



CARNEGIE ENDOWMENT  
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# THE G20 AND GLOBAL ECONOMIC AND FINANCIAL RISKS

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Mr. Chairman, Mr. Ranking Member, distinguished members of the subcommittee, thank you for inviting me here today. In my testimony, I will address three issues: the G20's role in the Euro crisis, its role in restarting sustainable economic growth, and the G20's own functioning.

### **Can the G20 help coordinate a response to the Euro crisis, and what should that look like?**

As it did last weekend, the G20 can exercise moral suasion on the eurozone countries to act more forcefully. More important, in the event that Spain and Italy are unable to raise money at reasonable interest rates—as happened to Greece, Ireland and Portugal—the fallout on the global and European economy would be so severe that it is doubtful in my view that the Europeans could handle the crisis on their own. In this case, the G20 would then have to coordinate a response.

Bailing out Spain and Italy would entail, as in the case of the other peripheral countries, covering their public financing requirements for three years. The associated loans would amount to about \$2.1 trillion. This large sum poses two separate problems. First, if the IMF were to fund one-third of the total, as it did in the case of the other countries, its share would amount to about \$700 billion, exceeding its current \$400 billion new lending capacity—recently indicated by Managing Director Christine Lagarde. The eurozone countries, for their part, would have to find \$1.4 trillion, which exceeds the available capacity of the rescue fund, the European Financial Stability Facility (EFSF), by over \$1 trillion, not counting any draw on the fund that may be needed to recapitalize European banks.

Though the eurozone economy is large enough to theoretically cover such an outlay, in practice it remains a half-built economic and political union and each individual member would be hard-pressed. Eurozone member nations manage their own fiscal and financial operations as do U.S. states, but there is no federal government of anywhere near corresponding size or clout that can spend—and just as importantly, borrow—like the U.S. government can. Moreover, the European Central Bank (ECB) lacks the Fed's political legitimacy to intervene in support of member nations, and is, in fact, explicitly forbidden by treaty from doing so. The resignation of two German ECB board members over its emergency purchases of the periphery's government bonds is a clear signal of the profound opposition to such a course.

The institutional deficit of the European monetary union explains why marshaling an appropriate and timely response to the Greek crisis, whose debt is less than 15 percent of that of Spain and Italy combined, has been so extraordinarily difficult. But the political dimension is only one aspect of the problem should the crisis spread to the larger countries. Markets are very well aware that a bailout of Italy and Spain may fail, as it has in the case of Greece, and that the ability of the European core countries to cover these losses is limited. The spread on France's government bonds relative to Germany's has doubled in recent weeks and is now well in excess of 100 basis points. In motivating its recent decision to place France's AAA credit rating on downgrade watch, Moody's pointed to France's share of the EFSF guarantees, which already amounts to 8% of its GDP, not counting new commitments to recapitalize its banks. According to the IMF, Germany's debt-to-GDP level is projected at

77 percent and France's at 90 percent by 2015, and it is clear that other large expansions of the EFSF would place France, and perhaps Germany in dangerous territory.

But these calculations greatly understate the problem. Even with a bailout, a sudden halt of financing to Spain and Italy would be accompanied by a severe recession in those countries which would have a major spillover on the rest of Europe. (Real domestic demand in Ireland and Greece, for example, is down 20 percent and 15 percent, respectively, compared to 2007, and is expected to continue to fall in Greece.)

Were, on the other hand, Italy and Spain forced to fend for themselves, in the event of a sudden stop in financing, an extremely dangerous European and global banking and economic crisis comparable in size and virulence to the Lehman episode, further undermining the public finances of all European countries, could erupt. Bearing in mind the disproportionate role that banks play in the European economy, Europe's political divisions, and the European governments' limited ability to respond now compared to 2008, it is easy to envision a scenario in which the acute phase of such a Lehman repeat would last not six months, but many years. Some may think that this scenario is alarmist, but I think it is important to bear in mind that, whereas the U.S. subprime mortgage market totaled between \$1 and \$1.5 trillion at its peak (depending on how subprime is defined), the outstanding debt of the European periphery now totals \$4.6 trillion.

The global implications of such a scenario are dire. The United States would be affected, through trade and foreign investment (profits from its international companies and returns on the equity and bond portfolios of U.S. residents), but most importantly through the banking system. U.S. banks have \$850 billion in direct exposure to the eurozone, including nearly \$400 billion in exposure to eurozone banks. Moreover, they have an additional \$1.8 trillion in indirect exposure, through instruments such as derivative contracts and guarantees. These numbers do not include U.S. exposures to banks in the UK and other European countries outside the Euro zone which are themselves exposed.

