedback loop between sovereigns and banks" and measures to support growth agreed at the EU Summit 10 days later were all there in the Los Cabos Leaders' Declaration and Action Plan. It is true that nothing definitive was stated about fiscal union or the conversion of the European Central Bank into a regular central bank that can insulate sovereign bonds from market revolt. But there was no consensus amongst European leaders themselves on these issues. G20 commitments, it must be remembered, are country led. *G20 Leaders Declaration, Los Cabos, Mexico, June 19, 2012*. <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html>.

²⁴ While the Los Cabos Leaders' Declaration exhorted countries with fiscal space to continue with stimulus in general terms, the country-specific linkage between fiscal space and stimulus that featured prominently in the Cannes Action Plan was dropped in the Los Cabos Action Plan. This severance allowed the USA, which was not included in the group of countries with fiscal space at Cannes, and now faced a "fiscal cliff" deriving from the double whammy of automatic federal expenditure cuts and expiry of tax cuts, to commit to continuing stimulus at Los Cabos.

The G20²⁵, however, is perhaps still too sanguine about private investment taking the lead in infrastructure investment in view of weak animal spirits, continuing deleveraging, and the leading role played historically by governments in financing and supporting infrastructural investments on account of long gestation periods, low returns and attendant risks. Public investment, including public works on a large scale, was part of President Franklin Roosevelt's 'New Deal' and therefore a feature of the fiscal policy response during the Great Depression. During the Global Financial Crisis, however, this tool was not widely used, with the possible exception of China, where it seems to have worked quite dramatically. This is perhaps because public investment creates jobs directly, and gives a sense of permanent income increase that neutralizes Ricardian equivalence by giving households the confidence to spend the additional income.²⁶ Public investment in infrastructure can also crowd in private investment.²⁷

Pressured by the need to enhance their tax base to reduce mounting fiscal imbalances G 8 countries launched a new initiative at their Summit in Lough Erne held on June 17, 2013, which was subsequently endorsed by G20 leaders at St Petersburg. G20 Leaders launched a new initiative to protect their tax bases from 'Base Erosion and Profit Shifting' (BEPS) in an age of rapid globalization. The full implications of this initiative are still unclear. TNCs have long been migrating Industrial production, and increasingly services as they become more tradable, to EMEs, lured by low wages, productivity shifts and attractive tax rates. While much of the final consumption deriving from these activities continues to remain in OECD countries, this shift in economic activity has raised growth in EMEs, and along with economic activity and growth has come higher tax revenues. The initiative is likely to prove more contentious as it proceeds. Be it as it may, the timing of this initiative is at cross purposes with the G20's initiative to boost private investment in a broken global economy low on investment confidence. When growth and animal spirits are low, and governments want private investment to take over the load from public expenditure for a sustainable recovery, an international initiative to tighten or aggressively target tax avoidance, especially when corporate tax receipts have not dipped out of proportion to the fall in growth, can only make the recovery more difficult. Of the two 're-balancings' identified by the G20 itself for a sustainable recovery, global demand rebalancing is clearly in evidence, but a question mark still hangs over the second rebalancing, namely from public to private.

Macroeconomic stabilization, growth and jobs, which dominated the first two G20 Summits at Washington and London Summits, came back to occupy centre stage

²⁵ 25 G20 Leaders' Declaration, St. Petersburg, September 6, 2013. <http://www.g20utoronto.ca/summits/2013stpetersburg.html>

²⁶ Brad DeLong and Lawrence Summers recently argued that when economic activity is depressed, and monetary policy is zero bound, fiscal multipliers should be larger than usual. DeLong and Summers (2012). The IMF came to a similar conclusion in its findings that fiscal multipliers were higher in the early phase of the crisis, although they tended to decline over time. Blanchard and Leigh (2013).

²⁷ A fuller discussion on the issues relating to infrastructure and the recovery can be seen in C. Rangarajan and Alok Sheel, *Growth or Austerity*, op. cit. pp. 77–81.

in the last two Summits at Cannes and Los Cabos in the wake of the Euro Zone crisis and fears of a double dip. These concerns remained paramount despite some improvement in the near term data, and despite this being the first Summit where growth was seen strengthening in the US and Japan, and recovery in the UK and the Eurozone, but further weakening in EMEs. Growth concerns in EMEs were magnified in the run up to the St Petersburg Summit by market expectations of imminent rollback of the abundant global liquidity arising out of non-conventional monetary policies in advanced economies, pressuring the financing of the current account deficits of EMEs and their currencies. They were caught in a catch-22 type situation—standing to gain through the trading channel on account of the US recovery, but standing to lose through the financial channel on account of the US Federal reserve's response to the recovery.

