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Challenges for Global Macroeconomic Stability and the Role of the G7

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edited by
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PART II. COMMENTS BY DISCUSSANTS

“Reduce Policy Uncertainty, Now” Recommendations from Seven Think Tanks to G7 Leaders

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In view of the Italian Presidency of the Group of Seven (G7) in 2017, the Italian Ministry of Foreign Affairs and International Cooperation (MAECI) asked the Istituto Affari Internazionali (IAI) to conduct a research project on “Major Challenges for Global Macroeconomic Stability and the Role of the G7”. The IAI contacted a major policy think tank in each of the other G7 member countries to participate in the project. The participating think tanks are: Center for International Governance Innovation (CIGI, Canada); Centre d’Etudes Prospectives et d’Information Internationales (CEPII, France); Kiel Institute for the World Economy (IfW, Germany); Japan Institute for International Affairs (JIIA, Japan); Royal Institute for International Affairs (Chatham House, United Kingdom); and Peterson Institute for International Economics (PIIE, United States).

As coordinating think tank, IAI has proposed that the project should cover the following three subjects, representing major challenges for G7 policy-makers: macroeconomic policy coordination, international trade relations, and global financial stability. Each participating think tank was asked to prepare a concise paper addressing all or some of the issues from the perspective of its own country, outlining areas of possible consensus for joint actions to be achieved within the Group and offering independent policy recommendations relevant for the G7 deliberations. The seven country papers were presented by their respective authors at an international conference held in Rome on 27–28 March 2017 and discussed by a broad range of experts from academia and international institutions.

The proceedings of the conference are presented in this volume in the following order: the papers of the seven think tanks (T7); the contributions of discussants who submitted written texts; and the remarks of two keynote speakers, Dr. Ignazio Visco, Governor of the Bank of Italy, and Ambassador Raffaele Trombetta, G7-G20 Sherpa to the Italian Prime Minister. The Annex contains the list of contributors and the conference programme.

In this introductory note, a summary of the main points of the country papers and of the discussion will be provided for each of the three thematic sessions of the conference and for the concluding session on the role of the G7. A final paragraph will briefly outline the main conclusions of the project and the policy options recommended to the G7 policy-makers.

Main Points of the Country Papers and Summary of the Discussions

Macroeconomic policy coordination

Despite some positive signs of cyclical recovery in late 2016 and early 2017, there is broad consensus among the T7 about the unsatisfactory performance of the world economy from a structural point of view: growth below potential, persistent unemployment and/or underemployment, low levels of investment and declining productivity, rising income inequality, ageing populations, etc. The T7 are unanimous, albeit with some nuances, in advocating a fiscal stimulus designed to boost public investment and a broad range of structural reforms. There are however significant differences of emphasis on the nature and content of fiscal actions, on the sequencing of fiscal and structural measures and on the appropriate degree of multilateral coordination of such strategies.

CEPII advocates a coordinated fiscal stimulus by G7 economies to promote investment particularly in R&D and in technologies to reduce greenhouse emissions. These are likely to have a more substantial long-term payoff and can play a crucial role in the context of climate change strategies. CEPII also considers it important to strengthen G7 coordination in the implementation of the BEPS (base erosion and profit shifting) programme launched by the OECD and in the monitoring of tax reforms currently under discussion in member countries.

PIIE, recalling the commitment of the Trump administration to provide fiscal incentives to private participation in infrastructure investment projects, envisages a possible compromise agreement in the G7 to coordinated increases in public investment involving Germany and countries with sufficient fiscal space. PIIE also would advocate G7 coordination on tax policies, particularly if the US were to introduce a border adjustment tax, in order to limit its impact on trade flows.

IfW and **IAI** are in favour of initiatives to support public investment while addressing long-term growth challenges through structural reforms. IAI in particular suggests a coordinated approach at both the national and international level: at the national level, fiscal measures should be specifically designed to support structural reforms, exploiting their mutually reinforcing interactions; at the international level, coordination should focus on transnational investment infrastructures (in the energy, transport and ICT sectors) and technological innovation.

Chatham House sees a role for fiscal action by G7 countries with fiscal space, to boost demand and to relieve the burden on monetary policies, thereby allowing a normalization of the monetary stance and a more balanced policy mix; this should also be accompanied by outward-looking structural reforms designed to increase productivity while minimizing possible negative implications domestically and internationally.

JIIA considers it essential that in light of increasing uncertainty for global growth the G7 should reaffirm its support for the policy framework for strong, sustainable and balanced growth agreed in the G20, together with its Mutual Assessment Process. Structural reform should complement monetary and fiscal policies, along the lines suggested by the OECD in its "Going for Growth" programme.

CIGI's contribution outlines a detailed framework for coordination of investments in productive infrastructure, which are essential to provide stimulus to aggregate demand and to boost productivity. Coordination would involve roles for both the G7 and the G20. Each G20 country should implement a National Infrastructure Investment Programme (NIIP), managed by an independent technical commission with the aim of identifying projects that private sector firms would be willing to implement under appropriate legal and regulatory frameworks that would ensure adequate economic incentives. An internationally Coordinated Infrastructure Investment Programme (iCIIP) would be established to ensure that NIIPs are implemented in a coordinated way. The G7 would formulate broad principles regarding consistent international standards for the interconnectivity of key infrastructures, modalities for international coordination of investments, and international consistency of legal and regulatory frameworks. The G20 would oversee the planning and implementation of the iCIIP.

Significant contributions to the debate on the advantages and disadvantages of policy coordination were offered by the discussants. **Douglas Laxton** (IMF) proposed a general framework to design comprehensive, consistent and coordinated macroeconomic policies. Such an approach can be used to support growth at the current juncture but more so in the event of a negative shock to the global economy. Laxton argued that a comprehensive policy strategy should use all three policy prongs – monetary, fiscal, and structural – because applying them in combination overcomes constraints faced by these policy instruments individually. Based on simulations conducted at the IMF, Laxton indicated that coordinated policies across major economies can amplify the effects of individual policy actions through positive cross-border spillovers. International coordination of fiscal and monetary stimulus can boost global nominal GDP, helping to keep debt-to-GDP ratios in check. In sum, the suggested approach would dispel the perception that there is only limited policy space.

