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

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Global economic governance has evolved dramatically in recent years. Emerging and developing countries have risen in importance. Technological change, faster connections and the rising tide of globalisation in general strengthened economic and financial interdependencies on a global scale. At the political and the institutional level, stepping up international cooperation became indispensable. The global economic and financial crisis served as an accelerator for international cooperation and this is when the Group of Twenty (G20)[2] gained significant importance. With swift and decisive actions, the G20 managed to avoid an outright depression during the financial crisis in 2008 and 2009. However, while there was common agreement on what to do when the crisis broke out, since its end the G20 has been struggling to maintain its relevance.

Questions raised long time ago by Robert Triffin became relevant again. His dilemma captures the following conflict of interest for the system's core country (and reserve currency issuer): when it refuses to provide other countries with its currency, international trade would stagnate; but if it would provide an unlimited supply, global confidence in its currency decreases. Although Bretton Woods has ended, the fundamental dilemma as put forward by Robert Triffin is still very much alive: will holders of reserve currencies serve short-term domestic or long-term global interests? By means of this question, Triffin's intellectual legacy is still relevant for today's global economic governance.

With the present article we argue that it is high time that the international community shifted its focus from "winning the war" – i.e. responding to the 2008 crisis – to "winning the peace" – i.e. overcoming the legacy of the crisis and creating conditions for strong, sustainable, balanced and more inclusive

[1] This article is prepared as follow-up on the Robert Triffin International Conference held on 6 June 2017 in Brussels. I would like to thank Guergana Stanoeva and Sebastiaan Wijsman for their contribution in preparing it.
[2] The G20 includes the following countries Argentina, Australia, Brazil, Canada, China, Germany, France, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, Turkey, United Kingdom, United States, South Africa, South Korea and the EU. Spain has the status of a permanent guest country.

growth. Making the case for global cooperation in a multilateral context is all the more critical in the context of rising populism and protectionist threats. But how can global governance become more effective? And what should be the role of the European Union (EU) in this process? Can it be in the lead and help "win the peace"?

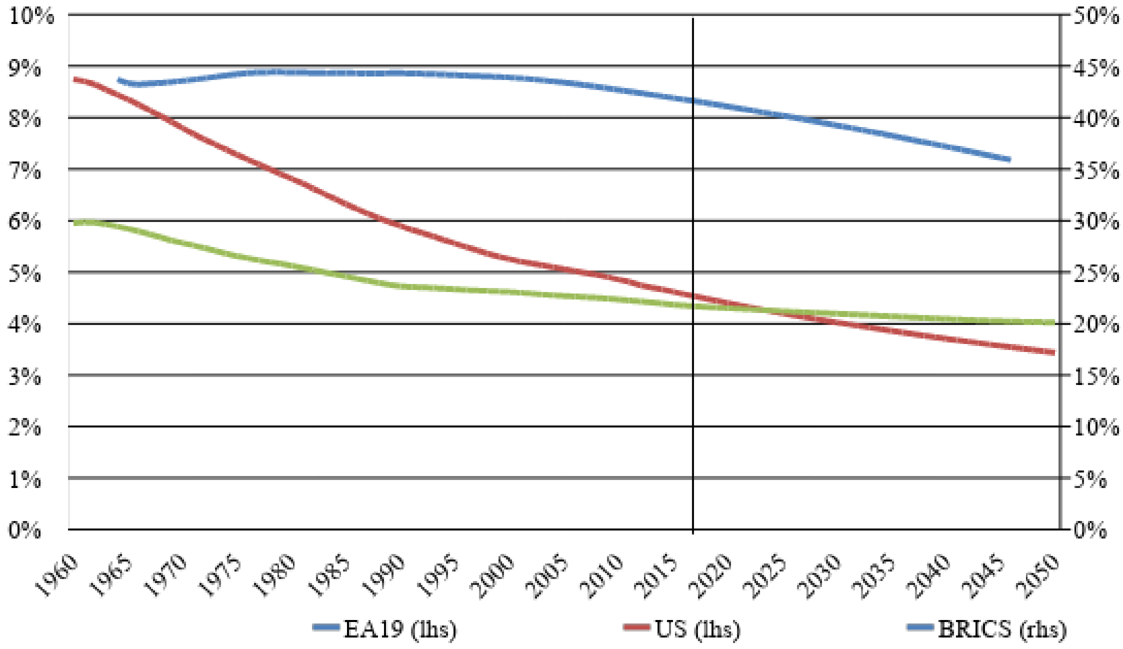
The article is organised as follows. First, it presents some important long-term trends in the global economy. Second, it puts global economic governance in a historical perspective by looking at the evolution of the international monetary system and Triffin's dilemma in the heart of it. Third, it highlights the importance of international cooperation and addresses the impact of the financial crisis on global governance. Fourth, it elaborates on the G20 and in particular on its key achievements and remaining challenges. It then depicts the role of the G7 in the global governance and outlines the main challenges facing multilateralism. Finally, it discusses the preconditions for the EU to make a difference in the new global economic governance.