Since the initial reaction of EMEs to QE was on the whole negative because it appreciated their currencies, they found it difficult to take a stronger position against this roll back at St Petersburg. While monetary policy all over the world responds to the domestic business cycle, the case of the US Fed is singular in that its policies also shape cross-border capital flows by virtue of the dollar being the effective global reserve currency. This constrains the monetary stance of other countries in ways that may be inappropriate for their own business cycles. In 2007-08, when the Fed turned on the liquidity tap EMEs, who recovered relatively quickly from the crisis, hesitated to tighten monetary policy for fear of attracting more capital inflows. India's currency appreciated despite a widening current account deficit. Now, when growth is weakening, EMEs hesitate to loosen monetary because, whatever the Fed's real intention, the resultant monetary tightening is drawing capital out of EMEs. Reserve build up in EMEs is as much a defensive response to US monetary policy as the pursuit of export led growth by some EMEs. It is for this reason that EMEs had earlier argued for greater policy flexibility in dealing with cross border capital flows in the run up to the Cannes G20 Summit.

5 Concluding Remarks

5.1 Assessing the G20 Macroeconomic Policy Response

The global financial and economic crisis of 2007–2008 elicited a strong, globally coordinated policy response orchestrated by G20 central banks and Leaders which was without precedent. This policy response was tempered by lessons learnt from the Great Depression, and the use of macroeconomic policy tools following the shift from the gold standard to the free-float Bretton Woods system, in particular the interplay between monetary and fiscal policies. Consequently, central banks and governments by and large eschewed the cardinal sins, such as contractionary monetary and fiscal policies, and the kind of extreme protectionism embodied in the infamous Smoot—Hawley tariffs of the 1930s, that culminated in the Great Depression.

The near-term impact of these extraordinary policy measures was a spectacular recovery in global economic growth in 2010. However, this recovery was fleeting. The G20 perhaps declared victory too soon at Pittsburgh, since advanced economies were still on monetary and fiscal life support. Private investment and consumer confidence—animal spirits—that alone can drive a sustainable recovery had not returned, and unemployment levels remained at near crisis highs if the discouraged workers who had stopped looking for employment are included. Recent studies, including those of the IMF itself, underscored that slow and protracted recoveries from past financial crises, especially those associated with housing busts, should have also sounded a note of caution IMF (2009b); Claessens (2008); Reinhart and Rogoff (2009b).

By 2011 the global economy was again on a downward trend. The global economy and financial system were still in shambles in advanced economies²⁸, and a big question mark hung over the resilience of EMDEs that were widely considered to be the new nodes of stability in the global economy. A new and dangerous fault line has opened up in the Eurozone that has slipped into a double-dip recession. This has raised questions regarding the appropriateness of the policy response, in particular whether the protracted use of essentially discretionary short-term policy instruments has more negative medium- to long-term consequences than short-term gains, and what should be the appropriate policy stance going forward.

In particular, concerns over public debt, and inflation down the road, have divided economists and policymakers into two major camps²⁹. Those who are of the view that there can be no fiscal consolidation in the absence of strong growth favour continuing with macroeconomic stimulus.³⁰ Despite the dramatic increase in public sector deficits and debt, and large liquidity injections by central banks, sovereign borrowing costs by and large remain low and inflationary expectations continue to

²⁸ Barring periodic quarterly recoveries that have proved to be false dawns each time, as they indeed did during the long Great Depression of the 1930s. The recent rebound in US housing prices, which is widely expected to drive the recovery of consumer demand in the USA, should be read with the sobering data that shows that the housing mortgage market is now entirely dependent on state support through Fannie Mae and Freddie Mac that are now guaranteeing about 90% of all residential mortgages, and even these are being ultimately bought by the US Federal Reserve. Tett (2013).

²⁹ It is moot whether it was the sharp divide in policy, or bond market revolt, that originally pushed peripheral European countries towards austerity. Altman (2013). Be it as it may, the USA (fiscal stimulus) and Germany (austerity) in particular have clashed lately on the issue in international forums such as the IMF, G20 and G7. UK's about-turn from stimulus to austerity was also a conscious policy decision rather than induced by bond markets.

³⁰ The Nobel Laureate Paul Krugman has from the very beginning been a consistent votary of this point of view, arguing that fiscal stimulus in the US was ineffective because it was too small. Krugman has written prolifically on the subject over the years. The main arguments are summarized in a recent piece, viz. Krugman (2013). Lawrence Summers, former US Treasury Secretary is of a similar view. Summers (2013). Martin Wolf, chief economics commentator of the *Financial Times* is another high profile protagonist of the stimulus and growth camp. Wolf (2013a). It would appear that the IMF itself holds this view. Cottarelli and Jaramillo (2012); Eyraud and Weber (2013); IMF (2013c).

be well anchored. Innovations in monetary policy, such as QE, seem to have opened up unlimited monetary space even beyond zero-bound interest rates, and virtually unlimited fiscal space through rock-bottom sovereign borrowing costs. The general risk aversion in financial markets—‘flight to safety’—has also increased the demand for sovereign bonds of major advanced countries. Extraordinarily high levels of public sector deficits and debt normally considered unsustainable in normal times now cohabit with rock-bottom interest rates.

