



## G20: Governance and economic transformation key for SDG success

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### Key messages

- As the G20 prepares to meet in Antalya, global growth prospects look uneven, fragile and subject to downside risks.
- In this G20 briefing, we discuss the 'triple whammy' of shocks: a slower China, a higher US interest rate-US dollar dynamic and lower oil prices.
- A G20-LIC forum for economic transformation would be a welcome step in supporting the SDG of inclusive sustainable growth.
- The promotion of labour productivity targets and innovation for LICs is necessary given their importance in economic transformation.
- The G20 should call for enhanced global economic governance with a view to monitoring risk-taking behaviour.
- As it assumes the G20 leadership, China should play a key part in forging a greater role for the BRICS in a rules-based system for global finance.

## Abbreviations

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ADB	Asian Development Bank
BCSA	Bilateral currency swap agreement
BIS	Bank for international Settlements
BRICS	Brazil Russia India China South Africa
CMI	Chiang Mai Initiative
CRA	Contingent Reserve Arrangement
DFID	Department for International Development
EU	European Union
FDI	Foreign Direct Investment
FOMC	Federal Open Market Committee
FSB	Financial Stability Board
IMF	International Monetary Fund
LIC	Low Income Country
LMIC	Low and Middle Income Country
MDGs	Millennium Development Goals
OECD	Organisation for Economic Co-operation and Development
RMB	Renminbi
SDGs	Sustainable Development Goals
SDR	Special Drawing Right
SEA	South East Asia
SMEs	Small and Medium sized Enterprises
SSA	Sub-Saharan Africa
US	United States
USD	United States Dollar
WEO	World Economic Outlook
WTO	World Trade Organisation

## Executive summary

As the G20<sup>1</sup> prepares to meet in Antalya, focus will turn to progress in achieving inclusive growth and the promotion of small and medium sized enterprises (SMEs), a key priority for Turkey's G20 presidency. However, as the G20 prepares to hand the leadership over to China, global growth looks fragile. In this briefing, we discuss the impact of current financial shocks and ways in which the G20 should be an agenda setter for sustainable growth – through economic transformation and better global economic governance. The G20 should:

**Address financial fragility to safeguard growth.** A triple whammy of shocks lies ahead: a slowing Chinese economy that is transitioning to consumption-led growth, a weaker paradigm for oil prices and a strong US dollar/US interest rate dynamic. It is the combination of these shocks that stands to be a source of particular uncertainty for LICs and emerging economies. We look at exchange rates, debt dynamics and capital flight as reference points for comparison to South East Asia's (SEA) 97/98 financial crisis.

**Call for economic transformation.** In its recent World Economic Outlook (WEO), the IMF highlights that China's transition is welcome and that the decline in the oil price is likely to add to – rather than detract from – global growth. We argue that resource-rich economies must seize the opportunity to diversify into new sectors and oil importers should utilize the windfall gains from lower oil prices. Otherwise, unsustainable debt dynamics and a deterioration in terms-of-trade<sup>2</sup> will disturb inward investment and growth.

**Increase inclusion in global economic governance.** The post-2008 recovery has been characterised by a significant increase in global liquidity (BIS 2013). Notwithstanding this, only Germany and the US have reached 2007-2008 peaks in per capita GDP (Reinhart and Rogoff 2014) and low income countries (LIC) and low and middle income countries (LMIC) growth has slowed. It is fair to say that the coordination called for in 2008, to protect against negative financial spillovers, has not been effective<sup>3</sup>. Alternative arrangements – ranging from the BRICS bank to LMICs/LICs' stockpiling of reserves – are a testament to this and to failed IMF governance reform (Woods 2010).

**G20 push for global financial rules** has been successful with the implementation of Basel III and the FSB. Global financial rules are necessary for good governance – a global public good that continues to be undersupplied (Hou, Keane and te Velde (2014)). Beyond this, higher-frequency information sharing is necessary to act in a timely fashion in response to early warning systems (Woods 2010). A financial regulator (in addition to the BIS and the FSB) to regulate particular types of risk taking behaviour is necessary to harness the impact of financial spillovers. This will safeguard LICs' sustainable longer term growth.

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<sup>1</sup> The G20 is comprised of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union (EU).

<sup>2</sup> A country's terms of trade is defined as the ratio of the value of its exports to the value of its imports.