1. Long-term trends in the global economy

The rise of emerging markets and developing countries in the international economy is driven by changes in growth dynamics and demographic developments. First, the population of emerging markets is increasing relative to the population of advanced economies. Figure 1 depicts the share of the BRICS[3], Euro Area (EA) and United States (US) in world population. In the 1960s the BRICS' population was three times larger than the combined population of the US and the EA. Today, this ratio has increased to four and a half, whereas long-term projections point to a BRICS' population that could be five times larger in 2050. Moreover, the share of the BRICS' population itself is expected to decline relative to the other (non-BRICS) emerging and developing economies.

[3] Brazil, Russia, India, China and South Africa

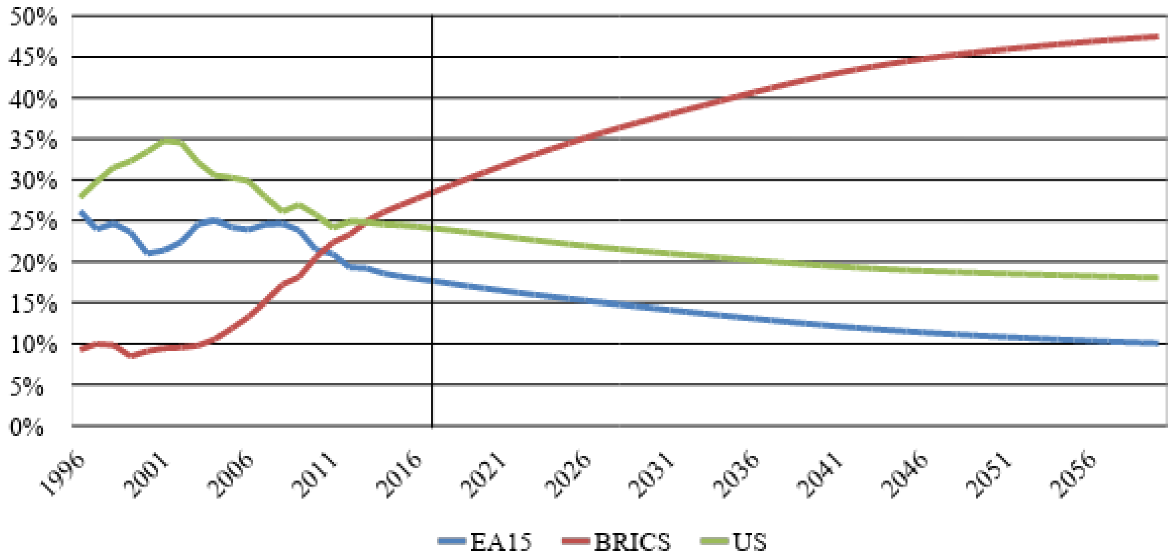
Figure 1 Population of EA19, US and BRICS as share of world population



Source: World Bank

Second, turning to growth dynamics, Figure 2 shows how the BRICS' share in the world economic growth is expected to rise in relative economic weight from around 10% of global GDP in the late 20th century to over 45% by the middle of the 21th century. On the contrary, the EA's and US' share in the world economic growth declines. This implies a shift of global economic power from advanced to emerging and developing countries.