Discussants from academia raised a number of questions about the feasibility of policy coordination. Prof **Menzie Chinn** (University of Wisconsin and NBER) noted the challenges faced in policy coordination when there is significant model uncertainty (i.e., when parties cannot agree on the nature of the set of payoffs in the coordination exercise) or when there is a high degree of policy uncertainty (i.e., when policy directions cannot be predicted nor credibly committed to). Under these circumstances, which are likely to persist for some time, Chinn advised policy-makers to be realistic and accept the very limited ability of certain parties to implement even those policies they support, and to focus in on policy areas where the parties can easily implement policy measures. Based on the current uncertain policy climate in the US, Chinn argued in favour of coordination in trade policy and in foreign exchange policy to prevent currency manipulation and a resurgence of protectionism.

The challenge of policy coordination was analysed in a broader context by Prof **Giancarlo Corsetti** (Cambridge INET). He noted that coordination should manage a "great rebalancing" entailing external positions, monetary and fiscal policy mix, private and public debt, income distribution and unemployment in advanced economies, productivity growth and global ecological/health risks. The rebalancing process would take place in a context characterized by high policy uncertainty and where American strategies could lead to an international regime of trade restrictions and financial deregulation (i.e. the opposite of the Bretton Woods regime). Under these circumstances an international initiative to coordinate investment in infrastructure, technology innovation and human capital would provide benefits for various aspects of the rebalancing process (increasing demand, enhancing productivity, reducing the risk of protectionism). However, Corsetti argued that there are complex issues to be addressed regarding the financing, timing, scope and governance of such international investment strategy, which could undermine its implementation. The strategy would also be exposed to the risk of global financial instability, which would test the ability of the international community to elicit crisis prevention and crisis management.

Similar concerns were expressed by Prof **Marcello Messori** (LUISS, Rome), who saw the need for changes in the policy mix of G7 countries in order to overcome the present radical uncertainty. Messori attached great importance to the risks associated with the forthcoming decoupling in monetary and fiscal policies in the EU and the US. The decoupling could trigger an appreciation of the US dollar, thus providing further pressure on the US to take protectionist measures. In a climate of policy uncertainty, rising protectionism and changing policy mixes, there would be a risk that financial market interactions could lead to the worst kind of equilibrium. This situation would call for stronger coordination among G7 countries, particularly focusing on the reduction of current account imbalances. Imbalances are in turn the result of a discrepancy between aggregate savings and investments: policy coordination should channel savings towards productive investment, providing compensation for unintended restrictive impacts.

A more confrontational approach to policy coordination in the G7 was outlined by Prof **Richard Cooper** (Harvard University). On the one hand, non-US members should stand firm in the face of the new American Administration, explaining what are their interests and priorities from a national and international point of view. On the other hand, it should be recognized that the major obstacle to policy coordination, both in the G7 and beyond, are the policies of Germany which result in a combination of surpluses in the balance of payments and in the fiscal budget at the expense of its trading partners, especially in the European Union. Until such conflicting positions are resolved, Cooper was sceptical about the possibility of an agreement on macroeconomic policy coordination and of reviving investment activity with public initiatives, because of the negative impact of policy uncertainty on growth and on business expectations.

International Trade Relations

Recent political events in Europe and the United States have shed light on the growing social discontent with the impact of trade and financial liberalization. A strong and widespread backlash against globalization is currently influencing the political agenda of traditional parties and the debates of policy-makers, economists, international institutions and market participants. The theme has been at the centre of the contributions by the think tanks and of the ensuing discussions. Although a belief in the need to reverse the resentment against globalization and to resist the threat of protectionism was generally shared, different views were expressed on how to translate these intentions into concrete measures and practical international arrangements.

The contribution of **PIIE** acknowledges that the advent of the Trump administration poses a threat to the survival of the open, multilateral trading system that has been gradually built over the last 70 years and that has performed remarkably well even during the global financial crisis: the implications of such a breakdown would be disastrous. At the same time, PIIE argues that a different outcome could be achieved within the G7 provided that members are ready to support a “better trade agenda” that would take into account some of the concerns voiced by President Trump (who has constantly called for “better deals” for the US) and by other anti-free trade advocates. Such an agenda could encompass: (i) plurilateral agreements that include the US and that the new administration might be willing to support (reaffirmation of the WTO standstill rule; implementation of the Trade Facilitation Agreement already negotiated in the WTO; completion of the Trade in Services Agreement and Environmental Goods Agreement); (ii) multilateral and bilateral agreements that do not include the US (such as EU–Canada and EU–Japan); (iii) new bilateral agreements involving the US (a new US–Japan agreement to replace TPP; a new US–EU agreement to replace TTIP; new FTAs, after Brexit, between the UK and other G7 members). Moreover, PIIE argues that the G7 initiative should also include a programme that responds to concern raised about globalization: measures to improve disposable incomes in lower-middle income brackets, strengthened safety nets to counter unemployment and weage reductions, better education and training initiatives. Finally, the G7 should launch a major concerted effort to educate their publics on the benefits of globalization.

CEPII stresses the need in the current political and economic climate to act forcefully to prevent the doom loop between protectionism and retaliation and to address the backlash against free trade and globalization. In the context of quickly changing international economic patterns, with institutions frequently lagging behind, coordination is more useful than ever and yet more difficult to achieve. CEPII is sceptical about the possibility of reviving wide-ranging trade negotiations of the traditional kind at a technical level in the present circumstances and points to the need to address specific issues such as the status of China as a market economy under the WTO accession protocol. This is a highly sensitive issue, with far-reaching implications that can only be dealt with at a political level. Addressing concerns about globalization is also a top political priority and focusing on international trade could be a lever to foster cooperation in other fields such as exchange rates, or social, environmental and tax rules. Coordination in tax policy in particular is a promising avenue as it interacts across various policy areas.

