THE G-20 SEOUL 2010 SUMMIT
STRENGTHENING THE GLOBAL RECOVERY

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INTRODUCTION

On November 11-12, heads of state and government of the Group of Twenty (G-20) will meet for the fifth time since they started convening two years ago to deal with the global financial crisis and the ongoing recovery. This time around, G-20 leaders will meet in Seoul, Korea. It will be the first time that a non-G8 and newly-industrialized country hosts a G-20 summit, demonstrating the increased representation of new political and economic actors in international policy coordination and global governance.

Yet, the recent policy debates and media reports have focused on concerns over impending currency wars in the form of competitive devaluations and unilateral policies. Many of these debates and reports seemed to cast pessimism and cynicism over the G-20’s ability to effectively pursue international policy coordination and economic cooperation. However, the recent agreements made by G-20 finance ministers during their late-October meeting in Gyeongju seem to have brought back some optimism and hope for progress. Nevertheless, it still remains to be seen how the outcomes of the upcoming Seoul Summit will impact the future of the G-20 to effectively continue as the “premier forum for international economic cooperation.”

Joining the debate on the challenges and expectations for the G-20 Seoul Summit, experts from the Brookings Global Economy and Development program explore a range of critical issues and offer policy recommendations for G-20 leaders to consider in order to strengthen the global economic recovery.

Kemal Derviș focuses his analysis on the key interconnected macroeconomic policy challenges that are critical for the upcoming meeting, including issues of fiscal policy coordination, spillover effects from monetary and exchange rate policies, and global current account imbalances.
Eswar Prasad and Karim Foda assess the state of the global economy and find that it has lost momentum and is teetering between a slowdown and a tepid recovery. They assert that G-20 leaders need to address the issues surrounding the growing dichotomy between emerging markets and advanced economies in terms of macroeconomic prospects as well as policy space.

Raj Desai, Anirban Ghosh and Homi Kharas look into the G-20 agenda of development at the upcoming Summit. They examine how fragility and conflict in many developing countries continue to hinder development and economic growth, and state that the G-20 Summit in Seoul is an excellent opportunity for leaders to address this issue.

Mauricio Cárdenas and Eduardo Levy-Yeyati stress that the G-20 Seoul Summit will be a critical test for international policy coordination. They argue that G-20 leaders should stop the United States and China from pursuing the beggar-thy-neighbor policies that pose a major threat to global economic stability.

Domenico Lombardi examines the economic performance of European countries and discusses what European leaders bring to the table at the G-20 Summit in Seoul. He argues that at the upcoming meeting European countries will back the United States in its increasing confrontation with China, which will provide a critical swing in the pressure on China to pursue greater flexibility in its exchange rate policies.

Edward Sayre assesses how Middle East economies have fared in the two years following the global financial crisis. He states that the G-20 has the ability to assist the Middle East during the recovery phase through guidance and policy support in three areas: trade reform, public sector reform and private sector development.

Mwangi Kimenyi and Ezra Suruma discuss how the global economic recession brought to a halt one of the longest periods of economic expansion in Africa’s history. They offer four policy recommendations for G-20 leaders to consider in aiding Africa’s development that include greater representation of Africa in the G-20, fulfilling prior commitments and improving transparency, private sector involvement and public-private partnerships, and increased vigilance against illicit resource flows.

Colin Bradford and Johannes Linn argue that, amidst the overheated rhetoric and doubts regarding international cooperation, G-20 leaders have a collective responsibility at the Seoul meeting to agree on a policy package for global rebalancing, international financial regulation and international institutional reform. They offer eight policy recommendations for leaders to take forward in Seoul in order set the course for a steady global economic recovery.
Framing the Issue

The G-20 leaders meet in Seoul at the end of the first decade of the 21st century and at a highly uncertain and unusual time for global policymakers. The depression that threatened the world economy in 2008 has been averted and the G-20 played a significant role in the global policy response, as symbolized most notably by the 2009 London Summit. It is important to stress at the outset that the utility of the G-20 leaders meetings should not be evaluated only by what happens at the meeting itself, but by looking at the whole process that leads up to the summits. In the weeks leading up to the London Summit, the immediate challenge was to ensure that a broadly coordinated global fiscal expansion took place—one that was sufficient enough to compensate for the collapse in private demand triggered by the worldwide panic and coordinated enough so that leakages abroad would not frustrate national efforts. At the time, it also appeared urgent to give the IMF enough financial fire power to prevent the crisis that had erupted in the advanced countries from spreading to the emerging markets. The London and then Pittsburgh meetings also helped launch the longer-term work toward Basel III and reforms in the financial sector.

The Seoul meeting faces a substantially different world economy and an altered set of challenges than those of London and Pittsburgh. While there are many important issues to discuss at Seoul, such as development, financial sector supervision and Basel III, I will specifically focus on the key interrelated macroeconomic policy challenges, which are critical and urgent for the upcoming meeting.

Policy Considerations

Much is at stake in Seoul for macroeconomic policy. The G-20 will survive and meet again in Paris in 2011, but whether it can really become a steering group for the world economy and strengthen international economic cooperation depends to a significant degree on the Seoul meeting and its aftermath.
The first macroeconomic challenge remains that of fiscal policy coordination, but in a context different from that of 2009 and amidst renewed concerns that large current account imbalances are a key dimension of the overall macroeconomic policy coordination challenge. U.S. Treasury Secretary Timothy Geithner’s proposal made at the October 23-24 finance ministers meeting for “current account target zones” reflects the concern for the spillover effects of national macroeconomic policies and for the need to see surplus countries contribute more to overall effective demand.