Figure 2 Real GDP at market exchange rates as share of world total



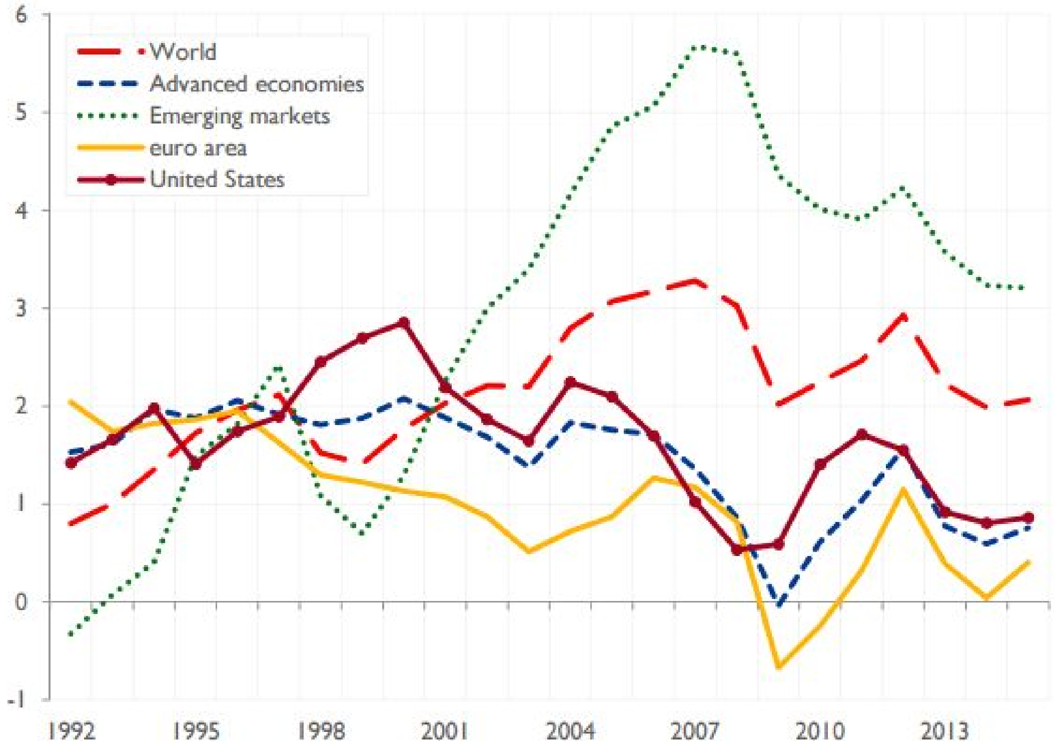
Source: OECD long-term baseline projections (June 2013).

Notes: 1) Actual GDP data until 2012. From 2013 to 2015, GDP data from the OECD Economic Outlook. From 2016, GDP data from the OECD long-term baseline projections.

2) EA15 includes Austria, Belgium, Germany, Spain, Estonia, Finland, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Slovakia and Slovenia. The OECD does not provide data for the rest of the EA Member States.

One of the factors behind the loss of GDP share of the advanced economies is the slowdown of productivity growth. As Figure 3 indicates, labour productivity grows considerably faster in emerging markets than in advanced economies. Low productivity growth in the latter was already underway before the financial crisis and has continued to undermine rises in output and living standards in recent years.

Figure 3 Labour productivity growth (as output per employee)



Source: Conference Board. Note: Growth is measured as annual percentage change on three-year moving averages

2. The global governance system: A historical perspective

These long-term trends have not affected global governance until recently. After the Second World War, the global economic governance was structured around the so-called Bretton Woods system which encompassed a number of rules and institutions. Bretton woods, named after the area in New Hampshire (US) where it was agreed, established the International Monetary Fund (IMF) and the World Bank as central institutions in 1944. Three years later, the General Agreement on Tariffs and Trade (GATT), the precursor of the World Trade Organisation, was signed in Geneva.

As regards the international monetary system, the central feature of Bretton Woods was a fixed exchange rate of all currencies vis-à-vis the US dollar. The central role of the US dollar in this system maintained and reinforced the role of the US in global governance. However, already by the early 1960s, US monetary liabilities towards non-residents exceeded US gold holdings. Hence the well-known Triffin dilemma: If the US refused to provide other countries with US dollars, trade would stagnate and the world economy would eventually be trapped in a deflationary bias. However, if the US provided an unlimited supply of dollars, the certainty that it would convert them into gold would erode confidence in its international currency.

The system eventually collapsed, as Triffin had predicted. Faced with the dilemma, the system’s core country preferred not to maintain its commitment to keep the value of the dollar in terms of gold, but rather to pursue its internal needs while providing the other countries (which were not adjusting either) with its reserve currency. US policymakers' lack of regard for repercussions on other economies meant that this was at the same time an international "non-system", and a unipolar system based on the dollar. In the long run this proved unsustainable, and the end of the Bretton Woods system started with the decision by President Nixon in 1971 to unilaterally terminate the convertibility of the US dollar into gold. Compounded by the first oil price shock, by 1973 the major currencies began to float against each other.