A more cautious position is outlined in the paper by **IfW**, which focuses on the German perspective. Germany continues to defend an open trading system, but it is not prepared to play a proactive role in promoting further liberalization of global trade. Such a position reflects both the widespread scepticism in the German electorate on the gains from globalization and the understanding within the government that further extension of globalization should be subject to stricter public surveillance.

IAI's contribution points to the need to continue to use the WTO framework as much as possible despite the current uncertain political climate. The G7 should try to forge a common trade agenda in view of the next WTO Ministerial meeting, including a full implementation of the Trade Facilitation Agreement. The EU should conclude and implement its trade agreement with Japan and Canada and express its readiness to negotiate free trade agreements with other willing partners, provided that such agreements include explicit and concrete measures to protect the affected members of society from the impact of globalization on their jobs and living standards. In addition, any dispute among partners to the agreement should be brought before an independent supranational body. Finally, IAI underlines the need for stricter IMF surveillance on exchange rate movements, as the spread of protectionism would raise the risk of competitive devaluations and currency manipulations.

The need for stronger cooperation within the WTO is endorsed also in the papers by **Chatham House** and **JIIA**. Chatham House calls for tougher anti-protectionist tools at the WTO to signal G7 countries' commitment to free trade. The G7 could also develop common regulatory standards and encourage mutual recognition in order to reduce non-tariff barriers to trade, especially in services. JIIA believes that G7 members have to contribute in a realistic and pragmatic way to the next WTO Ministerial Conference to ensure its success, while seeking new approaches for trade liberalization, such as the "soft law approach" embodied in the Trade Facilitation Agreement. Chatham House, moreover, advocates a code of practice to avoid countries using competitive exchange rate devaluations under IMF surveillance, while JIIA calls for full compliance with existing guidelines on exchange rates in order to avoid destabilizing financial markets.

The discussion on trade issues was concentrated on a few points. **Prof Cooper** admitted that the global free trade system was in danger because of the positions taken by the new American President. However, he felt that translating pronouncements from an electoral campaign into actual policies was not going to be easy. Moreover, President Trump is not against free trade per se, but is worried about trade with countries that have a large surplus vis-à-vis the United States. Prof Cooper concluded that the room available in the G7 for manoeuvre on trade is not insignificant.

Daniel Gros (CEPS) raised a specific point about welfare gains from trade, arguing that gains come from the reduction of trade barriers rather than from an increase in trade volumes. He noted that trade barriers are already very low in advanced economies, so a further lowering by these countries is not a guarantee of large welfare gains. Trade barriers have been lowered to a lesser extent in emerging economies, where the prospects for considerable welfare gains are therefore larger, also considering that emerging economies now account for a much larger share of the world economy than in the past. He thus suggested that international efforts should concentrate on lowering trade barriers in emerging economies.

Prof **Paolo Guerrieri** (Sapienza University of Rome) argued that trade issues are especially important for the G7 agenda in view of the new mercantilist position of the US and the slowdown of international trade. Other G7 countries should reaffirm their strong willingness to cooperate on trade, raising the prospect of possible retaliation on their part if the US takes protectionist measures. He recognized, however, that the persistence of global current account imbalances, such as the German case, represent a serious obstacle to finding common ground in the G7. More generally, Guerrieri advocated a change in the approach in trade negotiations to take into account the growing importance of trade in services. Standards for trade in services are more difficult to regulate and to negotiate, making international cooperation more relevant in this field.

Global Financial Stability

The risk of a return to conditions of financial instability is seen by the T7 as a possible consequence of the high level of policy uncertainty characterizing the current political and economic juncture. **JIIA** recalls that in view of the increased uncertainties caused by political events within the G7, "stability" has become ever more important.

Chatham House regards the issue of financial stability as an item of a broader "fairness agenda" which the G7 could endorse essentially by underlining the benefits of fair trading arrangements and the value of the multilateral institutions that seek to ensure fairness. In this context, completing the financial regulatory reform coordinated by the Financial Stability Board (FSB) is seen as necessary for financial stability. Reform would remove a negative factor weighing on confidence in banking systems and allow a more rapid restoration of credit channels; stability and fairness considerations should also be taken into account in ensuring that regulations do not hamper banks' profitability.

In its contribution, **IfW** recalls the various phases of the process of regulatory reform since the global financial crisis and points to the need to complete the process both at the European and the global level. To ensure financial stability the paper considers it important to minimize the role of taxpayers in bank bail-outs and to give regulators the power to force troubled banks to restructure or liquidate. Rules have been introduced to that effect, but the risk is that they are not fully implemented, especially for banks that are considered by markets "too big to fail". Further risks arise from the inability of the international community to agree on measures such as a financial transaction tax or short selling constraints. Moreover, the widespread recourse to quantitative easing strategies by major central banks impairs the traditional business model of banks by shrinking net interest margins and the scope for maturity transformation; it also creates a low interest rate environment which encourages risk-taking and the formation of asset price bubbles.