The emerging markets of the G20 would also be affected through the trade and banking channels as well as through ownership of European government bonds. But they are more exposed to a European crisis than the United States in two main ways: Europe attracts exports equivalent to 5.4 percent of its GDP (compared to 1.7 percent of GDP for the United States) and they are more likely to suffer a contagious withdrawal of external financing, as is already happening, while the United States is protected by its safe haven status.

Were this risk to materialize, it would be entirely appropriate for the G20, operating through the IMF, to seek to support the European adjustment. In order to cover, say, half of the cost of the bailout of Spain and Italy and retain the firepower to deal with the fallout on other countries, the IMF's resources would have to be expanded by about \$1 trillion, of which the U.S. share would be \$177 billion. It is important to bear in mind that IMF resources represent contingencies, not actual outlays, part of a "bazooka"—to use former Treasury Secretary Paulson's term—that may not need to be used. Such IMF loans have historically been paid back.

In the event of an expanded eurozone commitment, the G20 should insist that the IMF impose demanding conditions not only on the recipient countries, as it does at present, but also on Germany and the other core countries, as well as on the ECB. These conditions would be designed to ensure both that the program is well funded and designed, but also to promote the establishment of the institutional framework needed for the currency union to be sustained in the very long run. Such steps would include new fiscal and monetary arrangements capable of dealing with the diversity of European situations, a powerful European Banking Authority, mechanisms for managing default and exit from the eurozone, as well as structural reforms that increase the flexibility of the markets for goods and services inside the union.

The suggestion that the United States may need to provide additional IMF resources while it has not yet ratified the previously agreed-on expansion will appear audacious to some. But this is, in my view, the situation we may soon have to confront. Against the risk of a eurozone collapse, the G20, including the United States, should see expansion of IMF resources as a relatively cheap form of insurance. Even if it remains unused by the eurozone this time around, it may well come in handy in the not too distant future as the fallout from the financial crisis and the Euro zone crisis continues to reverberate.

### **Can the G20 help restart sustainable economic growth?**

Yes, by appropriately mandating the main specialized economic agencies—the IMF, OECD, World Bank, and WTO—and by monitoring their work. This is already happening to a degree, but here, I would like to highlight two areas where a shift of focus is warranted and where leadership from the United States is badly needed. The first relates to the appropriate focus of global growth policies, while the second relates to restarting the world trade system as a driver of reforms.

#### *Global Growth Policy*

Policies for restarting sustainable economic growth as managed, for example, through the Mutual Assessment Process of the G20/IMF, suffer from two deficiencies in my view. First, they do not place sufficient emphasis on domestic policies and instead overstate the importance of global rebalancing. Second, domestic policies are not paying sufficient attention to structural reforms as distinct from macroeconomic management.

It should be obvious that domestic policies, and not those of other countries as reflected in trade balances, are the overwhelmingly important drivers of economic growth. After all, in the United States, for example, domestic demand is 34 times larger in absolute terms than (negative) net exports. And any single trading partner has only a very limited impact on the United States' GDP through net exports. For example, I have made the following calculation.

Assume that, in response to U.S. pressure, Chinese leaders could dictate that their country's savings be reduced immediately by 10 percent of GDP—approximately \$500 billion. Even more implausibly, assume further that none of this additional spending could go toward domestic products, and that all of it instead went to imports, immediately making China a larger external deficit nation proportional to its GDP than the United States. If the increase

were allocated geographically in proportion to China's recent import spending, the direct effect on U.S. exports and demand would be only \$40 billion—or 0.3 percent of U.S. GDP—equivalent to about one-ninth of U.S. fiscal stimulus measures in 2010.

This type of calculation actually overstates the importance of policy changes in other countries on the United States, since imported components and raw materials account for a significant part of the total value of U.S. exports. So the demand impulse from exports is less than it appears. On the other hand, the importance of imports in assuring the efficiency of U.S. producers and exporters, not to mention living standards, tends to be overlooked.

More generally, while demand stimulus is sometimes needed in emergencies, its importance—whether it occurs through fiscal and monetary policy in the United States or in its trading partners—in assuring sustainable long-term growth is almost insignificant. Structural reforms, such as privatization and liberalization of product and factor markets and encouragement of research and development, are a much more important driver of long-term growth. Under a broad definition of structural reforms, I would also include tax and expenditure reforms that modify incentives, reduce waste, and assure that a nation's fiscal situation remains on a sustainable path.