After the end of the Bretton Woods system, global economic governance evolved towards a more multipolar system. The international monetary system is no longer solely centred on the US dollar, but is increasingly built on several pillars, including an important role for the euro and the yen, and a renminbi which is growing in significance.

Has this put an end to the Triffin dilemma? The way in which the international monetary system works has changed and thus the modalities through which the dilemma operates have changed considerably. However, the fundamental tension between short-term domestic policy incentives and the stability of the international monetary system has not. Key issuers and holders of reserve currencies pursue domestic objectives independently of what would best serve the global system and even their longer-run interest. To the extent that these policies pay insufficient attention to negative externalities for other countries and longer-term macroeconomic and financial stability concerns, they tend to produce unsustainable imbalances and fuel vulnerability in the global financial system. Hence, the Triffin dilemma is essentially still alive.

3. The global economic and financial crisis: Accelerator of global economic policy cooperation

The economic and financial crisis that broke out in 2008 demonstrated the high degree of global interdependence and the importance of effective global governance. The crisis taught us three key lessons: First, global spillovers transmitted via financial markets can have dramatic consequences. For example, the Greek debt crisis had a direct impact on other economies in Europe and beyond.

Second, financial and monetary stability have a global dimension. The exchange rate does not insulate national economies in a world of free capital movements. For the past few decades, international macroeconomics has postulated the so-called "financial trilemma”: With free capital mobility, independent monetary policies are feasible if and only if exchange rates are floating. Some analysts (see for example Helene Rey (2013)[4]) argue that widespread co-movement in capital flows, asset prices and credit growth across countries – a global financial cycle – makes the trilemma moot: This financial cycle "transforms the trilemma into a 'dilemma,' or 'irreconcilable duo', implying that independent monetary policies are possible if and only if the capital account is managed. Hence, the conclusion is that countries that want to keep capital markets open must choose between monetary autonomy and exchange-rate management.

Third, in a post-crisis world, close cooperation between policy makers is essential to avoid zero-sum 'beggar-thy-neighbour' policies. The term 'currency war' gained widespread publicity in 2010, in the context of the G20, by then-Brazilian Finance Minister Guido Mantega to depict competitive devaluation, i.e. countries competing against each other to achieve relatively low exchange rates for their own currencies in search of competitive advantage.

In addition to its economic impact, the financial crisis also had major consequences at the institutional level. The perception of the relative decline of advanced economies accentuated by the crisis boosted the confidence of emerging powers. Emerging and developing economies called for faster reform of global institutions, especially of the IMF and the World Bank. As a result, a number of global institutional innovations took place to address the challenges of the crisis. Most importantly, the G20 was elevated from a Finance Ministers' group to the level of Heads of State and Government.

4. G20: Key achievements, decisions and challenges

The G20 has emerged as an informal forum that promotes cooperation between advanced and emerging-market countries on key challenges related to global economic growth and stability. It represents almost 90% of global GDP, two-third of the world's population and 80% of world trade. At the 2009 Pittsburgh Summit, the G20 designated itself the premier forum for international economic cooperation.

Over the years, the G20 has proved to be an effective forum bringing advanced and emerging economies together. It has demonstrated that it can take swift and decisive action when dealing with the global financial crisis in 2008-2009. Moreover, the G20 has helped to reduce the mistrust between advanced economies and emerging markets for the benefit of all. In doing so, the G20 has been the platform countries were looking for to exert influence on partner countries' policies that were producing significant spillovers.

[4] Helene Ray (2013) "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence".

Key decisions

There are several key decisions that shaped the G20's influence. When the global crisis broke out in 2008-2009, the G20 managed to avoid a 1930s style great depression, through a coordinated G20 response to the global recession and the stabilisation of the financial system. The Summits in Washington (November 2008), London (April 2009) and Pittsburgh (September 2009) focused on four key issues: (a) the macroeconomic stimulus needed to avoid the repetition of depression similar to that of the 1930s; (b) the tripling of the financial resources of the IMF to strengthen global firewalls and support countries under financial stress because of the crisis; (c) the agreement to implement reforms to restore the stability of financial markets in order to avoid a collapse, and to strengthen regulatory and supervisory regimes so as to avoid future crises; and (d) finally, the commitment to refrain from protectionism (in contrast to the 1930s) and roll back restrictive trade and investment measures taken previously.