The increasing share of trade in total demand throughout the world means that the effectiveness of any one country’s fiscal policy often significantly depends on the fiscal policies of other countries. But while the world economy at the time of the London meeting necessitated a broad global fiscal expansion, the challenge for Seoul is how to orchestrate a gradual transition toward fiscal policies that are more differentiated by country and address the concern about rapidly climbing gross and net debt to GDP ratios in many advanced economies. However, this transition toward more “normal” fiscal policies has to take place at a time when the recovery in the advanced countries remains very fragile, with unemployment stubbornly high in many countries, particularly the United States. Debt worries have to be addressed while job creation must be the primary concern in many countries. An across the board panicked fiscal retreat, where the retrenchment taking place in one country would be amplified by the retrenchment in others, would likely lead the industrialized world into a second recession. It is undeniable that some countries have lost fiscal space. For them, the costs of immediate fiscal consolidation are smaller than the costs they would incur if there were a complete loss of confidence and a chaotic inability to service public debt. Greece and some other peripheral European countries have been such examples. At the same time, strong effective demand in countries like Germany and China is essential to help countries like Greece succeed in their efforts.

The fiscal policy coordination questions for Seoul are: who can afford to and should maintain an expansionary fiscal stance and for how long? Who should consolidate rapidly and by how much? What does this imply for the overall structure of world demand?

The recent U.S. proposal for current account target zones recognizes that it is overall economic policies rather than just exchange rate policies that determine national saving, investment and current accounts, and that national policies have international implications. It is exactly in order to answer this type of question that the mutual assessment process aiming to achieve strong, sustainable and balanced growth was launched by the G-20 meetings. The Seoul meeting will test this commitment and the process through which it is supposed to be implemented. Failure to reach and project broad agreement on the next stage of macroeconomic policy coordination would severely undermine the G-20 as the “premier forum” for global economic cooperation. While the major advanced countries may have most to suffer from failure, it is unlikely that the emerging markets would be able to maintain the very high growth rates experienced in 2010 if the advanced countries approached zero GDP growth. At market prices, and that is the relevant metric in this context, the advanced countries still account for about two-thirds of world
GDP. While there is a clear difference in the pace of potential and actual growth between the emerging markets and advanced economies, there is no total decoupling. Growth rates go up and down in substantial synchronization. There is a decoupling of trend growth rates but no clear cyclical decoupling (Canuto and Guigale, World Bank 2010). Emerging market economies, therefore, have a clear stake in the recovery of the advanced economies. At the same time, growth in the emerging markets has become a much more significant driver of global growth and of growth in the advanced economies.

A second challenge facing the G-20 process is to clarify and ameliorate the nature and quality of fiscal policies and more broadly macroeconomic policies in the context of a cooperative approach to policy design and implementation. It is important to look at fiscal, monetary and structural policies together, rather than in isolation, and to improve the balance between and quality of these policies. For example, too strong a belief in the ability of fiscal policy to fine tune the evolution of demand is dangerous. It is unlikely that short-term expansionary measures such as tax cuts “today,” accompanied by announcements of “future” tax increases, can lead to the desired expansion in private demand. Expectations about the future will certainly have some impact on today’s behavior. It is not that easy then for fiscal policy to be expansionary in the immediate future while concurrently launching a process of medium-term consolidation. In that context, differentiation between types of fiscal policies is crucial. If a public sector—such as that of the United States which can access funds at very low long-term interest rates—borrows to invest in infrastructure and other assets with a good long-term rate of return, it should be able to support the recovery by increasing public investment without harming its balance sheet. On the other hand, if long-term untargeted tax cuts are enacted while economic actors are holding back their investment and consumption because of a combination of ongoing deleveraging and anxiety about the future state of public finances, that kind of fiscal expansion is not going to support immediate recovery. It will harm the public sector’s balance sheet and increase concern about the future. Therefore, the G-20 has to come up with packages of growth friendly medium-term fiscal policies and fiscal rules and structural reforms that are differentiated by country to reflect very different national circumstances but mutually complementary and reinforcing in a way that anchors expectations, reduces uncertainty and projects the strong global cooperative spirit achieved at the London and Pittsburgh meetings.

A third challenge relates to monetary and exchange rate policies. Capital mobility and the actual and potential size of capital flows make the spillover effects of the national monetary policies of systemically important countries even greater than the spillover effects of fiscal policies. Flexible exchange rates, while helpful, are not a panacea that can protect domestic monetary policy independence as much as is argued in some of the basic theoretical literature. Sharp up and down movements in exchange rates have real economic costs. Sterilization of large capital inflows is feasible only up to a point. Rapid, steep appreciations can have serious effects on employment in the tradable sector—a key fear behind the unwillingness of China to let its currency float. An entirely unilateral approach to monetary policy and its implications for capital flows and exchange rates by major countries
would be a huge problem for global economic cooperation.

In the context of Seoul, the wave of capital inflows into emerging market economies has been perceived as linked to very unilateral U.S. monetary policy pronouncements on quantitative easing, so that the pre-summit dynamics have actually weakened cooperation between the U.S. and other non-Chinese emerging members of the G-20 even though they also want the yuan to appreciate. While there is real concern in the emerging market countries about their competitiveness being undermined by Chinese exchange rate policies, there is also concern about U.S. monetary policy and the perceived unilateralism of its decision making. Some still remember the early 1980s, when Paul Volcker sent U.S. and global interest rates soaring, contributing to the emerging market debt crisis of that decade. The worry today is about zero interest rates in the U.S. sending huge amounts of volatile capital flows into emerging markets rather than the other way around. If the major participants in the G-20 process give the impression that they will conduct their macroeconomic policies entirely independently of the process of international cooperation, the G-20 cannot become the “premier forum” set forth in Pittsburgh. It is important to underline that perception is also important. It would help a great deal if U.S. policy pronouncements could be more closely linked to the calendar of the G-20 and would show real concern for the spillover effects of U.S. policies. The best way to induce China to cooperate is to stress the benefits of cooperation and to build large coalitions of members willing to cooperate. At the end of the day, international cooperation can only work if there is such concern over spillover effects and if there are some further steps toward shared sovereignty. Unfortunately, the G-20 is still far from such an approach.