A good example of inadequate attention to structural reforms comes from Japan, which has been mired in slow growth and deflation for close to two decades. Japan has tried every trick in the macroeconomic policy book—repeated fiscal stimulus, zero interest rates, and quantitative easing—without any notable success in breaking out of its rut, and its public debt has exploded. The fact that it has systematically run a current account surplus has not helped. But observers of the Japanese economy long ago identified a number of structural weaknesses on which little or no action has been taken—for example, the nation's demographic decline combined with extremely restrictive immigration policies; an inefficient, overregulated, and protected service sector; super-protected agriculture; overbuilt and corrupt infrastructure sectors; and a state-owned post office and savings bank that artificially channels a huge part of the nation's savings to the purchase of government bonds instead of to more productive activities.

Similar structural weaknesses help explain the dire growth and competitiveness problems in countries such as Greece, Italy and Spain, which in addition suffer from extremely inflexible labor markets, where “insiders” enjoy job security and extensive benefits while an army of outsiders remain in precarious occupations or are unemployed.

Instead of insisting that the G20 pay so much attention to trade imbalances, which are a minor part of the problem and largely reflect a needed adjustment to domestic imbalances, the United States would be well served to place a greater focus on the latter, and especially on how structural distortions, including misguided tax and expenditure policies are hobbling the G20 economies. The OECD and World Bank are especially well-placed to support this work.

There is also a very rich reform agenda here on which the United States and China, the two largest economies, could lead the G20 by example. Detailing the needed structural reforms in the United States and China would take us beyond the current topic, but one structural

reform area of great importance—in which the United States has just taken a notable step forward through ratification of agreements with Korea, Colombia, and Panama—is trade.

### *Trade Policy*

WTO disciplines, reinforced by the G20's standstill agreement on new trade restrictions in November 2008, helped contain protectionism during the height of the crisis and avoid a repeat of the disastrous experience of the 1930's. That is the good news.

The bad news is that the failure to conclude the Doha Round of multilateral trade negotiations ten years after they began shows that the WTO is broken as a liberalizing force. This means that huge parts of global economic activity, including large segments of services, foreign investment, manufactures imports in developing countries, and agriculture—all areas of vital interest to the United States—may remain essentially exempt from effective WTO disciplines. The world economy is still being propelled by the great opening up that occurred in the 1980's and 1990's as country after country embraced more market-friendly policies, but the inability to move forward on deeper global trade reforms will, in my view, increasingly constrain sustainable growth in years to come.

Just as it has done with the IMF and the World Bank, the G20 should now focus its attention on how the WTO can be reformed. How can the WTO regain the effectiveness of its predecessor, the GATT system?

Drawing on work carried out by the trade council of the World Economic Forum, of which I am a member, I would recommend that agreement to the current Doha draft be linked with establishment of a forward agenda of “plurilateral” negotiations. Plurilateral negotiations are negotiations among a critical mass of countries on a specific issue, such as trade in environmental goods, for example. Unlike multilateral rounds, they do not require that all members agree on every single agenda item before a deal can be struck. Examples of successful prior plurilateral negotiations include the Government Procurement Agreement and the Information Technology Agreement. Examples of plurilateral agreements that could be of great interest to the United States and to many other countries would include many areas in services and trade in high-technology products.

By supporting such a course, the United States would accept an admittedly low-ambition Doha deal, but, in the process, capitalize on a few aspects of the Doha draft that are of interest (such as trade facilitation), break the impasse in the WTO, and establish a new, much more flexible negotiating framework capable of yielding gains in a wide range of sectors in the decades to come. Though I believe there is interest in adopting a plurilateral approach to negotiations among the WTO membership, progress is only possible if the United States actively supports it and works through the G20 to promote it. As the next step, the G20 meeting should mandate trade ministers to meet to: a) link a Doha conclusion to plurilaterals, b) reach agreement on such a deal, and c) establish an agenda for reforming the WTO. The G20 trade ministers would then promote this approach among the entire WTO membership.

## **What should the G20's role be in the long run, and what would make it more or less likely to succeed?**

The G20 heads of state summit was born of the financial crisis, was sponsored by the United States for its first meeting in Washington in November 2008, and was charged to be the preeminent forum for global economic policymaking at the Pittsburgh summit in September 2009. Comprising ten emerging markets, nine advanced economies, and the EU, the G20 has the potential to fill a large gap in global economic governance that its predecessors, such as the G7 and G8, were not able to bridge. It reflects the reality of a global economy where emerging countries are headed towards representing well over half of global GDP and trade.

In a forthcoming paper co-authored with Kati Suominen of the German Marshall Fund, I argue that, to succeed in global economic governance as well as crisis-fighting, the G20 needs to confront four major challenges: sticking to its comparative advantage, being realistic in what it can achieve, effectively integrating emerging economies in decision-making, and clarifying its own structure and composition. It will also need leadership from its largest members, beginning with the United States but supported by China.