The main argument of the **IAI** contribution is that reform of the financial architecture is necessary but not sufficient to ensure global financial stability. Regulatory reform has to be completed and the regulatory regime needs to be stabilized, putting an end to the period of regulatory uncertainty that has characterized the aftermath of the global crisis. However, IAI recalls the important analytical work conducted by the IMF, the BIS and the OECD which points to the need for a comprehensive strategy of capital flow management that would counter the risks of financial instability created by full capital mobility, while preserving its benefits for the financing of trade and investment. There is consensus among the international institutions that a key role in such a strategy should be played by macroeconomic policies, including monetary, fiscal and exchange rate management as well as by sound financial supervision. IAI notes that little progress has been made so far in the fora of international cooperation to establish a policy framework for capital flow management on a global scale. A G7 initiative on this issue could envisage a unified approach to monitor potential sources of instability and to promote coordinated policy responses to forestall the impairment of the global financial system. The institutional context for the performance of monitoring and coordination would be within the G20, but the G7 could play an important role in the exercise. The objective of the strategy would be to orient global financial markets towards monetary and financial stability: the G7/G20 would provide some form of “multilateral forward guidance”, signalling to markets the determination to counter unwarranted changes in market interest and exchange rates, which may give rise to destabilizing capital flows.

The central lesson to be drawn from the global financial crisis, in the view of **PIIE**, is that global financial stability requires international cooperation in crisis prevention and crisis management. The position of the US on these issues is still unclear but there is a risk that global financial stability may be weakened. In the area of crisis prevention, PIIE argues that reforming and replacing the Dodd-Frank Act is likely to weaken the US financial system. If the US were to scale back its participation in the FSB and its commitment to international financial reform, this could start a race to the bottom in the regulatory field, increasing financial fragmentation and regulatory arbitrage. In the area of crisis management, the crucial issue is the adequacy of the global financial safety net (GFSN) centred in the IMF. Here again PIIE sees a risk of American disengagement when important decisions have to be taken in the coming years regarding the increase of IMF financial resources. This would be a severe blow to the capacity of the international community to manage crises that threaten global financial stability. To cope with this situation, existing regional financial arrangements in Europe and Asia would be called to play a larger role, possibly through an expansion of the existing network of bilateral swap arrangements among central banks. In any case, the non-US members of the G7 will have to impress upon the Trump administration the importance of continuing US support for the financial reform process and for the institutions of international monetary cooperation that are central to crisis management.

Discussants on global financial stability covered a broad range of issues. **Claudio Borio** (BIS) made the point that macroeconomic and financial stability issues are inextricably linked and that all policies – prudential, monetary, fiscal and structural – should take financial stability considerations into account, nationally and internationally. The element that links macroeconomic and financial stability is the financial cycle which, through a sequence of financial booms and busts, causes financial crises involving serious macroeconomic costs. Borio then analyses the risks for the global economy from the perspective of the financial cycle and the policy implications to contain those risks, nationally and internationally. At a national level, policy-makers should address the financial cycle more systematically, rather than relying exclusively on prudential policy to ensure financial stability. Internationally, there is a need to complete the financial reform without weakening prudential safeguards; global safety nets should be preserved and, if possible, strengthened; in macroeconomic cooperation, there is a need to shift the emphasis from current account imbalances to financial imbalances. Borio is not overly optimistic about the probability of progress in these policy areas, but feels that the G7 could act as a catalyst, leading by example in the reconsideration of the process of policy cooperation.

Prof **Luigi Guiso** (EIEF, Rome) placed the issue of global financial stability in the broader context of the "great political reversal" that has originated from the deep scars of the global financial crisis. Guiso analyses the causes of the reversal against trade openness and globalization and concludes that the success of anti-globalization movements is due to their ability to promise protection against any source of insecurity, quickly and at no cost. As the sense of insecurity is widespread, the offer of protection enjoys immediate popular support. Guiso then wonders whether the political reversal will result in the end of globalization. In his view, there are strong factors in the current global production process that make it difficult to unravel. There may be a slowdown in globalization, but not a reversal. Policy-makers, however, will have to deal with the economic insecurity suffered by large segments of society. Traditional policy instruments of social protection may prove to be inadequate given the insecurity produced by the displacement of human capital, as well as rapid changes in industrial structures and in specialization patterns. A more profound rethinking of the welfare state may be needed. The process of financial reforms needs to be completed, but some of the new regulations have created economic insecurity; it is appropriate now to pause and give markets and intermediaries time to adapt to the new regime.

Stefano Micossi (Assonime) returned to the issue of financial reform to warn about the current backlash against financial regulation. In addition to the risk of a repeal of Dodd-Frank in the US, resistance to regulation is now materializing also in Europe, under pressure from German, French and Italian banks. This is probably a reaction to the phase in which lawmakers were willing to introduce new regulations on "everything that moves", but the risk of a race to the bottom initiated by a watering down of Dodd-Frank should not be underestimated. Micossi then expressed scepticism about the use of macroprudential policy as an instrument to pursue financial stability. In his view, if there is compliance with microprudential rules and if microprudential supervision is correctly conducted together with the appropriate monetary policy, that will be enough. Finally, Micossi argued that tax policy coordination is also important for financial stability. Unfortunately, there are conflicting interests within the G7, especially as regards the taxation of profits of American companies operating in Europe. Here again it is important to avoid a race to the bottom, which could induce destabilizing financial flows caused by profit shifting.

Prof **Richard Portes** (London Business School and CEPR) reacted mostly to points raised by Micossi and Borio and in the IfW paper. As to the role of macroprudential policy, Portes disagreed with Micossi underlining the importance of the analysis of systemic risk which is the main objective of macroprudential policy. Doubts about the effectiveness of macroprudential policies concerned the lack of political consensus on the need to endow the bodies entrusted with macroprudential supervision with effective powers to enforce their recommendations. Portes reacted by a point made by Borio on the current level of interest rates by arguing that low interest rates were absolutely aligned with the natural rate of interest, which is actually negative. Finally, Portes argued that the introduction of QE by several central banks had not generated new sources of financial instability, contrary to the position of the IfW paper.

The Role of the G7 in the Global Governance

In the concluding panel, speakers addressed a wide range of issues, economic, political and institutional.