A fourth challenge is to complement concerns about and focus on current account imbalances and spillovers with careful consideration of internal growth dynamics and imbalances. Variations in net foreign demand for a country’s output have no doubt become an increasingly important element in changes in total demand. They are far, however, from being the only or even the main driver of growth, particularly for the very large U.S. economy. There is a strong element of wanting to blame “someone else” in the currency wars and global imbalances debate. The economic press often makes it seem like macroeconomic outcomes are entirely determined abroad. It is true that changes “at the margin” are important in economic dynamics and one must look at both levels and rates of change. A 5 percentage point decline in the Chinese current account surplus would amount to a little more than half a percentage point addition to net demand in the rest of the world. That is certainly very significant, but cannot be the driver of world growth or U.S. growth. There is need for a little “rebalancing in the rebalancing debate.” Policymakers and politicians oscillate between not paying any attention to international matters and arguing that everything is determined abroad. Surely, reality lies somewhere in between. In that spirit and in the context of the need for “domestic rebalancing,” particularly in the U.S. and China, it is important not to let the valid concern for current account imbalances obscure the need for far reaching internal structural reforms. Part of that rebalancing may have to address the stunning income concentration at the top that has taken place.
in both countries and the implications it may have for the management of effective demand, employment and financial intermediation. Recent research at the ILO but also at the IMF—not a hotbed of radical liberalism—suggests that the way productivity gains are shared may have implications for the effectiveness of traditional macroeconomic policies (see Kumhof and Ranciere’s “Unemployment Crisis,” Rajan’s Fault Lines and Reich’s Aftershock).

**Actions Items for the G-20**

The G-20 should and hopefully can be the premier international forum for economic and financial cooperation. It should even become a kind of steering group for the global economy. It can make proposals, launch cooperative processes and use the summit attendance of leaders to increase the attention given to the issues at stake. It must do so in the spirit of enabling, rather than replacing, the more formal and universal institutions of global cooperation in the macroeconomic policy context, particularly the IMF. Increased emphasis on the IMF’s role in the mutual policy assessment process proposed by Secretary Geithner should be welcomed. While the G-20 nations represent an overwhelming share of global GDP and population, sovereign nation states still make up the fabric of the international community and no self-appointed grouping can claim universal legitimacy. Moreover, smaller countries are not only experiencing the spillover effects of what happens in G-20 countries, but can themselves generate spillover effects despite their small size, as exemplified by the Greek crisis. Finally, while in need of further development, the IMF has an implementation capacity that an informal grouping such as the G-20 cannot and should not have. It is essential therefore that the proposals brought forward through the G-20 process are submitted to the universal and more legitimate governing organs of the IMF and other international institutions—imperfect as they may still be—for formal decision and follow-up. In that perspective, it would be much better if the G-20 met in early September, *before* rather than *after* the formal annual meetings of the Boards of Governors of the IMF and the World Bank, as happened in the case of the Pittsburgh meeting. Otherwise, the G-20 process might inadvertently weaken the more inclusive cooperative decision making within the Bretton Woods institutions. Pressing ahead with governance and quota reform at the IMF remains crucial, of course, and the tentative agreement reached by finance ministers in Gyeongju is a significant step in the right direction.

There is much concern expressed in the days leading to the Seoul meeting that the G-20 is not able to do its job. Part of this disappointment has to do with the exaggerated claims that have been made for the G-20 by its most ardent supporters in academia as well as some of the G-20 leaders themselves. Part of it is due to viewing the G-20 simply as a summit meeting rather than as a whole process of cooperation between countries and their civil servants and civil societies leading up to the summit. Part of it is due to an underestimation of the difficulties involved in moving from the smaller G-7 setting to the absolutely necessary larger and more complex G-20. No doubt the question of the effectiveness of the G-20 remains open. But in looking at what has been achieved in two years, there is reason for optimism. Never before have these systemically important countries analyzed and debated data and issues so intensively together.
Never before have the large new economic actors of the 21st century shared the head table with the older mature economies. Never before has an emerging country such as Korea prepared such a meeting as the host with this admirable degree of professionalism and dedication. The big problems of international economic policy coordination will not be solved overnight. Patience and persistence are of the essence. I remain hopeful that the Seoul meeting will symbolize one more significant step in the direction of managing our global interdependence and security.

References


Framing the Issues

The global economy has lost momentum and is teetering between a slowdown and at best a tepid recovery. Advanced economies are stuck in a funk and even the dynamic emerging markets have lost some of their swagger. In Seoul, G-20 leaders will need to address the issues surrounding the growing dichotomy between emerging markets and advanced economies in terms of macroeconomic prospects as well as policy space.

In most emerging markets, growth has rebounded strongly after the crisis and there are concerns about equity market and real estate booms, with rising inflationary pressures in a number of them. Among advanced economies—with Germany as a notable exception—output growth has been modest at best, job growth has been weak and unemployment has stayed high. Policy stances will therefore have to be very different across the two groups of economies.

The Global Recovery and Policy Considerations

Financial markets took a beating in 2010 Q2 roughly around the initial period of the European debt crisis and continued to weaken through 2010 Q3. This correction appeared to signal a reversal of the optimism that led to equity markets getting ahead—perhaps too far ahead—of improvements in real economic activity. Equity markets have rebounded in the most recent quarter, with an especially strong rebound in emerging markets where capital inflows have played an important role in boosting equity values. Many emerging markets are attributing the latest influx of capital inflows to policies of monetary easing and increased money supplies in advanced economies.

Real economic activity has eased up after initially surging from the low levels around the trough of the global recession in late 2008. Real GDP growth has not done too badly, especially among emerging markets, but growth in industrial production, exports and imports have all dipped across the board over the last
two quarters. Employment growth in the advanced economies also remains weak. If the negative trends in these variables persist, real GDP growth might moderate in the next couple of quarters, adding more headache to a G-20 priority of coordinated stimulative and contractionary macroeconomic policies between advanced economies and emerging markets.

Among G-20 economies, consumer and business confidence have leveled off from their gains earlier this year. Even though business confidence is still rising in advanced economies, it has not yet made up the ground lost during the crisis, and consumer confidence has entirely lost momentum. Consumer confidence has dipped sharply in the U.S. and many emerging markets, which could portend a slowdown in domestic demand growth for such economies — an important consideration in the context of global rebalancing.