The enacted macroeconomic packages were without precedent both for their size and in terms of the economies involved in this coordinated policy response. Aggressive monetary policies together with expansionary fiscal policies (amounting to several points of GDP and complemented by the work of automatic stabilisers) contributed to stem the collapse of demand and to bring global growth in positive territory already in the second half of 2009. Results were so encouraging that at the Toronto Summit in June 2010, it was decided to start withdrawing the fiscal stimulus, which from hindsight turned out to be a premature decision.

After these turbulent years, the G20 started to focus on structural changes. At the summit in Seoul in November 2010, the Leaders' most important decision was to finalise the IMF quota reform which included a doubling of the overall quota of the Fund, a significant (6.4%) shift of IMF shares to emerging market and developing countries and a reduction of the advanced European presence in the Executive Board by two seats in favour of emerging market countries. At the Cannes Summit in 2011, Leaders agreed on a common methodology to approach global imbalances. This resulted in a number of policy recommendations to be taken in a coordinated way in surplus and deficit countries in order to put global imbalances on a downward path and in the meantime ensure a rotation of global demand that would support economic activity. In St Petersburg in September 2013, the G20 decided to address base erosion and profit shifting, tackle tax avoidance, and promote tax transparency and automatic exchange of tax information. At the Brisbane summit in November 2014, the G20 put forward structural reform measures and growth strategies to meet the ambitious goal of lifting its collective GDP by more than 2 per cent over five years. Finally, at the Hangzhou summit in September 2016 G20 members agreed to use all policy tools (monetary, fiscal and structural) individually and collectively to achieve the goal of strong, sustainable, balanced and inclusive growth. It was acknowledged that monetary alone cannot lead to balanced growth and should be supported by fiscal policies and structural reforms.

Remaining challenges

However, there also remain challenges for the G20. First, in order to stay relevant, the G20 needs to develop itself from a short-term crisis response forum to addressing more long-term challenges for the global economy It has responded adequately to the 2008 crisis but it should now overcome the crisis' legacy and create the conditions for strong, sustainable and balanced growth. Second, for the credibility and effectiveness of the G20, it is essential that members implement their existing G20 commitments, for example on international tax transparency and financial regulatory reform. Consistent monitoring will be essential to ensure effectiveness of reform and a global level playing field. Third, given its diverse membership, the G20 needs to show leadership to identify points of common interest and new topics to cooperate on, such as anti-terrorism financing or digitalisation. Finally, the G20 must address the backlash against globalisation and focus on its unfair benefit distribution which risks fuelling populism.

5. Challenges to multilateralism

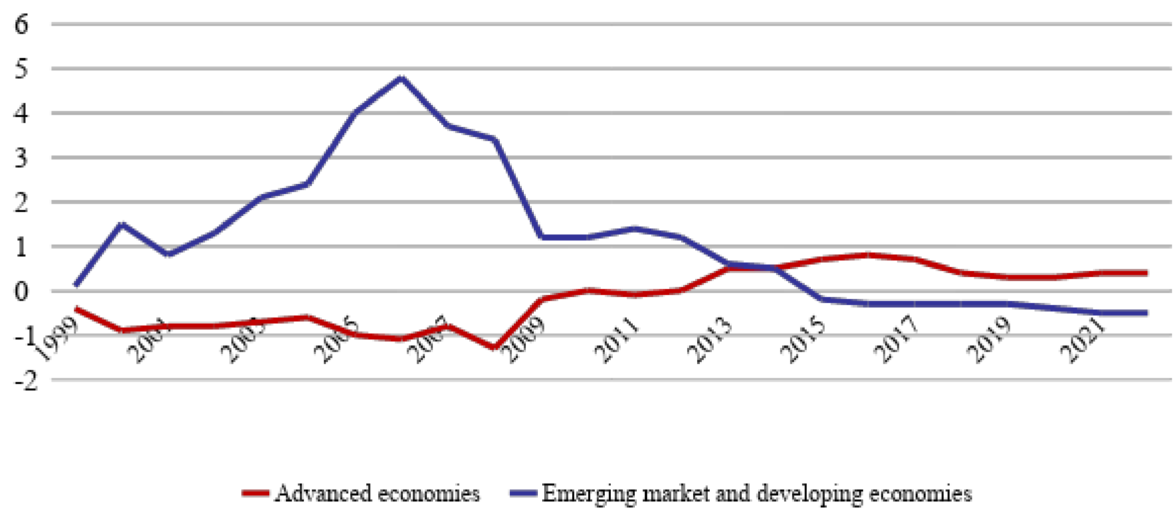
Along with recent developments, a number of challenges to multilateralism are emerging. Divergences among major advanced economies are traditionally dealt with in the Group of Seven, commonly referred to as G7[5]. Until recently, the G7 was the internal caucus on key G20 issues like trade, financial regulation climate change. Common positions on these have also helped the G20 move forward. However, the attitude of the new US administration risks changing fundamentally the global coordination game. Consensus is breaking down with bilateralism threatening the multilateral, rules-based system and mistrust setting in. Traditional "exogenous" assumptions are being questioned. Global fora risk being seen more as an amplifier to a bilateral agenda rather than looking for genuine multilateral solutions to common challenges. There is not only a risk of an increased shift to bilateralism for trade agreements, but also a US disengagement may be looming for what concerns the international monetary system, competitive tax shifts may emerge and there is a risk of rolling back on financial regulation. Moreover, cooperative solutions are lacking to effectively tackle the migration challenge and climate change.