The second camp is of the view that the current downturn is not entirely cyclical. There has been permanent loss of demand on account of household wealth destruction, deleveraging and rising savings. A strong, sustainable recovery from the Great Depression in the post-war period was greatly facilitated by the demographic profile of, and the large investment needs in, the worst affected economies. The worst affected economies of the Great Recession, however, had been slowing and ageing even prior to the Great Recession, and labour income that drives final consumption demand was stagnant. Their fiscal balance sheets were being strained by rising welfare expenditure. These trends were exacerbated by the recession. There are therefore lingering market concerns that the downturn in growth may not be just a short-term problem, and markets may need credible assurances that structural problems in the way of a sustainable recovery will be, and are being, fixed for animal spirits to fire again.

This camp points to the relative ineffectiveness of monetary and fiscal policies to stimulate growth, and to the lasting damaging impact of high levels of public debt on market confidence and growth potential. There is also a fear that huge liquidity injections by central banks would eventually be inflationary. An extreme view within this camp favours front loaded adjustment and austerity. The argument is that after a sharp, one-time downward adjustment, growth would revert to normal levels, while the deadly spiral of rising indebtedness would be arrested.³¹

A less extreme view that draws attention to the German experience under Chancellor Gerhard Schroeder more than a decade earlier points to the need for structural reforms alongside fiscal stimulus that should be used to cushion the pain. This approach also underpins the ‘three arrows’ of ‘Abenomics’ currently being adopted by Prime Minister Shinzo Abe in Japan. It is pertinent that IMF’s macroeconomic stabilization programs in developing countries combine liquidity provision with painful structural reforms that restore and raise growth potential on a sustainable basis.

³¹ The Bank of International Settlements, which has underscored that extended stimulus is only delaying the structural reforms that alone can drive a sustainable recovery, also appears to fall into this camp. The BIS view differs significantly from that of the IMF, which is clearly on the side of extended stimulus. Bank for International Settlements (2013). There are clear indications that after its disastrous brush with austerity, the European Union may be heading in this direction. The European Commission has recently decided to permit France, Spain and the Netherlands to breach the 3% budget deficit cap for a short period provided they undertake far-reaching labour reforms. Spiegel and Daneshkhu (2013). These countries, however, still have market access to finance deficits. The big challenge in the Eurozone is on how to finance stimulus in countries such as Greece and Portugal that have effectively lost market access.

The G20 Framework initially focused aggressively on external structural adjustments, and a fair degree of rebalancing was achieved.³² However, a similarly sharp focus on internal structural reforms and adjustment that could have restored or even raised growth potential was perhaps missing. While the immediate need was for fiscal expansion that targeted consumption, including ramping up provision for automatic stabilizers where these existed, as these can yield results quickly, spending on investment provides the added benefit of increasing long-run growth prospects, which consumption does not. In a protracted downturn, associated with financial crises, there was a manifest need for a better balance between consumption and investment-oriented fiscal expansion Baldacci et al. (2009).

The growth–austerity debate is about the short term, as nobody disputes the urgency of fiscal consolidation and structural reforms to improve competitiveness over the medium term. There are at least six sets of troubling forward-looking questions over the medium to long term for the G20 to ponder.

The first question is, how long should policymakers persist with the extraordinary macroeconomic stimulus? Although interest rates are zero bound, and fiscal deficits and public debt have risen dramatically, fiat currency appears to give almost bottomless policy space during a severe downturn: despite unprecedented levels of liquidity injection by central banks and large fiscal deficits by central banks, neither inflation nor sovereign borrowing costs have gone up in advanced economies.³³ National income in a number of major advanced economies—with the notable exception of the USA and Germany—is still below the 2007–2008 level. They have also entered a second dip recession, despite large amounts of monetary and fiscal stimulus. Their current average annual growth rates are far below the 1994–2003 (pre-boom) average. This is clearly the worst recovery from recession in the post-war period. Nevertheless, the recovery in the USA, which has had the largest and most sustained monetary and fiscal—before the recent sequestration—stimulus, is so far the most robust amongst advanced countries. The IMF is of the view that when private and external demand are in retreat, and monetary policy in a liquidity trap, fiscal multipliers are higher than usual.³⁴ It is therefore possible to argue that over the short term, at least, continued stimulus is necessary, and there is adequate policy space to persist with it. The US Federal Reserve has indicated that it would start exiting from its extraordinary monetary policy only when the unemployment rate dips below its target of 6.5%, or inflation exceeds its target of 2% U.S Federal Reserve (2013).