The rather bleak global picture is reinforced when examining trends in specific countries. In the United States, real economic activity has held up reasonably well, driven by decent and sustained industrial production growth, and continued growth in imports and exports. Employment growth continues to improve relative to the trough, although it’s still barely in positive territory. But both business and consumer confidence have eased off, another sign that domestic demand may not be making a strong comeback anytime soon.

Germany is one relatively bright spot amidst the gloom. Its industrial production growth has stayed strong, as have growth rates of exports and imports. Consumer and business confidence are also continuing to rise. Consequently, while Germany has also been beset by weaknesses in equity markets, its overall economic activity has stabilized.

China and India continue to barrel along although their red hot pace of growth is showing some signs of cooling off. In China, industrial production growth and trade growth have moderated, business and consumer confidence have stagnated, and equity markets had fallen sharply before flattening out in recent weeks – signs that Beijing may not make any changes in the near term on its exchange rate policy.

A common feature among G-20 economies is that their financial systems, characterized by poor performance of equities and weak credit growth until recently, are not providing much support to the real economy. Weak financial markets and lackluster employment growth have dented consumer and business confidence, which could hold back the recovery in aggregate demand in advanced economies.

Financial market sentiment around the world appears fragile due to concerns that macroeconomic policy tools may have reached their limits in terms of supporting economic growth without creating untenable risks for the future. Uncertainty about the regulatory landscape may also be restraining financial market performance, although some of this uncertainty should now have been resolved by the Basel III accord.
**Action Items for the G-20**

Short-term stimulative policies in advanced economies are generating enormous risks over the longer term, especially with rising levels of public debt and aggressive monetary easing in many countries. While the recovery in advanced economies clearly needs support from macroeconomic policies in the short run, it is important that G-20 leaders in Seoul prioritize the development of credible medium-term plans for withdrawing monetary stimulus and putting debt on a more sustainable trajectory.

Most emerging markets need fiscal and monetary tightening—which could partly be accomplished by allowing for currency appreciation—to cool off asset market booms that could eventually turn into busts.

The difficult jobs picture is a common theme across G-20 countries and is in large part responsible for the specter of currency wars as countries try to maintain the competitiveness of their export sectors, which tend to be good at generating jobs. It is encouraging that G-20 finance ministers pledged at their recent meeting in Gyeongju to forewear competitive currency devaluations and explicit protectionist policies. But this still remains a risk to be guarded against, given the domestic political pressures building up in each country as unemployment remains stubbornly high and job creation remains lackluster. A reaffirmed commitment at the G-20 Summit in Seoul to avoid competitive currency devaluations would help further strengthen the encouraging pledge made by G-20 finance ministers in October.

All told, the optimism of the summer is giving way to the realization that a balanced global economic recovery is going to be a long and hard slog. The G-20 objective of robust, balanced and sustainable growth remains a chimera for now.
The Issue

In the Pittsburgh G-20 communiqué from September 2009, the G-20 leaders launched a framework for strong, sustainable and balanced growth. Building on this framework, the G-20 leaders plan to discuss development issues at the Summit in Seoul.

Leaders should recognize that as the global economy recovers from the financial crisis of 2008, fragility and conflict remain the primary detriments to sustainable growth in many developing countries. Conflict is still prevalent in the developing world and its effect on economic growth, including the destruction of both human capital and infrastructure, are well understood. In 2008, there were 35 separate instances of armed conflict. Thirty-eight countries were considered “critical” in terms of their vulnerability to collapse or conflict in the Failed State Index of 2009.

Policy Considerations

A recent study on the causes of violent armed conflict in developing countries finds that aid shocks, defined as large drops in foreign aid, increase the likelihood of armed conflict. When a recipient nation experiences an unexpected lowering of foreign aid, its government is weakened by forced cutbacks of popular programs and/or destabilized by large budget deficits. The study found that this encouraged conflict.

If negative aid shocks cause conflict, are there policies that can reduce these shocks thereby reducing the risk of conflict? Probably yes. We have looked at the determinants of aid volatility and find that donor behavior and relationships explain a significant fraction of volatility, although global shocks (like commodity price fluctuations) and domestic shocks (like elections) also contribute.

We find that recipient countries that have aid patrons are more likely to be protected from sudden aid shortfalls than those who get aid from multiple donors. If a recipient nation has one or two main donors, or patrons, then aid is concentrated in do-
nors who are invested in the success of the particular recipient country and who are less likely to impose negative shocks in aid flows. Furthermore, once a donor maintains a significant presence in a country, it can develop an understanding of local conditions and politics, and tailor its aid to generate economies of scale and better development results. It can take on the hard, long-term work of building capacity in the recipient country so as to enhance the legitimacy of the government and delivery of public services, which are two essential ingredients of state-building and conflict-prevention.

If this theory is correct, we should expect countries with greater donor aid concentration to have lower probability of sudden drops in aid, and hence lower incidences of armed conflict. In the chart below, we show the average donor aid concentration of two groups of countries, those that had a civil conflict in the subsequent three years, and those that did not have a civil conflict in the subsequent three years. Looking at data from 1960 through 2005, we see strong evidence in support of our hypothesis. In every year for the 45-year period, countries that actually had a conflict in the following three years had a lower donor aid concentration than those that avoided conflict.

But the chart also shows some worrying trends. Aid concentration is getting lower, not higher, over time, suggesting that there is an ever-greater risk of aid shortfalls and hence conflict in the future. This is consistent with overall trends in aid toward a more fragmented global system with little aggregate consistency among donors. Many donors are spread thin over many countries with little effort to improve the global division of labor.