For Prof **Iain Begg** (London School of Economics), the core challenge confronting the G7 is to provide a governance steer to other policy actors on how best to manage globalization. Under current circumstances, governance implies mobilizing support for maintaining openness of the trading and financial system; managing the impact of financial spillovers in case of unwinding of central banks' assets; finding convincing answers for how to manage flows of people; reflecting on medium-term approaches to management of flows of technology and knowledge; and improving the management of the causes and consequences of political uncertainty. Begg surveys various policy options to deal with these challenges and concludes that there may be sufficient consensus on what needs to be done and why, but less clarity on how to make change happen. A focus on the political economy of "*how*?" would be worthwhile for the G7 and the G20.

Prof **Giancarlo Corsetti** believes that G7 meetings should focus on some key objectives: first, to conduct a dialogue on the narrative of the global situation, in order to reach a common perception of the reality and a common diagnosis of what needs to done; second, to identify areas of common concern; and third, to exercise peer pressure on members to maintain good practices. On this last point, it is important not to rely too much on the "house in order approach": although it is appropriate to keep one's house in order, it must be understood that the concept is not safe from a theoretical point of view and does necessarily lead to a better outcome internationally.

In the view of Prof **Paolo Guerrieri**, the G7 could continue to play a significant role despite the growing relevance of the G20 in the field of international cooperation. The G7 should exploit its unique composition of likeminded advanced nations to stimulate and orient the activities of the G20. In the present juncture, the G7 should promote a coordinated strategy to revive productivity on a broad scale. This requires a two-pronged strategy of public investment and structural reforms, aimed at opening markets in key sectors and encouraging competition. This strategy could be defined as both keynesian and schumpeterian as it would act jointly on the demand and the supply side of economic systems, fostering liberalization, innovation and investment.

Domenico Lombardi (CIGI) painted a more sobering outlook for the role of the G7 because of the current lack of consensus among its members on the needed direction of policies. Under these circumstances, the G7 is unlikely to reach agreement on macroeconomic policy coordination, on trade relations and on exchange rate management. The prospects are more encouraging as regards the possibility of launching a broad programme of investment in infrastructures and new technologies. An agreement in this field is more feasible because such a programme would be beneficial to countries experiencing a slack in demand as well as those countries running at full potential. More generally, the coming G7 Summit will provide an opportunity for frank exchanges of views among the leaders, hopefully paving the way for better personal relations and a more cooperative attitude regarding urgent priorities in the international agenda

A somewhat radical evolution of the role of the G7 is outlined in the note by **William White** (OECD). The G7 is facing an existential crisis due to the growing importance of the G20: it can no longer "call the shots" nor can it "go it alone". Without a major reform, the G7 is likely to become increasingly irrelevant, which would be a pity since the G7 still has a lot to offer in terms of policy advice. White suggests that the G7 should withdraw from the business of offering short- to medium-term policy advice about macroeconomic issues, which should be left to the G20. The G7 should instead focus on identifying longer-term problems common to almost all of the G20, along with suggestions as how cooperative actions might mitigate these problems.

The G7 should thus have a new and explicit mandate, a set of instruments to be use in the pursuit of the mandate and a process for ensuring democratic accountability. Regarding this mandate, White provides the traditional list of structural long-term problems to be analysed by the G7, but adds two relatively neglected problems to the research agenda: the role played by credit and debt in the economy and the associated risks and benefits; and the role of the international monetary system in dealing with payments imbalances, monetary spillovers and excessive monetary stimulus. As for the set of powers to pursue its agenda, White suggests the establishment of a permanent G7 Secretariat to overcome the agenda burden that comes from the rotating presidency, and to provide secretarial support. Finally, White proposes a procedure of full transparency about what the G7 proposes to the G20 and what it intends to do on its own to lead by example. A complementary role for the G7 might then be to keep track of the implementation record, listing suggestions to the G20 that have been adopted or not.

Keynote speeches

Ignazio Visco, Governor of the Bank of Italy, stated in his dinner address the importance of reducing global policy uncertainty, in line with the broad consensus expressed during the conference by T7 and discussants. There are encouraging signs that economic growth is gaining momentum on a global scale, but there is ample empirical evidence that demonstrates that persistent economic policy uncertainty is detrimental for economic growth and trade as well. This growing uncertainty has not translated (yet) into financial market volatility. Governor Visco emphasised that this divergence should not be ignored, because this conundrum cannot last forever. Eventually, either economic policy uncertainty will recede or we will witness an increase in financial volatility that will negatively affect global economy. Hence, global policy uncertainty needs to be reduced promptly through an international effort: thinking that this kind of problems can be addressed by national governments alone is just a mere illusion. An open-minded cooperative confrontation is not a simple solution but it is the only efficient one.

In his closing remarks, Ambassador **Raffaele Trombetta**, G7 Sherpa, explained how the key goal for the Italian Presidency of G7 is to build the foundations of renewed trust, trust among countries and trust of citizens towards institutions. To achieve this goal, Italy has set a programme of work which rests on three main pillars.

The first one is “Citizen Safety”, spurring G7 countries to act together to address the worries of citizens caused by different factors, ranging from geopolitical instability to terrorism. A particular attention will be devoted to the phenomenon of human mobility and to the crisis in sub-Saharan Africa and the MENA region. The second pillar is centred on “Economic, Environmental and Social Sustainability”, stressing the importance of implementing UN Paris Agreement “COP21” on climate change and tackling inequality on different levels.

The key word at the centre of the third pillar is innovation, that has to become the catalyst of sustainable and inclusive economic growth. G7 countries need to share their efforts to make sure that the digital revolution can offer an opportunity to reach higher standards of living and of well-being, rather than representing a threat to jobs and employment.