<sup>3</sup> For further details, see the declaration of the Summit on Financial Markets and the World Economy <http://www.g20.utoronto.ca/2008/2008declaration1115.html>

## A 'triple whammy' of shocks

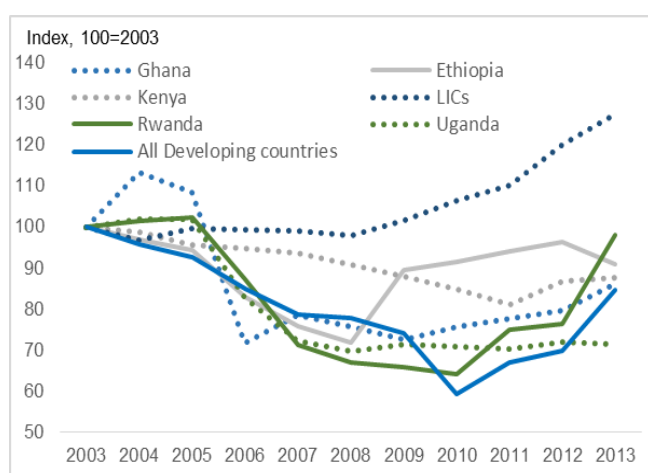
The G20 meets at time when the outlook for economic growth is particularly uncertain for emerging and developing economies. Not only is global growth decelerating and uneven (IMF 2015), but it is also subject to a range of downside risks. Financial shocks are squarely part of the landscape and stand to impact both actual and potential growth (Gordon 2015) for emerging and developing economies.

South East Asia's 97/98 financial crisis highlights how severe the impact of capital flight can be on long-term growth (Weisbrot 2007). Currently, economies with large financing needs will bear similar risk with a combination of higher interest rates and depreciating exchange rates. Dollar-denominated debt (figure 1) could become unsustainable with a higher USD and particularly vulnerable to higher interest rates (Tyson 2015). SSA currencies have weakened more compared to past periods of US rate rises (figure 2).

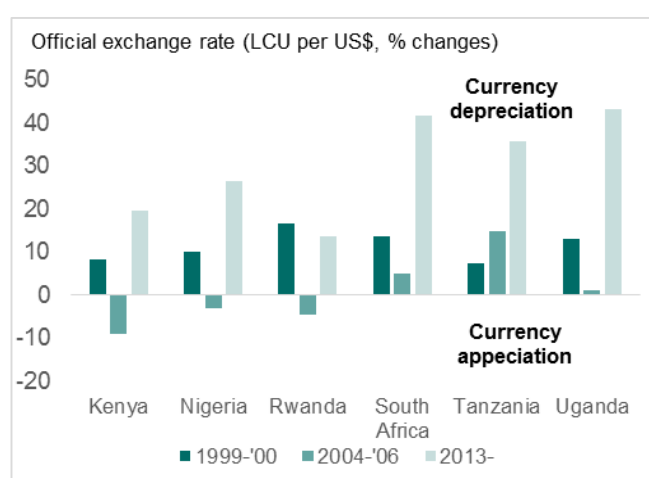
As China prepares its 13<sup>th</sup> five-year plan (Economist 2015) all eyes are on its slowdown and potential spillovers from its growth rotation. In isolation, this slowdown would have been problematic given that China accounts for up to 93% of mineral and fuel exports in SSA (Hou, Keane and te Velde 2014). For oil exporters, China's transition is now heightened by structurally weaker oil demand due to US energy independence (Papadavid 2013); this is notwithstanding the global boost to GDP from lower oil prices (IMF 2015).

The third source of financial fragility is a stronger US dollar stemming from rising US interest rates as the FOMC raises its policy rate. A stronger dollar could trigger unsustainable debt dynamics in certain SSA countries given the growth in dollar-denominated debt (Hou et al. 2014). This downside growth risk will be amplified as investment flows out of emerging and developing markets back to the US as the FOMC raises interest rates (BIS 2015).

**Figure 1. USD denominated external debt\***



**Figure 2. SSA FX during past FOMC rate rises**



Source: World Bank, Bloomberg, \*Figure 1 shows author's calculations of changes in (US-dollar denominated) external debt stock

## Sustaining economic transformation

The Turkish G20 presidency's focus on supporting SMEs has been couched in its strategy of country-led initiatives for inclusive and robust growth. Policies promoting structural economic transformation are effective in both achieving growth and for improving the quality of growth. And it is when emerging from crises that it is most effective to reform. The South East Asian 'tigers' have been successful in promoting sustainable growth in the decades following their own financial crisis, given their focus on economic transformation and human capital development (OECD 2014).