![Donor Aid Concentration Chart](chart.png)

Source: OECD DAC Aggregate Statistics, Uppsala Conflict Data Program and authors’ calculations
Action Items for the G-20

The G-20 Summit in Seoul is an excellent opportunity for the leaders of the main donor countries to discuss the causes of fragility and conflict in developing countries and to take preventive measures to maintain stability. Modernizing aid practices and improving aid effectiveness by making aid more predictable and less volatile is a good place to start. The United States is already moving in this direction. On September 22, President Obama announced the creation of a new U.S. foreign aid policy, which promises to focus on results rather than processes. The most important “result” from development assistance in the 38 vulnerable countries in the world would be maintenance of peace and stability. Leaders should discuss how the principles for engagement in fragile states and situations, developed by the OECD Development Assistance Committee, are working in practice. They should also review the findings of the International Dialogue on Peacebuilding and Statebuilding and commit to implementing these guidelines and principles in their own aid agency efforts. This can be the most cost effective way of reducing conflict in poor countries and setting the foundations for strong, sustainable growth around the world.
Framing the Issue

Long gone are the days when the G-20 proved an essential forum to facilitate a pragmatic and consensual approach to dealing with the global economic crisis. International coordination, which was remarkable when almost everyone was in the downdraft, now seems distant and elusive. Reconciling divergent recovery paths and national interests appears formidably difficult. Make no mistake, the Seoul meeting will be as critical a test for the G-20 as the Washington and London meetings were.

The occasion could not be more taxing, as the antagonistic views in the U.S. and China about each other’s responsibilities in global rebalancing are leading to a standstill with harmful consequences for others. As with many wars between powers, it is often the small nations in the middle that suffer the most. In this case, it is the emerging economies and Latin American countries in particular that are caught in the crossfire of the U.S.-China currency war.

Policy Considerations

The problem is well known. The U.S. economy does not look good; double-dip recession, deflation and liquidity traps are keywords of the day. With interest rates already near zero, the Federal Reserve is now aggressively trying to avoid a relapse by reflating the economy with a new dose of quantitative easing (QE2). But with U.S. households swamped with debt and less-than-bright business prospects at home, the liquidity boost moves largely overseas where expected returns are higher. This U.S. dollar tsunami is far too large for emerging economies to swallow.

Despite the free-market rhetoric, QE2 is ultimately a euphemism for the weak dollar. With virtually no fiscal room to stimulate the economy, exports are the only hope. Narrowing the U.S. current account and reducing global imbalances are other prized outcomes. This Fed-engineered dollar depreciation seems an appealing proposition from the American standpoint, except for the fact that the emerging world
and particularly Latin America cannot and should not bear the burden of the dollar realignment.

For starters, QE2 is a countercyclical policy that, by definition, is bound to be temporary. If QE2 is successful at all, U.S. inflation should ultimately pick up as a combination of excess liquidity and a surge in commodity prices, inducing the Fed to reverse gears and embark in monetary unwinding. In other words, QE2 is not a structural solution to America’s woes. At best, it is a temporary patch that will make the patient feel better for some time. But the strategy has negative side effects, especially on the smaller economies that, unlike China, cannot prevent the appreciation of their currencies.

Latin America is one case in point. The region is at a critical crossroad in its development strategy. During the last two decades, it has lost a significant share in global manufacturing exports and has become even more specialized in primary products. This has not been a problem so far, but it will become a major one once China’s appetite for commodities stabilizes, which many predict will happen during this decade. Strong currencies today only deepen a pattern of specialization that is not going to pay off forever.

In this context, it is no wonder that, to varying degrees, the Latin American and other emerging countries’ defensive response to the currency wars is increasingly consensual. However, their tactics are severely limited. Foreign reserve accumulation is being actively pursued in countries such as Argentina, Brazil, Colombia and Peru, while capital controls have been implemented in Brazil and Argentina, and are being debated elsewhere in the region. True, the benefits of these interventions tend to be limited given the size of the problem, but the counterfactual is certainly worse. Where would the Brazilian real be today had the government explicitly chosen full exchange rate flexibility?

More fiscally responsible countries can relieve their central banks from part of the burden of intervention by winding down stimulus packages to generate a primary surplus. The surplus could be applied to mop up the flood of dollars by reducing dollar debt or purchasing foreign assets. But with a gloomy outlook for the global economy, significant public savings in emerging countries may be too much to ask.

**Action Items for the G-20**

Individual responses aside, this currency war poses a clear demand for the G-20 to stop the U.S. and China from pursuing the beggar-thy-neighbor policies that ultimately represent a major threat to global economic stability. The U.S. is exporting its problems to the smaller emerging economies, while China’s reluctance to appreciate its currency ultimately means a loss of competitiveness not for the U.S. but for those countries that produce similar goods.

Seoul was planned to deliver some modest progress on the two main agendas opened at the London Summit: financial reform (now limited to the new Basel III recommendations), and financial safety nets (where we expect the G-20 to salute recent IMF proposals and declare victory).
But the currency issue should dwarf all of this to become the actual real test for the G-20’s ability to coordinate global economic policies. Will the group be able to broker a workable truce in the currency wars, or will it emulate similar flops in the Copenhagen meeting on climate change, or at the never ending Doha rounds?

Emerging countries should actively support the first option. Otherwise, their role will no longer be that of the innocent bystander, but a casualty in other people’s wars.
Framing the Issue

As leaders prepare for the G-20 Summit in Seoul, the European economies are performing better than expected with an average annual growth that the IMF estimates at 1.7 percent this year. Germany is leading the pack with a projected growth rate of 3.3 percent, undoubtedly one of the best performances since reunification. Fueled by increasing exports, the German current account balance will stand at more than 6 percent by year-end. This is yet another unprecedented and unexpected performance, explained in part by a weak euro exchange rate reflecting uncertainties and financial turmoil in the peripheral economies of the euro area. Aware that these positive developments were materializing, German Chancellor Angela Merkel had little to ask of her fellow leaders at the June G-20 Summit in Toronto as well as little to offer them.

Despite repeated calls from Washington to pursue a more cooperative macroeconomic stance by increasing German aggregate demand in the face of an anemic U.S. economic recovery, Chancellor Merkel reiterated in Toronto the commitments she had already announced back home before the June Summit. The consequence of that has been, in practice, to sink the G-20 framework for “strong, sustainable and balanced growth” before it could even get afloat. A cooperative U.S. administration had to retrench, facing a unilateralist and inward-looking Europe focused on the potentially devastating implications of the Greek crisis.