Conclusions

Several areas of consensus have emerged from the T7 papers and the contributions of the discussants:

- The G7 has a role to play in the global economic governance as a group of likeminded advanced countries with a considerable economic and financial weight in the world economy.
- The G7 can exert its influence by providing policy advice and leading by example within the G20, which remains the premier forum of international economic cooperation.
- At the current political juncture, the G7 can provide an opportunity for these countries' leaders to know each other better and reach a common understanding of their respective interests and aspirations; this may contribute to rebuilding a sense of mutual trust among the leaders.
- Despite differences of view on the actual components of the policy agenda, there is a broad consensus among the T7 that a top priority for the G7 is to reduce the exceptionally high level of policy uncertainty which characterizes the current political and economic juncture: this may contribute to preventing a resurgence of financial tensions in capital and foreign exchange markets.
- An early G7 agreement on a programme of investment in infrastructures and new technologies, on defining a "better trade agenda" with adequate social protections, and on completing the financial regulatory reform would broadcast to public opinion and financial markets a powerful stabilizing signal and would contribute to restoring conditions for a strong, sustainable and inclusive growth.

PART I

T7 POLICY PAPERS

1.

Co-ordination in Tense Times: Issues for the G7

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International economic relationships have been marked by increasing tensions in recent months. A political backlash against globalization has materialized in a several industrialized countries, potentially paving the way for more divisive policies in the near future. At the same time, signs are multiplying that international economic patterns are changing quickly, with institutions frequently lagging behind. In such tense times, co-ordination is more useful than ever, even though it is more difficult to reach. This paper lays out a few simple thoughts about possible avenues for such co-operation, spanning across various policy areas. While not the only *fil conducteur*, tax policy appears to be an area of special interest in this respect, as we outline in several places.

1. International trade

Until recently, international trade used to rhyme with turbo-charged growth and (challenging) discussions of liberalization agendas. It is no longer the case. On any account, the prospects for international trade co-operation and development are bleak, to say the least. Fully acknowledging this background is a prerequisite if useful discussions are to be held.

1.1 Slow, unpopular and contentious: the bleak prospects of international trade

The background on international trade issues can be characterized by five defining features.

1) *The slowdown and its protectionist bias*. The slowdown in international trade has been widely commented upon.[1] It is best characterized with respect to the income elasticity of trade, calculated as the ratio between the growth rates of world trade and world income, both expressed in real terms. While an elasticity beyond two seemed to be the rule in the fifteen-year period preceding the 2008-2009 crisis, it has seldom exceeded one in recent years, and trade seems to be decelerating further in the last two years, halting altogether according to some data sources.[2] This slowdown is now widely recognized as being structural, and its main explanations are known. They relate to sluggish income and investment growth, to China's structural rebalancing, to the lesser dynamism of global value chains and possibly to protectionist measures. However, the magnitude of their respective roles remains hotly debated. The IMF conclusion that weak demand and investment is the main explanation suggests that the structural break is external to the trade realm.[3] However, this conclusion is difficult to square with the fact that the decline is apparent not only in growth rate but also in terms of elasticity, and that investment is weak but now growing on a stable path.[4] Many other analyses, in

[1] See, for example, International Monetary Fund (IMF), "Global Trade: What's Behing the Slowdown?", in *Subdued Demand: Symptoms and Remedies. World Economic Outlook, October 2016*, p. 63-119, http://www.imf.org/external/pubs/ft/weo/2016/02; David Haugh et al., "Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What can Policy Do About It?", in *OECD Economic Policy Papers*, No. 18 (September 2016), http://dx.doi.org/10.1787/5jlr2h45q532-en; and ECB Task Force on Global Trade, "Understanding the Weakness in Global Trade. What Is the New Normal?", in *ECB Occasional Paper Series*, No. 178 (September 2016), https://www.ecb.europa.eu/pub/pdf/scpops/ecbop178.en.pdf.

[2] Jos Ebregt, *The CPB World Trade Monitor: Technical Description*, The Hague, CPB Netherlands Bureau for Economic Policy Analysis, September 2016, https://www.cpb.nl/en/node/158802.

[3] IMF, "Global Trade: What's Behing the Slowdown?", cit.

[4] Sébastien Jean, "Comments on IMF's "Global Trade: What's behind the Slowdown?"

addition to the central importance of China's rebalancing, point to the change witnessed in the dynamics of the development of global value chains (GVCs). The spread of protectionist measures is also mentioned, but to date no valid empirical proof has been provided showing that it played a significant role in causing the slowdown. This doubt notwithstanding, there are suggestions that protectionist measures have been accumulating recently. Whatever role protectionism played in explaining the slowdown, it seems increasingly likely that slower trade is spurring protectionist decisions. In contrast to the early 2000s, when access to emerging markets was a *sine qua non* condition for growth, increasing international protectionism appears to be a zero-sum game, in which governments frequently seems to consider protecting their producers against foreign competition as the easiest way to protect their country's interests.

2) *The political backlash against globalization*. Politically, it is evident how contentious trade has become. The American presidential campaign is perhaps the most spectacular illustration of the backlash against globalization, with the two main candidates harshly criticizing international trade and its consequences. Donald Trump's protectionist agenda seems to have played a significant role in the decisive victories he won in Rust Belt states. Similarly, opposition to globalization has been shown to have played a key role in explaining the leave vote in the Brexit referendum, even though this was not the question asked.[5] In a different way, the psychodrama surrounding the official signature of CETA, the agreement between the EU and Canada, also revealed the depth of tensions on trade issues. Through these examples, it becomes clear that globalization is increasingly divisive in Western societies, with some opinions and constituencies feeling left aside, or at least feeling that the gains from globalization are not well shared, and are not worth its costs. Resounding demands for protection are expressed, which are a priority for many constituencies.

– Or Why There Is More to Trade Slowdown than Weak Demand", in *Le Blog du CEPII*, 18 October 2016, http://www.cepii.fr/Blog/bi/post.asp?IDcommunique=483.

[5] Italo Colantone and Piero Stanig, "Global Competition and Brexit", in *BAFFI CAREFIN Centre Research Papers*, No. 2016-44 (November 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2870313; Diane Coyle, "Brexit and Globalization", in *VoxEU.org*, 5 August 2016, http://voxeu.org/node/61004.