³² While initially it seemed that the unwinding was mostly cyclical, it now appears likely that it has large structural components as well on account of the rise in US savings and China's new focus on domestic demand reflected in its 12th Five Year Plan.

³³ Peripheral Europe is of course the exception. But this is because sovereign debt in the Eurozone does not have the central bank backstop.

³⁴ In its October 2012 World Economic Outlook the IMF concluded that “consistent with research suggesting that in today’s environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronized fiscal adjustment across numerous economies, multipliers may be well above 1”, *IMF, WEO, October 2012*, Chap. 1, Box 1.1, pp. 41–43.

The second set of questions pertain to the size of fiscal multipliers. If fiscal multipliers are potentially high, why was the Japanese recovery so tepid, and why is the US recovery not more robust currently? Could this be because of the fiscal mix? Governments can stimulate the economy either through tax cuts or by directly increasing expenditure. Tax cuts have the advantage of easier rollback, unlike sticky public expenditure, and also give additional income to households for consumption and expenditure. However, when balance sheets are impaired, additional income might be used to draw down debt rather than consumed or invested. If tax cuts are perceived as temporary because of the huge build-up in public debt, Ricardian equivalence may also come in the way of translating additional income into expenditure. In a recession induced by a financial crisis, therefore, tax cuts may be less effective than direct government expenditure in stimulating the economy.

Since the impact of aggressive short-term stimulus has been relatively limited so far, it could be argued that the fiscal mix needs mid-course correction; that, while the overall (expansionary) fiscal stance has been appropriate, they have mostly overlooked the role of public investment, particularly public works on a large scale undertaken during the Great Depression. The latter could substitute for the lack of private investment, create new jobs and therefore the confidence to spend as the increase in income is seen as permanent, thereby counteracting Ricardian equivalence.

Public infrastructure investment also has the potential to lay the foundations of medium-term growth since it raises growth potential and crowds in private investment, unlike other kinds of government expenditure which may actually crowd this out. Infrastructure investment has both supply-side and demand-side features. Capital expenditure also typically has higher fiscal multipliers. Some recent studies also indicate that there is a strong correlation between investment in fixed capital, growth and job creation Spilimbergo et al. (2009); UNCTAD (2012). The demand for infrastructure in developing countries, which have several shovel-ready projects, is potentially almost without limit. Accelerated financing and implementation of these projects would therefore hasten both global and internal demand rebalancing, while the associated demand for capital goods can create jobs in advanced countries as well.³⁵

Since fiscal multipliers have not had the expected impact on output, particularly on employment that is more politically sensitive, there is a danger that policymakers might pin the blame on fiscal slippages abroad through international trade. The G20 has from the very beginning been alert to the dangers arising from protectionism that could amplify recessionary trends, as had happened in the 1930s. It has therefore repeatedly extended agreements on 'trade standstills', tasked the WTO to monitor protectionist measures taken by G20 countries on a continuing basis and put its weight behind initiatives for a speedy conclusion of the Doha Round of international trade negotiations to further open up trade. While it has failed spectacularly

³⁵ According to one estimate, \$ 1 increase in investment in developing countries is likely to cause a \$ 0.35 increase in capital goods exports from high-income countries. Lin (2013).

on the Doha front so far³⁶, it nevertheless succeeded in its efforts to keep traditional forms of protectionism at bay.³⁷

This restraint, however, could also, at least in part, be on account of the changing structure of international trade³⁸ that has left few domestic stakeholders in favour of traditional protectionist measures, such as high tariffs and quantitative restrictions, on account of the growing import intensity of exports and the trade in intermediates. Traditional trade defence measures or tariff increases are yielding to new forms of protectionism, such as discriminatory investment measures, fiscal measures, export subsidies, discriminatory bailouts, wage subsidies, visa and residence permits including reversing offshoring, central bank measures, regulating transactions of sovereign wealth funds and so on, that are not captured in WTO's trade protectionism metrics³⁹.

The third set of questions concern the impact of the extraordinary monetary stimulus. There is broad consensus that the enormous liquidity injection through non-conventional measures like quantitative and credit easing was necessary to ward off the deflationary spiral during the Great Depression of the 1930s. This is because in a financial crisis, rapid deleveraging in the private sector can lead to a rapid fall in the money multiplier.

However, beyond preventing deflation, and keeping sovereign borrowing costs artificially low, monetary policy has had limited impact in stimulating the economy as traditional transmission channels of monetary policy seem to be broken. The liquidity created has instead been directed back to the central bank by depository banks, spilled over into emerging markets and into commodity and asset price infla-

³⁶ Practically each G20 Leaders' Communique resolved to take the Doha Round to a speedy but balanced conclusion, even setting timelines for achieving this objective. Leaders were perhaps too optimistic regarding the possibilities of trade liberalization during a steep recession when the natural instinct is to close markets.