In this challenging environment, a renewed rise in global imbalances may be the trigger ending multilateral cooperation. External imbalances may be problematic if they are excessive and

[5] The G7 consists of the UK, France, Germany, Italy, Japan and the US

entrenched. Disorderly unwinding of large current account surplus or deficits can have high costs in terms of output and employment and could have significant spillovers on trade and financial partners. As figure 4 shows, there was a large imbalance during the pre-crisis period. While the US' current account deficit represented almost 6% of GDP in 2006, China's current account showed a surplus of 10% in 2007. After having reached a peak in the run-up to the crisis, global imbalances went through an important correction, mainly on the side of emerging economies.

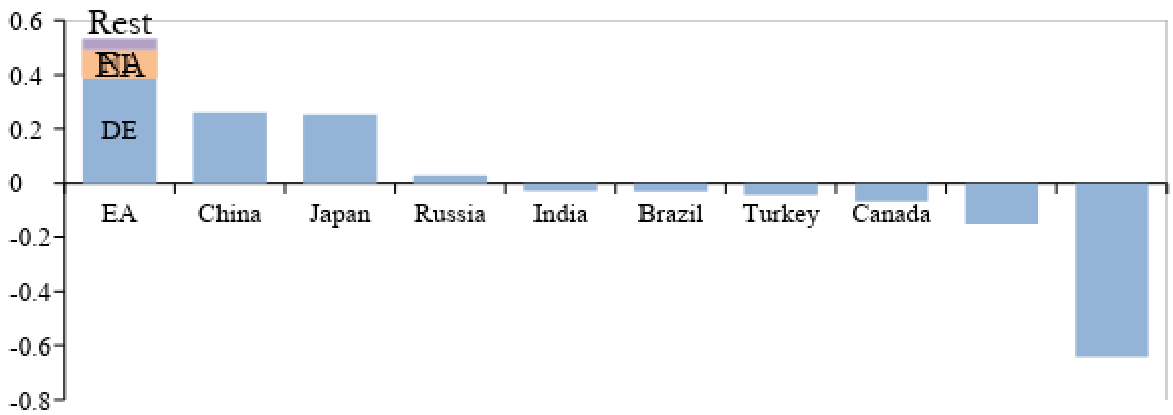
Figure 4 The current account as percentage of GDP



Source: IMF Data Mapper

In recent years, the positions are being reversed: Emerging market and developing economies as a whole run small deficits while advanced economies register surpluses. Figure 5 depicts the current account balances as percentage of global GDP for some individual countries in 2016. Japan, China, Russia and the EA show current account surpluses. India, Brazil, Turkey, Canada, the UK, and US have (small) deficits.