3) *The WTO seems unable to deliver updated rules*. As regards multilateral negotiations, the WTO has hosted long overdue multilateral agreements in both of its latest ministerial conferences. While these agreements are in themselves valuable achievements, though, they fall short of meeting the ambitions set when the Doha Round was launched, back in 2001. As a matter of fact, they also fall short of addressing the need to update the rules governing international trade, more than 20 years after the Marrakech Agreement was signed. Since the failure to reach an agreement in 2008, it has become clear that the main trading powers cannot agree on a substantial, wide-ranging agreement in the multilateral trade arena. Put differently, the WTO no longer seems to be a forum where the rules of the game can be significantly renegotiated.
4) *Unclear whether an update can be expected from regional trade agreements either*. This reality explains to a large extent why regional agreements have flourished. For a long time, they were mainly used to organize trade relations between neighbouring countries, and their development with more distant partners remained limited, with the exception of a few countries like Chile, Mexico or Singapore, engaging in a strategy of additive regionalism. After 2008, and particularly from 2012 onwards, it has seemed that mega-regional deals could play a central role in setting new rules to govern international trade. With recent political developments, this prospect is vanishing. Not only does it seems that the incoming US administration is unlikely to proceed with ongoing projects, the recent CETA and TTIP controversies in the EU suggest that it will be difficult for the block to secure important regional trade deals in the near future –even though cannot be ruled out that the negotiation with Japan may be brought to a successful end. In sum, regional agreements may also no longer be an option for meaningfully updating international trade rules.
5) *National policies, trade defence and China's new status*. Against this background of paralyzed international negotiations, national policies may well remain the only game in town. As a matter of fact, accounts of trade-restrictive national policies suggest that they are spreading,[6]

[6] WTO, *Report on G-20 Trade Measures (mid-October 2015 to mid-May 2016)*, 21 June 2016, https://www.wto.org/english/news_e/news16_e/trdev_21jun16_e.htm. See also

even though the actual importance and restrictiveness of measures is difficult to assess and to compare with one another. Among the increasingly debated measures are trade defence instruments. Such instruments are legal under WTO agreements, but their use is codified through specific agreements, in particular those related to antidumping and to subsidies and countervailing measures.

This issue has become topical with the expiry of the 15-year transition period following China's accession to the WTO, during which the accession protocol allowed specific practices through which using a surrogate country method to instruct antidumping investigations against Chinese producers could be done without justification. China's request for consultations on 12 December 2016 is a first step towards a judicial settlement of the dispute surrounding the expiry of Article 15 (a) (ii) of its accession protocol to the WTO. That this dispute is to be settled based on existing rules and institutions might be interpreted as a signal that the system is able to cope suitably with this question. Such interpretation may well prove optimistic, though, for at least two reasons. The first one is that the stakes of these disputes are considerable, potentially far exceeding what the WTO's DSS has dealt with so far. Antidumping has so far been the most influential trade defence instrument, and China already been the leading world exporter for a few years. As a result, the stakes associated with changing the way of dealing with antidumping investigations against Chinese exporters are potentially very high.[7] In this context, it is questionable whether all parties will accept ensuing rulings. Recent examples have also shown how disputes can entail WTO-illegal retaliations, even though they are not explicitly presented as such. The second reason is that more than antidumping is actually at stake. While Article 15 (a) (ii) of China's accession protocol specifically deals with antidumping, the question raised by the expiry of this transition period is whether China has indeed transitioned to a position where it can be considered as playing by the rules defined by WTO agreements. The in-

Global Trade Alert reports, http://www.globaltradealert.org/analysis.

[7] Cecilia Bellora and Sébastien Jean, "Granting Market Economy Status to China in the EU: An Economic Impact Assessment", in *CEPII Policy Briefs*, No. 11 (September 2016), http://www.cepii.fr/CEPII/en/publications/pb/abstract.asp?NoDoc=9421; Chad P. Bown, "Should the United States Recognize China as a Market Economy?", in *CEPII Policy Briefs*, No. 16-24 (December 2016), https://piie.com/node/12318.

ternational trading system includes a special and differentiated treatment for developing countries, and it can accommodate waivers and exceptions for relatively small players and for countries in transition. China raises a different problem, though, because it combines a position as a trade superpower with high level of State intervention in trade.

1.2 Priorities for a co-ordination agenda

In sum, international trade relationships are undeniably facing a tense situation, from both an economic and political point of view. Against this background, aiming at wide-ranging negotiations or more-of-the-same trade liberalizations would be pointless. Priority should instead be given to preventing the doom loop of protectionism and retaliation, and to addressing the political concerns about globalization.

1.2.1 Preventing the raise of protectionism and trade conflicts: so far, so good, but it may not last

Even though protectionist measures have been spreading recently by some measures, the modern international trading system can be credited with a rather good track record on preventing the rise of protectionism. Fears that the 2008-2009 economic and financial crisis would spur protectionist reactions did not materialize, at least not in a disruptive way. It is difficult to establish any causality in this respect, and the realization that protectionism can be very costly in the GVC era probably played a significant role in explaining this relative moderation. Still, it is fair to credit the WTO with a good track record in preventing trade conflicts and the rise of protectionism. However, acknowledging this positive role does not mean that enhanced efforts are not needed in this area, for several reasons. Firstly, the WTO's Dispute Settlement System (DSS) is overloaded. There is a growing disproportion between the expectations placed by Member States as to its capacity to settle high-stakes, complex disputes on the one hand, and its light endowment in staff and budget on the other hand. The Appellate Body is probably the case in which this disproportion is most egregious. Accordingly, as its chairman recently declared, "almost certainly there will be delays and queues".[8] Beyond this understatement, it should be clear

[8] Thomas R. Graham, *Speaking Up: The State of the Appellate Body*, Special lecture hosted

that we are already in a situation where the WTO's DSS cannot play its role in a satisfactory manner, while it is facing the prospect of a "tsunami" of new cases, as Chairman Graham noted. Another possible threat to dispute settlement in the WTO is the creation of other bodies under different institutional frameworks, as has been considered in the context of negotiations or projects concerning the TPP or the Trade and Services Agreement (TiSA) negotiation. None of them is likely to be operational and effective at a large scale in the near future, but the sheer existence of these projects shows that the *de facto* monopoly enjoyed by the WTO in rule-based settling of international trade disputes cannot be taken for granted.