When it comes to the outlook for energy and resource-rich economies, diversification is key in avoiding the 'resource curse' and being overly dependent on resources for long-term domestic growth (Hou et al 2014, Frankel 2010). Policy is key in this: in Indonesia, earnings from oil and mineral resources made vital contributions to agriculture and rural development, providing a basis for long-term economic growth (DEGRP 2015). In diversifying domestic resources to new sectors of the economy, Indonesia was able to broaden the sources of growth. Oil importing countries are well placed, given their fiscal windfall, to promote transformative growth.

Financial institutions are instrumental for economic transformation. In SEA, access to credit (via long-term loans with low interest rates) played an important role in industrialisation. This is particularly relevant for SMEs in SEA: large industries were financed by FDI and related external finance, while SMEs were financed by public financial institutions and local commercial banks (DEGRP 2015). In Sub-Saharan Africa, SMEs are more financially constrained than in any other developing region. Only 20 percent hold a line of credit from a financial institution and 9 percent are funded by banks (ADB 2012).

China's financial liberalization is key in the economic transformation of its partners too. As it moves to open and deepen its financial sector, China will loosen capital flows into and out of its economy. And, as a part of that, it should move to a market-based determination of the RMB exchange rate. RMB internationalisation will bring growth in RMB-denominated financial instruments via offshore facilities. China's LMIC and LIC trading partners, which increasingly use the RMB as a transactional currency (Papadavid 2015), are well placed to seize this opportunity for local service sector growth.

## Boost global governance

A new global economic governance structure is needed for three reasons. First, enhanced rules-based financial governance would make institutions fit for purpose given the volatility and heightened transmission of shocks in today's finance-led globalization. Second, centralised currency reserve arrangements are more efficient than decentralised ones. The G20 has been successful in its inclusion of the BRICS economies. However, the BRICS' economic partnership with global institutions has fallen short of expectations, particularly when it comes to IMF reform. This could be due, in part, to the fact that the bloc has yet to speak with a one voice (Hou, Keane and te Velde 2014).

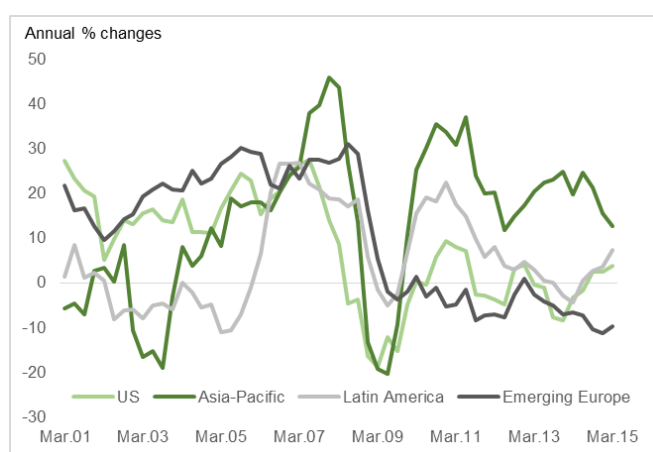
A lack of global economic coordination is costly. Alternative reserve arrangements made by LMICs and LICs, in the absence of a more centralised arrangement, are costlier (Woods 2010). Defensive stockpiling of reserves comes at the expense of foregone investment (Dabla-Norris et al. 2014). And even at the height of the 2008 financial crisis, South Korea and Singapore decided to activate a new temporary BCSA with the US Federal Reserve, indicating a lack of confidence in the BRICS CRA (Hou, Keane and te Velde 2014). An effective supranational authority could mean that national central banks' optimal reserve levels are lowered by as much as 45 percent (Steiner 2014).

An IMF governance shakeup is needed. Reform to make its quota system more representative of emerging market economies is overdue.<sup>4</sup> In time, as China liberalizes its financial system, the RMB will be included in the IMF's basket of Special Drawing Rights (SDRs). This is necessary, but not sufficient. In the absence of a more inclusive IMF, China's use of its financial surplus in SSA and SEA, via the AIIB, or the BRICS bank, risks the fragmentation of global institutions (Hou, Keane and te Velde (2014)).