³⁷ WTO, OECD and UNCTAD (2012). While a large number of minor trade restrictive measures have accumulated over time, in the aggregate, they affect only about 3.5% of world imports and 4.4% of G20 imports. <http://www.oecd.org/daf/inv/8thG20report.pdf> As a result, but for a slight dip during the deep recession in 2009 and early 2010, the ratio of global exports to global GDP (measured at market exchange rates), which had risen sharply during the preceding boom, did not decline.

Year	1995–2004	2000	2001	2002	2003	2004	2005	2006
Exports/GDP	23.7%	24.7%	24.0%	24.3%	25.1%	27.1%	28.4%	30.2%
Year	2007	2008	2009	2010	2011	2012	2013	
Exports/GDP	31.1%	32.4%	27.4%	29.8%	31.7%	31.3%	31.7%	
IMF <i>WEO</i>	October 2008 & April 2013							

³⁸ See footnote 24.

³⁹ An important caveat to WTO's measurement of protectionism is that several new measures are not included in their inventory, such as fiscal stimulus that differentiates between domestic and foreign or non-resident investors, local production requirements, visas and residence permits, financial support to domestic companies and central bank measures to enhance the functioning of credit markets and the financial system that influence international capital movements in complex ways. *Reports on G20 Trade and Investment Measures*, op. cit. p. 57. See also Evenett (2013).

tion⁴⁰ and fuelled fears of currency wars. The current disconnect between consumer and asset prices is reminiscent of the unsustainable housing sector boom in the run-up to the current crisis, with nuanced differences: the current asset inflation is in commodities and capital markets rather than in housing; the consequential ‘wealth effect’ had little impact on investment and economic growth Feldstein (2013) and the source of liquidity creation this time round is central, rather than shadow, banks. This situation could change, however, when private deleveraging runs its course, which it may well have in the USA.⁴¹

With the return of private demand and the money multiplier to normal levels, the enormous liquidity created by central banks would need to be rolled back to contain inflation. While entry into extraordinary monetary policies had a stabilizing effect on financial markets, exit from such policies could be destabilizing. Reversing QE and raising rates prematurely could choke the green shoots of recovery; reversing QE and raising rates too slowly risks unhinging inflationary expectations, as the huge amounts parked by depository institutions with central banks could quickly lead to a surge in credit. It would be well to keep in mind that just a statement by the Chairman Ben Bernanke in late May 2013 that the US Federal Reserve may reduce its asset purchases sooner rather than later sent strong tremors in international financial markets, with EMDE currencies and bond prices crashing, clearly indicating how destabilizing withdrawal of financial steroids is likely to be if not deftly managed. As interest rates rise, the price of the huge stock of assets on central bank—and also those of other banks who also moved into the safe haven of sovereign bonds—balance sheets earning near zero interest rates would also fall sharply, exposing them to potentially huge losses. The central banks losses would be passed on to the tax payer, increasing the burden of public debt.

The fourth set of perplexing forward-looking issues concerns the dramatic rise in public debt in advanced economies. This has so far not resulted in market revolt beyond the Eurozone periphery, as sovereign bond yields have fallen in inverse proportion to the increase in deficits and debt. This is not as counter-intuitive as it ap-

⁴⁰ Even Ben Bernanke, the driving force behind the creation of this liquidity, has warned that reckless speculation and search for yields in a low interest rate environment could inflate new asset bubbles. Harding et al. (2013). The Dow Jones has risen almost continuously over the past few years, scaling new highs, despite practically everybody being consistently downbeat on the prospects of global growth going forward. Junk bond yields are now where US Treasuries used to be in 2007. There is also a surge of ‘low quality’ capital flows to emerging markets strongly suggesting that push, rather than pull, factors are the driving force. “In the four years leading up to the Lehman Crisis in 2007 (2004–07), cumulative capital flows into EM totaled some USD3.1 trillion. This amount was substantially higher than the cumulative total of USD800 billion registered during the prior four years, 2000–2003. During the GFC (Global Financial Crisis), capital flows heading to EM collapsed, though they did not turn negative.... In the four years since the GFC (2009–2012), the cumulative capital flows into EM totalled USD3.9 trillion—even larger than the four years leading up to the GFC.” Jen and Dreisin (2013).

⁴¹ Private non-financial sector debt as a proportion of the GDP in the USA, which increased sharply during the boom preceding the credit crunch, has been declining since and is now consistent with its long-term growth trajectory. See *Bank for International Settlements, 83rd Annual Report*, op. cit. Graph II.8, p. 23.