Policy Considerations

But the scenario that Chancellor Merkel and the German economy may soon be facing is less appealing than that of a few months ago. For a start, the higher-than-expected growth is projected to level off next year at 2 percent. The euro has strengthened and may rise further, reflecting a weakening dollar as a result of the strategy of further quantitative easing pursued by the U.S. Federal Reserve. The euro has also appreciated vis-à-vis the yuan, as the latter is in practice
Chancellor Merkel and her fellow European leaders have been under intense pressure from the United States to streamline their representation on the IMF Executive Board, following the unexpected U.S. veto on the current size of the IMF Board in August, soon after the previous G-20 Summit in Toronto. The Europeans have just got the U.S. to go along with their exceedingly shy proposals for giving up a slight chunk of their roughly 8 chairs on the board in favor of greater representation for emerging and developing economies. And if this were not enough, European leaders have just swallowed a 6 percent voting shift from overrepresented to underrepresented countries, which will come primarily at the expense of Western Europe.

President Barack Obama is likely to meet a friendlier Chancellor Merkel this time around. However, the German Chancellor will still have little to offer Obama and the other G-20 leaders on the important policy issue of fiscal cooperation since Merkel cannot backtrack from her previous domestic commitments. Apparently, the German electorate is Ricardian, meaning the only way the Germans can be induced to spend more is if the government itself is willing to reduce its own net spending. This is not merely a question of economic behavior but a formal commitment since the promise to pursue a balanced budget in Germany has just been enshrined into law.

**Action Items for the G-20**

What then will Chancellor Merkel bring to the table at the G-20 in Seoul? Together with her fellow European leaders, she is going to back the United States in its increasing confrontation with China. This will provide a critical swing in the pressure that other G-20 members can apply on China to pursue greater flexibility in its exchange rate policies by allowing the yuan to appreciate vis-à-vis the major global currencies. This means that other emerging economies—both G-20 members and non-members—will be relieved that they need not openly sideline against China. Simply nodding this time may be enough.

Yet, agreement on moving toward market-determined exchange rates will not solve the global imbalances, though it will certainly generate an important pre-condition. What is key is that G-20 leaders agree in Seoul on a coordinated macroeconomic plan that would reduce savings in surplus countries and increase them in deficit economies. The U.S. has offered its availability to pursue a coordinated phased reduction in its current account imbalances but Germany has dismissed the idea while China has not fully disagreed. Will Chancellor Merkel have second-thoughts on her way to Seoul?
TIMELY ACTION BY THE G-20 CAN HELP MIDDLE EASTERN COUNTRIES HELP THEMSELVES

EDWARD SAYRE

Framing the Issue

As nations begin to recover from the worldwide recession sparked by the 2008 financial crisis, the Middle East hopes to continue where its macroeconomic performance had left off, with record levels of growth and job creation. However, in order for this to occur, the G-20 needs to support policies that promote continued private sector job growth in the Middle East as well as trade reform that addresses global imbalances and public sector reform that precludes future budget crises in the region. Saud Arabia, as the region’s sole representative at the G-20 Summit in Seoul, has a critical role in bringing to the table these priority areas that affect the Middle East and North Africa.

The enduring challenge facing countries in the Middle East is high levels of unemployment, which had recently begun to improve before the onset of the 2008 global financial crisis. Leading up the financial crisis, the years from 2000 to 2008 witnessed the highest levels of sustained economic growth for the region in the past 30 years. This boom in the region saw exports and foreign investment rise dramatically, budget deficits shrink, and such strong overall macroeconomic performance that unemployment, the perennial Middle Eastern macroeconomic weakness, fell more dramatically than at any time in its recent history. In Morocco, for example, the unemployment rate fell to less than 10 percent for the first time in 35 years. However, despite improvements in overall unemployment levels, this period of rapid economic growth did not resolve the region’s education and youth employment problems, and countries entered the global slowdown with large pre-existing hurdles, including high rates of youth unemployment and deteriorating job quality.

The 2008 global economic crisis and the regional crisis brought on by the sovereign debt crisis in Dubai in late 2009 threatened to reverse the macroeconomic advances that were supported by the boom. Fortunately, the Middle East was not as severely affected as other regions by the global slowdown and has managed to weather the crisis with relatively strong
growth rates. But, the factors that prevented a recession in the region, including high public spending and lack of integration with the global economy, are now impeding the region’s rapid recovery. According to the World Bank’s most recent Regional Economic Outlook, the region’s sustained growth during the recovery depends on global developments and improved emerging market demand. The G-20 has the ability to assist the Middle East during the recovery phase through guidance and policy support in three areas: trade reform, public sector reform and private sector development.

Policy Considerations

Trade imbalances are a key focus of the G-20 Summit agenda. If the Middle East is going to benefit from the global recovery, it must have support in reducing the large non-oil current account deficits that still exist in most countries in the region. For example, even with a robust tourism sector, Egypt is forecasted to have a record current account deficit in 2010. Specific policies that promote better global trade balances by eliminating currency distortions could improve the balance of trade outlook for the region. However, the most important single factor for improving trade in the short run would be to ensure macroeconomic stability in southern Europe. The fall in Middle East exports has been largely driven by lower demand in Europe; and any continued debt crisis such as those currently being experienced by Greece and Ireland and that threaten Spain and Portugal will harm Middle East trade prospects tremendously. By weakening the euro, these fiscal crises in Europe decrease the competitiveness of Middle Eastern exports.

Another vital area for G-20 assistance to the Middle East, and one that should be addressed during the Summit, comes in the area of public sector reform. Many G-20 nations are reforming their public sector labor market policies due to fiscal crises. Middle Eastern governments have long attempted to offer social protection through bloated public sector payrolls that offer lifetime jobs with generous wages and benefits. The concern is that without a fiscal crisis, governments in the Middle East postpone making difficult decisions about restructuring their public sectors and reversing the perverse incentives that make jobs in the public sector the preferred employment for young graduates. These incentives push young people toward getting an education simply for the credentials needed for government jobs rather than pursuing education and opportunities for skills development as part of a dynamic and productive workforce. The lessons of the current budget crisis in many G-20 countries should not be lost on the Middle East. While Saudi Arabia is the only official member of the G-20 from the Middle East, other countries in the region can work with the G-20 to develop a broad agenda of public sector reform that can avert future fiscal crises brought on by overly-generous public sectors.