Figure 5 The current account in 2016 as percentage of global GDP



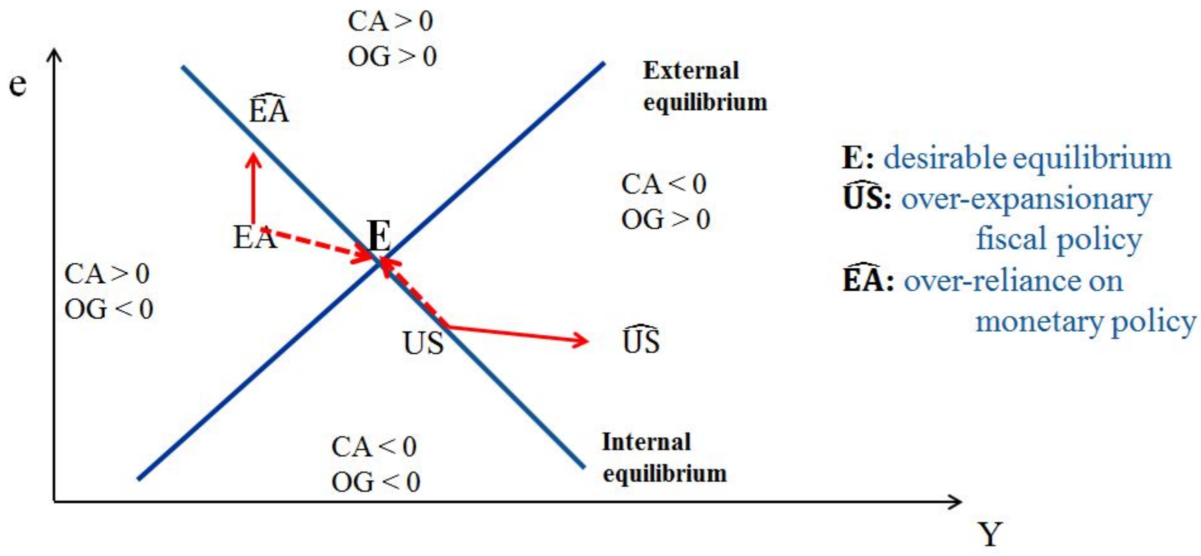
Source: Calculations based on IMF Data Mapper

The global imbalances become more an advanced economies problem rather than an emerging markets one. Focusing on the EA situation, we can see that Germany and the Netherlands have the highest current account surpluses in the EA. However, also previous deficit countries have started to reduce their deficits or even turned into surplus as part of the adjustment process. Consequently, the overall EA current account surplus attained historically high levels.

This development brings forward several risks. The EA needs to avoid that asymmetric adjustment increases its current account surplus even further. The unbalanced policy mix in the US which combines higher fiscal spending with sharper than expected rise in interest rates, could affect the dollar-euro exchange rate and increase the US deficit and protectionist pressures. This may be coupled with risks of hard-landing (i.e. disorderly adjustment) in China.

The rise of renewed global imbalances can be represented by the so-called Swan diagram as depicted in Figure 6. The Swan diagram illustrates the combination of aggregate demand (horizontal axis) and the real exchange rate (vertical axis) that ensures an internal and external equilibrium. The internal equilibrium contains all the points in which the output gap is zero and is represented as the downward sloping line. The upward sloping line represents the external equilibrium and contains all the points resulting in a current account balance. The graph has four quadrants accordingly in which the actual and desirable policy positions of the US and EA are reflected.

Figure 6 Global imbalance fuelled by unbalanced policy mix



The risk is that an over-expansionary fiscal policy in the US going hand in hand with more rapid normalisation of monetary policy would lead to an appreciation of the US dollar and a larger current account deficit. Conversely, over-reliance on monetary policy would imply the continuation of historically high current account surpluses in the EA. The spillovers of an unbalanced policy mix in the US would be sizeable, in particular for emerging economies having a large share of dollar-denominated debt (that is in some cases unhedged).

6. Preconditions for the EU to count

In order for the EU to make a difference in global governance going forward, it will need to meet a number of preconditions. First, projecting strength externally requires internal strength, which means the EU needs a higher degree of internal EU cohesion. In particular, this means the EU must complete the Single Market and become a genuine Economic and Monetary Union – including through a stronger economic and fiscal governance framework, a fully working Banking Union and a Capitals Market Union. The Commission Reflection Paper on deepening EMU published in May 2017 indicates the possible way forward. This was followed by a package setting out a roadmap for deepening of EMU in December 2017 including concrete steps to be taken over the following 18 months[6]. The EU also needs to overcome political challenges, in particular the migration crisis and Brexit.

[6] For more information on the European Commission package see: http://europa.eu/rapid/press-release_IP-17-5005_en.htm

Second, to make a difference globally, the EU should overcome its "small country syndrome". The EU consists of small and large countries, but many Member States, for historical reasons or otherwise, focus purely on domestic objectives and are not ready to take up broader responsibilities.

Third, the political phenomenon of the "small country syndrome" also has an economic counterpart, which can be labelled the "reverse creditor paradox". Historically, going back to Bretton Woods and before, creditors were in a stronger position, compared with the weaker position traditionally held by debtor countries. An asymmetry reigned in the international system, which meant that creditors ruled, as could also be seen during the euro area debt crisis. This political asymmetry has now been reversed. Therefore, the EU and EA are now at risk of a sort of "reverse creditor paradox".