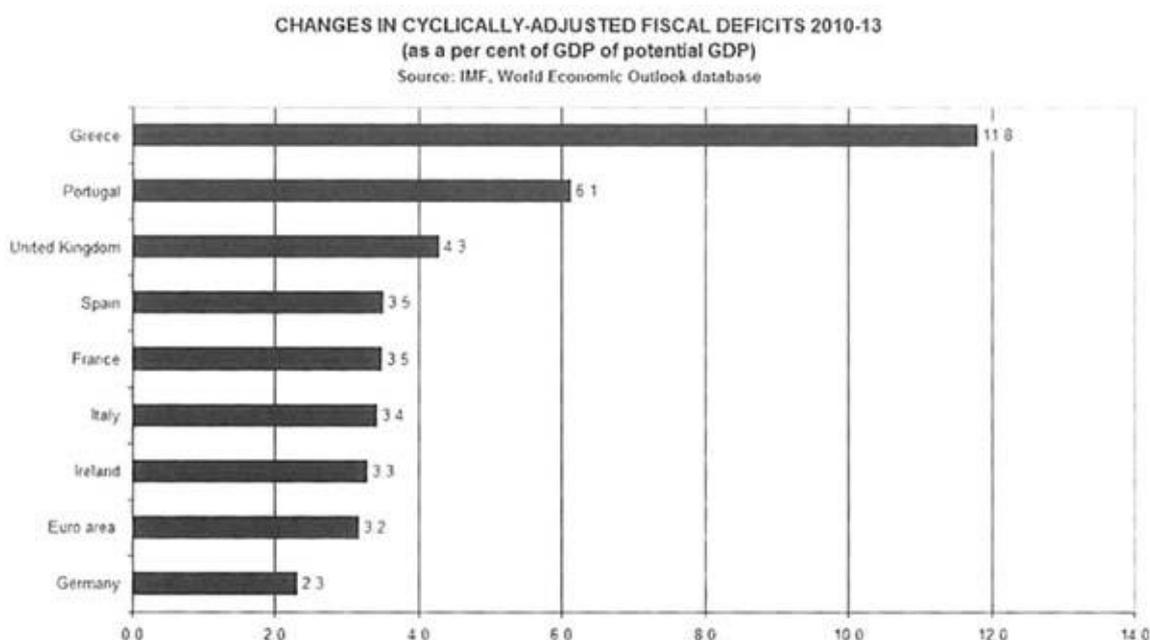


Fig. 9 Fiscal adjustment in Europe. (*Martin Wolf's Exchange* (Wolf 2013b))

pears, as deleveraging and general risk aversion in financial markets have increased the demand for risk-free assets. Large-scale purchase of long-term sovereign bonds by central banks through QE has further reduced pressure on sovereign bond yields.

However, as central banks in advanced economies normalize monetary policy current levels of debt in major advanced economies may become unsustainable, especially if trend growth remains low by historical standards on account of demand destruction and adverse demographics. At that point even if markets do not revolt outright, sovereign borrowing costs could increase significantly. It is even argued that sovereign bonds could also lose their risk-free status as the threat of sovereign default would increase substantially. Sovereigns however do not generally nominally default on domestic currency debt—they do so through inflation, or financial repression. The threat of such de facto default in advanced economies is very real, and may indeed have already begun through negative real interest rates. High levels of debt incurred by advanced countries during World War II were brought down through a combination of high growth and inflation (savings taxed through negative real interest rates). Although the western financial system has become market oriented since, with independent central banks setting monetary policy in a rule-bound manner, the toxic combination of low trend growth and high debt makes it difficult to see advanced economies simply growing their way out of high levels of debt. A return to financial repression looks inescapable.

The issue is no doubt, complex, double-edged and cutting edge, and it encapsulates the great macroeconomic conundrum of the day in advanced economies: slowing growth is associated with rising debt on the one hand; 'expansionary fiscal consolidation' is not possible when both domestic and external demand have collapsed, on the other. Therefore, as long as inflation remains low (i.e., as long as

private demand is not being crowded out), there may be no option to running large deficits and increasing debt to revive growth over the short term. One can quibble over the best fiscal mix and instruments to maximize public expenditure multipliers, but John Maynard Keynes' dictum that 'the boom, not the slump, is the time for austerity' holds good. It is however difficult to see a number of advanced economies grow out of the large accumulated debt in advanced economies without far-reaching structural reforms that renegotiate social compacts to reduce structural deficits and move them towards primary balance. The initiative at St Petersburg to increase the tax base may be difficult to achieve, and could even be counter-productive, in an environment where private investors are still risk averse. This is best done during a boom than a slump. The most likely out-come therefore is a mix of renegotiation of social compacts and financial repression, both of which have already started.