The third area that should be addressed by G-20 countries during the Summit is the need for a growing and dynamic private sector. In order for reforms concerning trade and international financial flows to have a direct impact on the Middle East, the private sector needs to be able to respond effectively to international incentives and signals produced by a competitive global economy. The Middle East has too often relied on the public sector to be the engine of job growth, and this is no longer sustainable. However,
the private sector is currently hampered by a regulatory environment that makes it exceedingly costly to hire new workers and expand operations. The private sector in the Middle East is also constrained by limited access to capital and reduced access to markets. Guidance and specific initiatives aimed at developing the private sector in the Middle East can go a long way toward helping private sector firms expand their markets and connect with larger businesses within the value chain of production. This will spur job creation and help in reducing the dependence of young people in the Middle East for government jobs. Given that young people in the Middle East who are without jobs in countries like Lebanon, Morocco and Algeria are likely to seek out job opportunities in Europe, many members of the G-20 have an interest in ensuring that there is sufficient private sector job creation in the Middle East. The G-20 SME Finance Challenge represents a positive step in supporting private sector development in the Middle East and other regions. The G-20 should continue to engage multilateral and bilateral organizations in working together in toward addressing the constraints in private sector development. In the Middle East in particular, the G-20 can capitalize on momentum of the entrepreneurship agenda initiated by President Obama’s Cairo speech and the Presidential Summit on Entrepreneurship held last spring to address these challenges.

**Action Items for the G-20**

The three areas of trade reform, public sector restructuring and private sector development are difficult to tackle and require intra-regional collaboration to devise concrete policy solutions. Saudi Arabia should take the lead in convening a post-G-20 Arab Summit that would bring together leaders from the region to discuss policy reform measures to expand private sector opportunities and better trade integration that would promote long-term growth opportunities for the Middle East.
Framing the Issue

The global economic recession brought to a halt one of the longest periods of economic expansion in Africa during which annual growth rates averaged over 6 percent before the crisis to just about 2.5 percent during the crisis. Recent reports show that overall economic growth in Sub-Saharan Africa declined sharply from 5.4 percent in 2008 to 1.2 in 2009. The primary channels through which the crisis was transmitted to Africa include the collapse of commodity prices and a decrease in foreign direct investment and remittances. The countries heavily dependent on commodity exports such as oil and diamonds, and agricultural commodities such as coffee, were affected much more drastically as the prices of these commodities experienced sharp drops. Poorly diversified economies like oil-rich Angola and Equatorial Guinea experienced double-digit declines in their growth rates. Nevertheless, most African economies have been fairly resilient during the recession as compared to many other economies with the exception of the fast-growing nations such as China, Brazil and India. Many of the economies have started to recover, and 27 of the 52 African countries are projected to have higher growth in 2011 compared to their pre-crisis trend.

Policy Considerations

Africa expects the international community to minimize the possible occurrence of another global economic crisis. It also expects them to take concerted and coordinated efforts to consolidate the gains made and to sustain economic growth in their countries. In this connection, African ministers of finance and central bank governors have held a number of forums from which several issues that they consider crucial have emerged. At the policy level, these efforts have been complemented by the African Development Bank (AfDB), the African Economic Research Consortium (AERC) and the African Growth Initiative (AGI) at the Brookings Institution highlighting some of the issues that are considered to be of major concern to Africa and which the G-20 countries should consid-
er at the Seoul Summit. Four areas of consideration include: greater African representation in the G-20; fulfilling prior commitments and improving transparency; private sector involvement and public-private partnerships; and increased vigilance against illicit resource flows.

**Action Items for the G-20**

**An African Voice in Global Governance**

The first and foremost priority is the issue of Africa’s voice in global economic governance. As President Zuma of South Africa has emphasized on numerous occasions, major decisions on global governance such as those pertaining to the World Trade Organization, the global financial crisis, climate change, etc. should not be undertaken without consulting the developing world.

With a population of nearly one billion, people Africa has only one nation that is participating as a member in the discussions that will go so far in shaping the economic future of the world. Now that the G-20 Summit is to be held in a newly-industrialized country (NIC) for the first time, there is some expectation that the problems of the poor countries might receive more sympathy this time around. Indeed, South Korea has promised to make a strong case for attention to sustainable economic growth. But that goal will be competing with the developed nations’ own challenges of deep unemployment and slow recovery back home. The best way to help the poor countries of Africa is to give them a chance to speak for themselves.

If the decisions of the G-20 are to become rules for everyone to act on, then it is high time its legitimacy were more properly defined and clarified so that all countries of the world can participate as full members of the global community. In the absence of such definition and representation, the imbalance between the rich and poor will very likely become worse.

**Honor Prior Commitments and Improve Transparency**

Africa faces a huge development finance gap that has grown even larger on account of dwindling revenues due to the economic recession. Furthermore, the crisis has substantially eroded economic security of many Africans, resulting in a risk that human development gains made over the past decade could be eroded. Thus, the support from the advanced economies is even more critical as these countries emerge from the recession. Although the industrialized countries have made good efforts in honoring prior commitments to developing countries, there have been substantial shortfalls. The 2010 Africa Progress Report chaired by Kofi Annan shows that some G8 countries have fallen far short of their commitments. While many of the advanced countries continue to face pressure from their citizens, there is a concern that some of these nations will delay in fulfilling their commitments to Africa. This could greatly undermine the progress made so far and the gains from previous assistance. Africans, therefore, hope that with regard to Africa, the G-20 Seoul Summit will focus on the additionality of aid as well as aid effectiveness and transparency.

The expansion of G8 to G-20 is encouraging to Africa and the developing world. There are high expecta-
tions that the enlarged club will be more receptive to the inclusion of Africa’s voice and to the issues that are of concern to the continent and other parts of the developing world.