### *Comparative Advantage*

The G20 is not designed to be a decision-making body: it is not universally representative and its deliberations are not ratified by parliaments. It is also not well-suited to engaging at the granular level, which would risk encroaching on the territory of established multilateral institutions, such as the IMF, World Bank, or WTO, whose technical competence is far greater.

The G20 is very well-positioned, however, to function like a steering committee. It is flexible enough to react quickly to events and, therefore, manage crises, but also to provide general guidance for how the international institutional architecture should evolve.

The G20 countries, which together account for the vast majority of the ownership and voting power in the major global institutions, should focus on the big picture and look to these institutions to translate the G20-designed strategy into explicit decisions.

### *Realism*

The G20 has unique strengths as a coordinating forum, but it also has limitations that should inform its agenda. Expectations of what it can accomplish must be tempered.

While the G20 economies were able to deliver on most of the commitments they made during the peak of the crisis, including fiscal stimulus, they have had much less success in dealing with longer-term issues, for example, restarting the trade agenda.

For one, the G20 and its watchers need to differentiate between the issues that multilateral institutions can genuinely make progress on and those—for example, taming global imbalances—that depend instead on domestic political processes in the largest economies and their willingness to engage.

One has to distinguish, in other words, between the need to improve the rules of the game and the need for key players to raise their game. Lacking enforcement tools, the G20 cannot induce action. But, over time, it can aim to develop broad consensus on the approach to take on global issues, nudge the executives in member states in new directions, and provide political cover for policy change at home. Such an approach is not always given to dramatic successes or flashy announcements.

### *Include the Emerging Economies*

The G20 has created the possibility of shifting coalitions that cut across developing and advanced country lines. But including emerging countries as full participants could also limit the G20's effectiveness. The argument is often made that even as the emerging powers demand a larger voice in international organizations, they resist taking on the associated responsibilities and are reluctant to yield sovereignty, even at the cost of torpedoing international consensus. There is some truth to this argument and, in my view, examples of it can be found in the Doha trade negotiations and in aid policy. But equally clearly, developing countries are not the only ones that have failed to live up to their international responsibilities, in areas ranging from agricultural trade policies to control of carbon emissions, not to mention taking adequate precautions to avoid financial booms and busts.

So while both the emerging and advanced economies need to learn from their mistakes, emerging economies need to be given time to get the hang of international negotiations, to articulate a clear vision of the specific policies they want to drive on the global stage, and to establish a clearer ordering of their various preferences and interests.

### *Structure*

To play a strategic role in global economic policy, the G20 must strike a balance between bringing too many countries and institutions around the table and being too small to be representative. Thoughtful leaders in such non-member nations as Denmark or Chile have questioned the legitimacy of the self-appointed G20, even though its members account for some 80 percent of world GDP.

But catering to these concerns would only lead to ineffectiveness. The G20 already borders on being too unwieldy and is also taking on too many issues at once, which risks diluting its focus. At the same time, power on the international stage, rather than numbers, ultimately determines who will call the shots. In the final analysis, the five or six largest G20 members are in charge and including another economy the size of Argentina will not change that fact.

To improve continuity and build institutional memory and capacity, proposals have also been aired to establish a G20 permanent secretariat and a more durable presidency. The current set-up is not ideal, but it is not clear that any alternative, such as the IMF model of national groupings headed by rotating chairs, would be preferable. A longer presidential term would also give one nation too much weight, as the 19 others would have to wait for their turn for years. And while a permanent secretariat would lead to more continuity, it would also, once established, increase the risks of bureaucratization, mission creep, and competition with other institutions.



### *The U.S. Role*

As the crisis began spreading across the globe in 2008, the G20, led by the US, which was at the epicenter of the crisis, helped avoid descent into a second Great Depression. Since then, it has also shown glimpses of its longer-term potential—beginning the hard work of revising the roles and structures of major institutions and setting the long-term global economic agenda.

Above all, the G20 needs to avoid the temptation to be all things to all nations and instead keep its eye on the ball—the systemic short- and long-term global policy issues that affect all nations and require major coordinated reforms. It also needs to know how to pick its fights and focus on those issues where there is a genuine emerging consensus about what to do.

The key factor between success and failure will be leadership. As in the past, there are only a handful of members that can swing the big decisions. Of these, the United States is still by far the most important and the only plausible leader—and will, in my view, remain so in coming decades. No relationship is more crucial for the United States in leading the G20 than that with China, a developing economy that is also the world's second-largest and fastest-growing economy. As in the past, the United States will lead best by example.