The fifth question is how the G20 should engage with the Eurozone, where it is clearly too early to talk of policy exit. Sharp fiscal adjustment appears to be pushing it into a prolonged recession. As a result it has become the biggest fault line in the global economy. There was a greater willingness at Los Cabos on the part of Eurozone Leaders to let the G20 deliberate their internal macroeconomic imbalances. However, this is a perplexing addition to the G20's menu of problems, as traditional instruments of macroeconomic stimulus and adjustment, such as the exchange rate and central bank backstop of fiscal policy, are not available to individual countries on the one hand, and there are political sensitivities arising out of the concept of the Nation State on the other. Sharp adjustments forced externally through nominal wage adjustments not only are more painful but also risk the kind of social unrest that characterized Europe in the 1930s. To the extent that the Eurozone anticipates several issues of macroeconomic management in an increasingly globalizing world that lie beyond the Nation State, the G20's success or failure to address the Eurozone question might well foretell its own fate as the institution of global economic governance of the future (Fig. 9).

The sixth and final question relates to the roadmap to guide policymakers in exiting extraordinary stimulus measures. Since there is a strong likelihood that a return to the Great Moderation growth rates may not be possible, policymakers should not be looking at the output gap, or to growth rates, to begin exiting, but to rising treasury yields and inflation. This point has already been reached in several EMDEs, but not in advanced economies. Inflation and rising yields on sovereign bonds are like distressed canaries in a goldmine, signalling the revival of animal spirits and closing of the output gap. At that point monetary policy would need to take over the mantle of macroeconomic stabilization from fiscal policy, finely balancing the need to anchor inflationary expectations by gradually normalizing interest rates and unwinding unconventional monetary measures, with the need to gradually inflate away high public debt through a degree of financial repression.

This balancing act is made even more difficult by the fact that long-term deflationary forces, predating the financial crisis, may have weakened the role of consumer price inflation as a robust marker of business cycles. Consumer price inflation was subdued despite unprecedented levels of growth and liquidity in the run-up to the global financial crisis, even as the overheating spilled over into asset

markets. In the light of their experience in the run-up to the global financial crisis, central banks may now be more willing to call asset bubbles before they burst even if consumer price inflation is below their targets Sheel (2013b).

These are all difficult questions to which there are no ready answers, as the past provides little guidance. Perhaps it is because of these complexities of macroeconomic policy formulation in a rapidly integrating global economy that even economists seem to be wringing their hands in despair, Blanchard et al. (2010, 2013) and policymakers are having to turn elsewhere for sage advice, such as *St Augustine* for the short term (Lord make me chaste, but not yet), or *Alice in Wonderland* for the long term (Jam yesterday and jam tomorrow, but never jam today), and even to Aesop's Fables such as *The Ant and the Grasshopper* (to understand the dynamics of global imbalances) and *The Fox who Lost its Tail* (building a consensus on back-breaking debt).

5.2 *Assessing the G20 as the Premier Institution of Global Economic Governance*

The first two summits at Washington DC and London marked the first stage of policy cooperation, culminating in the trillion-dollar London Summit. G20 Leaders resolved to do whatever was necessary to stall the slide in the global economy through an aggressive, coordinated macroeconomic response to the financial crisis. It is pertinent, however, that no country-specific commitments were asked for, and none were given. The policy response was also fairly undifferentiated across countries. The G20 deliberations fed into domestic policy, with each country doing what it considered appropriate. Though there were no country-specific commitments, this policy coordination was, nevertheless, a spectacular success, even though questions are now being asked whether the recipe itself was fully appropriate. A second Great Depression and deflation have been avoided but growth remains below trend.

At the third G20 Summit at Pittsburgh, it seemed that the coordinated response had pulled the global economy back from the brink of a second Great Depression. The G20 now turned its attention to long-term structural problems impeding a return to strong, sustainable and balanced growth, going forward. The G20 Framework, or Mutual Assessment Process, was conceived at Pittsburgh while preparing to exit from the aggressive and coordinated stimulus.

The second stage of policy cooperation at the fourth Summit at Toronto (2010) was differentiated across countries because of market reactions, a two-speed recovery and the need to rebalance global demand for strong, sustainable and balanced growth. Consequently, unlike the first stage, the G20 arrived at different policy prescriptions for different groups of countries: advanced deficit, advanced surplus, developing surplus, developing deficit and resource-rich economies. Perhaps because it was quite clear to what group each G20 country belonged, once again there were no country-specific commitments, apart from some general fiscal commitments

given by advanced economies to reassure financial markets, since the G20 seemed mindful of the potential divisiveness of 'naming and shaming'.

The third stage was at the fifth Summit at Seoul, where there was a realization that there was little forward movement in the desired direction. The possibility of country-specific commitments was seriously considered for the first time. A consensus was, therefore, arrived at to develop indicators on the basis of which country-specific commitments could be worked out and, therefore, made more acceptable.