Private Sector Investment and Public-Private Partnerships

Economic recovery and long-term sustainable growth must involve more vibrant private sectors in the African economies. To this end, African countries have indeed made tremendous progress in improving the investment climate. It is much easier to do business in Africa today than it was just a few years ago. Unfortunately, one of the casualties of the economic crisis has been a substantial decline in foreign direct investment to Africa. With its huge infrastructure financing gap, we see FDI and especially public-private partnerships as viable options for infusing investments and supporting sustainable recovery. Africa hopes that the Seoul Summit will consider strategies for increased public-private partnerships.

More Vigilance Against Illicit Flows of Resources

The development financing gap that African countries face could be greatly narrowed through increased transparency in resource exploitation and revenue allocation. Africa is extremely wealthy and is blessed with many valuable natural resources. Unfortunately, a significant proportion of these resources ends up in developed countries as illicit flows. The Global Financial Integrity (2010) estimates that total illicit flows from the continent over the last 39 years could be as high as $1.8 trillion! The report conservatively estimated that between 1970 and 2008, illicit financial flows from Africa were approximately $854 billion. In evaluating strategies to meet the financing gap, focus must be on curtailing these illicit flows; and Africa needs the collaboration of the G-20 to do so. In addition, the advanced countries should take decisive initiatives to assist in capital flight repatriation.
TAKING ACTION AT THE SEOUL G-20 SUMMIT

COLIN BRADFORD AND JOHANNES LINN

Framing the Issue

Dire warnings of an impending currency war are now widespread. As the global imbalances between the U.S. and China continue, they threaten to disrupt the Seoul G-20 Summit in November. In an atmosphere of rhetorical clashes and doubts of the benefits of cooperation, G-20 countries have been adopting unilateral measures to cope with vulnerabilities arising from large and volatile capital flows, misalignments in exchange rates and perceived price distortions in trade.

Policy Considerations

The inability of finance ministers and central bankers to agree on a path forward for global recovery and rebalancing during the IMF and World Bank annual meetings coupled with the intensifying “global clash over the economy” (Financial Times, October 12, 2010) has increased the pressure on G-20 leaders to address these tough challenges. In Seoul, G-20 leaders have a collective responsibility to agree on a policy package for global rebalancing, financial regulatory restructuring and international institutional reform so to calm the overheated rhetoric and set the course for a steady and entrenched global recovery. However, the recent decisions and agreements made by G-20 finance ministers during their October meeting in Gyeongju show that there is hope for progress.

The global imbalances issue is much broader than fiscal deficits in the United States and exchange rate undervaluation in China; other countries run sizeable deficits and accumulate excessive reserves. Concerted consumption growth in all surplus countries and cautious demand management in all G-20 deficit countries will be needed, not just in the U.S. and China. The agreement by finance ministers in Gyeongju to monitor and limit current account imbalances of all deficit and surplus countries is a step in the right direction. But global imbalances are about more than macroeconomic rebalancing of external deficits and surpluses, and of savings and consumption; structural reforms, investments in human capital, promotion of
R&D and technological and organizational innovations are also necessary.

**Actions Items for the G-20**

1. The long-standing global imbalances are deeply entrenched in the structures of major economies. Fixing them requires time for policies to adjust and for their impact to be felt in the real economy. At the Seoul Summit, G-20 leaders need to reinforce and sharpen the framework adopted by the finance ministers in Gyeongju by aiming for quantitative targets of surpluses and deficits. Beyond Seoul, there will be a need for G-20 countries and others to maintain a continuous focus on this problem, to press ahead with macroeconomic and structural policy reforms and to monitor their effects over a number of years into the future.

2. G-20 fiscal and monetary policy actions do not have to be identical, but they must be coherent and complementary when seen as a whole. The myth that policy coordination means everyone doing the same thing at the same time is getting in the way of everyone doing the right thing in the context of the global economy over the medium term.

3. International institutions, especially the IMF, must play an independent and vigorous role in providing the rigorous analysis and synthesis of the economic trajectories of countries and develop coherent policy options for the G-20 global rebalancing exercise. In assessing country trends and policies, the IMF must be seen as scrupulously fair to all participants and cannot cave to pressures from the more powerful governments. The policy harmonization role of the IMF for the future is as important as its lending and financing role has been in the past.

4. The new G-20 peer review of country policies, based on G-20 country economic submissions and IMF analyses, is crucial to the process of reconciliation and rebalancing. But the new surveillance process will be only as effective as governments want it to be. Governments will have to devise policies that are sensitive to the global economic linkages and will have to be transparent and responsive to feedback. The ultimate responsibility for the effectiveness of the G-20 peer review of macroeconomic policy management rests with the G-20 governments themselves.

5. G-20 summits should focus on concrete, credible outcomes that affect the jobs and livelihoods of people in their day-to-day lives so to address the current underlying public anxieties. Simple, direct communications need to link the often-complex G-20 policy actions to the practical concerns of people.

6. There is no substitute for getting the policies right. As important as communications and clear “messaging” are to global leadership and successful summitry, policy should drive the message, not the reverse. Cynicism, rather than trust, will be the result if grand words of action and cooperation at Seoul are then followed up with half-hearted steps or beggar-thy-neighbor policies.
7. G-20 leaders must make strong commitments to the Basel III accords on financial regulatory reform being put before them in Seoul. This is a critical element in the overall effort to create policies and institutions that can manage the global financial system and economy in a more steady, stable and responsible manner.

8. G-20 leaders need to broaden and deepen the governance reform process in the international institutions. Without buttressing the IMF’s mandate, leadership selection, chairs and shares issues, the IMF cannot take on the ambitious role it needs to play in the global rebalancing effort and in national and global financial reforms. The decision taken by finance ministers at Gyeongju to increase the shares and votes of emerging market economies in the IMF and to reduce the number of European chairs at the IMF Board in favor of developing countries represents significant progress. But without reforming and streamlining the chaotic system of multilateral development agencies, aid money will continue to be wasted and unnecessary burdens placed on recipient countries. In Seoul, G-20 leaders should set up a high-level commission to review the multilateral development system and to devise strong recommendations for its reform.