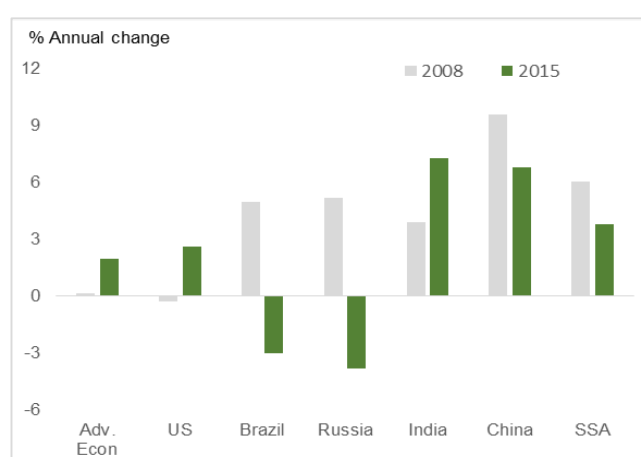
There is relevant information sharing that can take place between developed countries' sovereign wealth funds to inform best practice in developing country and fragile states' central banks. When it comes to emergent risks, the detection of early warning systems is in place thanks to the BIS, the FSB and the IMF. However, the ability to act and protect against these risks requires information sharing in a timely manner.

The nature of capital flows and finance-led globalisation is increasingly oriented to 'hot' money flows (BIS 2015). Basel III has instituted stability by ensuring higher levels of capitalization. However, there have been mixed developments in cross-border lending (figure 3). Global institutions will not be fit for purpose with the outstanding issues of systemically key banks that are 'too big to fail' and the rapid transmission of shocks. Investment banks and financial institutions need to be a part of the solution in setting industry standards for risk-taking behaviour.

**Figure 3. Cross border claims in bank credit**



**Figure 4. Global growth divergence**



Source: International Monetary Fund, Bank for International Settlements

<sup>4</sup> IMF reforms that were agreed in 2010 have not yet been fully approved <https://www.imf.org/external/np/sec/misc/consents.htm>.

## Policy suggestions

As an informal network, the G20's power lies in its ability to find consensus between leading economic powers. Its announcements have signalling power for policymakers and financial markets<sup>5</sup>. Its scope for impact lies not simply in consensus-building, but in its inclusion of emerging market leaders, non-G20 countries, businesses and think tanks (te Velde 2012). In protecting against financial shocks and promoting economic transformation it should:

- **Call for a G20-LIC economic transformation hub.** In its priorities document, the Turkish Presidency emphasized global economic integration of LICs through enhancing the private sector. A G20-LIC forum devoted to economic transformation would be a concrete and welcome step in supporting the SDG of inclusive and sustainable growth – compared to the MDGs that largely targeted poverty alleviation. The G20 is geared towards growth, making it an ideal forum to promote innovation and labour productivity targets for LICs – crucial for promoting transformation (te Velde 2015). A hub would enable countries to share best practice in implementing ‘highest growth impact’ commitments and facilitating growth strategies to absorb financial shocks. This would help meet the goal of a 2.1% boost to G20 growth by 2018.
- **Promote augmented liquidity provision.** As it takes stock of its presidency, there will be disappointment when looking for inclusive growth. A 2015 comparison vis-à-vis 2008 shows a deceleration in emerging and developing economies with little acceleration elsewhere except in India and the US (figure 4). A long-term shock facility, or an augmented contingency reserve arrangement, would be a step in the right direction. This would explicitly account for risks on the horizon for LICs rather than reacting to sources of financial uncertainty once they materialised.
- **Announce scope for a new financial regulator** – global institutions are not fit for purpose. Global economic governance is a global public good that is vastly undersupplied vis-à-vis the pace of finance-led globalization (Hou, Keane and te Velde 2014). The need for a global financial regulator has never been more urgent given that financial spillovers more frequent, probably, and amplified than before. A global regulator – or a rules based system – could follow in the same fashion as the WTO but be fine-tuned to monitoring monetary policy transmission, financial flows and algorithmic and electronic trading volumes.

Global initiatives are as important as country-led policies. As China takes the G20 mantle from Turkey, creating a rules-based system for global economic governance and seizing opportunities for economic transformation will be important. Key for China in particular as it takes the leadership from Turkey will be to forge a greater role for the BRICS in forming and enforcing a rules-based system for global finance. Similar economic partnership has worked in the past with the formation of the IMF and World Bank in creating a new economic paradigm.

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<sup>5</sup> This is particularly true with its announcements pertaining to exchange rates, as with the February 2012 communique on currency wars.



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