Fourth, the EA as a whole runs a large current account surplus which makes it vulnerable for criticism from other countries. Large current account surpluses do not contribute to global economic growth and demand, and export deflation. Surpluses are accordingly no longer seen as strength but rather as a sign of economic weakness and a source of political vulnerability. The EU is subject to the risk of attracting concentric fire from the US for not assuming its responsibility to boost global growth. At the same time emerging markets may criticize the EU for not acknowledging the shifts of power in global economy.

Leveraging strengths

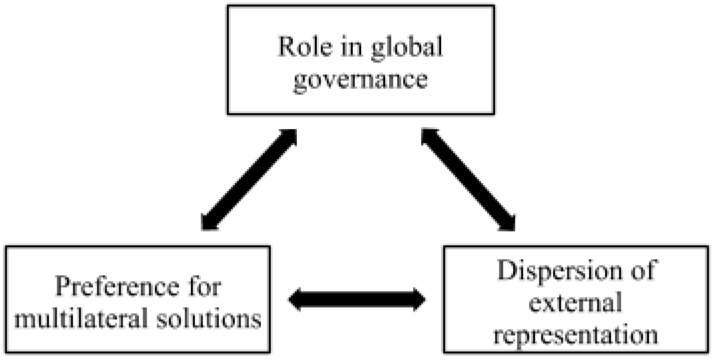
To overcome its weaknesses and to make a difference in global governance the EU should leverage its strengths. This means leveraging the attractive aspects of the European model to enhance the 'soft power' of the EU. In particularly the following four strengths can be leveraged by the EU.

First, the European social model is attractive for international partners, since it combines equality and growth. Second, by means of its environmental model, the EU has been at the forefront on many global environmental issues and on the fight against climate change. For instance, the EU was a driving force in reaching the first universal, legally binding global climate deal at the Paris COP21 conference in December 2015. Third, the EU is strongly committed to effective multilateralism. It always stands ready to work with its international partners on multilateral, win-win solutions. Finally, the EU at the moment represents a beacon of stability. Whilst for a long time it was in the eye of the storm during the crisis it is now seen as an anchor point of the world. Many of its international partners emphasise that they see the integration the EU and EA achieved as an "important global public good" that needs to be preserved and completed.

Reform EU's external governance

Besides strengthening its domestic governance, the EU should also reform its external governance. A new impossible trinity has emerged: It is not possible to achieve an important role in global governance if representation in multilateral forums remains that of Member States alone.

Figure 7 Overcoming the inconsistent trinity



Europe, and notably the EA, must be able to speak with one voice to make full use of its position. This requires a balancing act between integrated and national policies and institutions for their representation in multilateral forums. In forums such as the IMF, the G20 and the Financial Stability Board, Europe's representation remains dispersed while these forums decide on issues of key importance for global economic governance, such as the stability of the international economic system and the need to rebalance economies. Fragmented external representation leads to a lesser weight for the European message to the world or it weakens the effectiveness of the multilateral global governance framework via a tangle of state-to-state bilateral agreements. Only a single external voice, at least at the EA level, along the lines of the proposition of the Five Presidents' Report and the Commission Reflection paper on deepening EMU, can be conducive to a greater influence in global decision-making.

7. Conclusions

Since the abolishment of Bretton Woods, global economic governance has moved towards a multipolar system. Economic and demographic developments have changed economic weights and shifted trade patterns. Emerging and developing economies gained importance and the global governance has changed accordingly, whereas the financial crisis of 2008-2009 spurred this process.

Moreover, the financial crisis showed the importance of coordinated economic governance as financial spillovers spread the crisis across the world and the rise of the G20 was a major innovation resulting from this.

Although the G20 took swift action as response to the crisis, it struggles since then to remain relevant. It should move its focus from "winning the war", i.e. responding to the crisis to avoid the collapse of the global financial system, to "winning the peace", i.e. enhance conditions for strong, sustainable and more inclusive growth. At the same time, multilateralism faces challenges like excessive imbalances, opportunistic tax policies and protectionist pressures. Economic coordination provides clear benefits and the EU can strongly contribute in this respect. However, to play a role in global governance, the EU needs to address its weaknesses, leverage its strengths and overcome the fragmentation of its external representation.

Finally, Robert Triffin addressed the ever changing nature of global economic governance as follows: "… the construction of a stable and freer system of world trade and payments must be conceived as a continuing and permanent effort to adjust international institutions and policies to new needs and new possibilities". This accurately describes what the European Commission is trying to deliver in the G20 and other multilateral fora.