The fourth stage of policy cooperation was at the last G20 Summit at Cannes, in the form of the Cannes Action Plan, which contains country-specific commitments. However, problems regarding measurement and timelines persist and are still unresolved, especially since these commitments were made at a time when a cloud was hanging over the global recovery, and this cloud appears even darker now. An attempt was, therefore, made to distinguish between short-term and long-term policy commitments. Also, commitments were 'country-led' in the best G20 tradition, and mostly what the countries had committed as part of their own domestic policies in the public domain. The G20 debate is, nevertheless, clearly weighing on the trajectory of domestic policies.

Although the *G20 Framework* exercise has not resulted in an agreed set of enforceable macroeconomic rules, these four stages nevertheless indicate that the G20 has incrementally committed itself to more intrusive policy coordination within a relatively short period of time. As the G20 moves towards its fifth stage of macroeconomic policy coordination of assessing country commitments and holding them accountable, caution is warranted in placing unrealistic expectations on the budding G20 process going forward.

First, it is for the first time that the world's biggest advanced and developing economies are sitting at the same table and talking to each other, rather than talking past each other from separate forums. Although economic interests are beginning to converge, the trust necessary for even effective discretionary policy cooperation will take some time to be on a firm footing. Beyond this, agreement on enforceable rules-based policy coordination would run into issues of sovereignty, as they have in the case of the European Union. The past record of rules-based policy coordination gives little cause for optimism (Bird 2012).

Second, domestic policies respond to changing circumstances. For instance, prospects for the global economy have deteriorated considerably since commitments for fiscal consolidation were given at Toronto. How can commitments and assessments accommodate the need for such dynamic policy shifts? In the deliberations leading up to the Toronto Summit, there were differences of opinion over whether fiscal commitments should be date specific or benchmarked to the pace of recovery. This issue remains as relevant as ever.

Third, a huge divide now appears to have opened up between what electorates and markets expect from governments. Both electorates and markets are in revolt. Electorates are voting against severe austerity in country after country in Europe, unseating governments. While sovereigns should not allow themselves to be held hostage by the markets, they ignore markets at their own peril, as the taxpayer has

to foot the bill of market revolt upfront. They have already started footing the bill through negative real deposit rates. A sharp rise in public debt always follows deep crises and recessions, but this time round, markets do not seem too sanguine regarding the prospects for long-term growth necessary to bring down debt ratios going forward in countries where public debt has risen appreciably, and are, therefore, demanding higher returns. As a result, policymakers need to reassure markets how debt dynamics would be managed by persuasively clarifying or creating the engines of future growth.

Fourth, how can the G20 nudge countries' policies in mutually agreed directions and hold sovereigns accountable for commitments given, especially since these are not legally binding, and in the absence of any enforcement mechanism? The sovereignty of internal policies of nation states has been well recognized at least since the Treaty of Westphalia that is almost three-and-a-half centuries old. A distinction needs to be drawn between coordination and commitment. In the early stages the G20's focus was on coordinating policies—developing a consensus on what needed to be done, with each country contributing what it could, depending on individual-country circumstances. The G20 has been much less successful as it moved towards trying to obtain country commitments and holding their feet to the fire. The spirit of cooperation quickly evaporated amidst 'naming and shaming', which some members of the G20 had warned against in the early G20 deliberations.

Alongside these four negatives, however, is the fifth, which is a clear positive for global cooperation going forward. It is increasingly clear that economic integration is moving far ahead of political integration. The success of domestic policy actions in a fast-integrating world with growing market and policy spillovers is increasingly linked to global outcomes. Domestic business cycles are becoming more and more globally aligned. If rebalancing does not take place, growth will decline everywhere, but if rebalancing is uncoordinated, the outcomes could be even worse. Policy cooperation, and beyond that policy harmonization or convergence, is potentially a win-win. This harmonization is of course the work of specialized multilateral fora like the WTO (trade), Basel Committee on Banking Supervision (BCBS) (financial regulation), United Nations Framework Convention on Climate Change (UNFCCC) (climate policies), Global Forum (Tax), etc. However, given the systemic importance of the G20 aggregation, the forum could give the decisive push where required if their Leaders are firm in their resolve, as they were at the high point of the global financial crisis. The resolve has understandably weakened as the recovery takes hold. The benefits and hazards before such cooperation and harmonization are most clearly manifest in the case of the Eurozone and the EU, which is pushing the envelope of the Nation State beyond the limits of Westphalian sovereignty in place since 1648. To a great extent, the challenges ahead facing the G20 are similar. What is needed at this juncture is a new political economy and institutional structure to manage globalization, built on mutual trust and cooperation. Seen in this perspective, the G20 is a brave new experiment pushing the boundaries of globalization to harvest this cooperative dividend, and its Leaders will no doubt learn how to do so as they go along.

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