Another dimension of the WTO's contribution to preventing trade conflicts is its monitoring efforts. The value of this work should not be understated. Trade policy reviews and notifications have greatly increased the level of information available about partners' practices. Here again, though, several concerns remain. A recurrent one is that notification obligations are often late or imperfect.[9] Strengthening discipline and enforcement in that respect is required if the WTO is to play its role. Another concern is the increasing complexity of trade-distortive measures. Tariffs are increasingly constrained by WTO disciplines, they appear as an unnecessary cost to importers (including those belonging to an international value chain), and their overt protectionist character risks inducing tensions or retaliation. For that reason, a variety of other measures are increasingly used, which are far less easily measured and compared. This "murky protectionism",[10] including bias norms and standards, local content requirements, licensing, subsidies, and buy local provisions, makes it all the more challenging to produce wide-ranging, consistent and comparable data and analyses, as mentioned above. Renewed efforts are required to monitor effectively new developments.

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by the World Trade Institute of the University of Bern, the University of Geneva Law School and the Graduate Institute of International and Development Studies, Geneva, 22 November 2016, p. 7, https://www.wto.org/english/news_e/news16_e/ab_22nov16_e.pdf.

[9] For instance, the latest notification on domestic support in the agricultural sector refers to 2001 for Turkey, 2008 for Thailand, 2010 for China and 2010-2011 for India (source: WTO Agriculture Information Management System, acceded on 23 December 2016.

[10] Richard Baldwin and Simon Evenett (eds.), *The Collapse of Global Trade, Murky Protectionism, and the Crisis: Recommendations for the G20*, London, Centre for Economic Policy Research (CEPR), March 2009, http://voxeu.org/node/3199.

Beyond modalities, the deeper threat to the WTO effectiveness in preventing trade conflicts probably relates to its legitimacy. Like any organization gathering sovereign states, the WTO has no authority, the materiality of its influence critically hinges upon its principles, rules and institutions being considered as legitimate. Any member considering it more profitable to get rid of the system, or even simply of its commitments under the system, is free to do so. As emphasized above, however, Member States clearly seem unwilling or unable to agree upon a substantial update of the multilateral agreements the organization relies upon. Put differently, the WTO is condemned to work based on rules that were defined in a period where internet and mobile phones were barely known, and where the term "emerging countries" was mainly used to refer to Taiwan, Singapore and the like. Should the inability to update them endure, their legitimacy will inevitably erode.

The bottom line is that the capacity of the multilateral trading system to prevent large-scale trade conflicts or a protection upsurge may not last for long if left as is. Reform is thus indispensable. Having emphasized that multilateral and even regional agreements are not a realistic prospect to do so, it means that only political initiatives by the main actors and negotiations among them are likely to deliver. The most pressing issues have also been mentioned: addressing the questions raised by China's new status, and by the political backlash against globalization.

1.2.2 China's new status calls for political negotiations

The importance of the questions raised by the 15th anniversary of China's accession to the WTO has already been discussed above. The disagreement is deep, with China considering that its partners are not abiding by their commitments regarding antidumping procedures, while its partners do not view the functioning of its economy as being consistent with WTO rules. As a matter of fact, the present situation is paradoxical: the multilateral trading system, set up to ensure fair and undistorted competition among market economies, is now dominated by a country whose economy remains largely centralized. This is not to deny the remarkable transition of the Chinese economy over the last 15 years, nor its increasing reliance on market mechanisms. But it remains undeniable that state intervention is ubiquitous in its economy, in a way that bears no comparison with other major trading countries. Antidumping procedures cannot be considered independently from this specificity, because the former has thus far been one of the important ways used to cope with the consequences of the latter.

Among the main agreements on which the WTO relies is the one regarding subsidies and countervailing measures. This agreement stipulates that "no Member should cause, through the use of any subsidy" which would be "specific to an enterprise or industry or group of enterprises or industries", "adverse effects to the interests of other Members".[11] As a matter of fact, it is difficult to assess practically how such commitments should apply to China, where government intervention is widespread through credit allocation, land and energy prices, state enterprises, licensing and authorizations, or VAT rebates on exports. And no doubt Chinese competition has serious consequences for its trading partners.[12] Given the pressing demand for protection, it is impossible for China's main trading partners to renounce the main tool they have been using so far to deal with this competition without receiving guarantees in exchange.

The present context actually makes it legitimate, and probably even necessary, to make sure that defence instruments are efficient and timely enough to grant real protection to workers and firms when they are threatened by unfair competition. As long as such reform is principled and consistent with international commitments, it should be welcome. Rather than a purely judicial dispute, which may end up jeopardizing the whole institution, China's new status requires a political negotiation between the main partners to discuss how institutions and policies might be adapted to this new context. Political discussions about how to deal with overcapacities in the steel industry are an example of such negotiations.

1.2.3 Addressing concerns about globalization

More generally, addressing concerns about globalization should be a political priority. Part of the answer is necessarily national, through tax, ed-

[11] WTO, *Agreement on Subsidies and Countervailing Measures*, https://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm.

[12] See e.g., David H. Autor, David Dorn and Gordon H. Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States", in *American Economic Review*, Vol. 103, No. 6 (October 2013), p. 2121-2168.

ucation, infrastructure and territorial policies, for instance. In terms of international agenda, the question is how co-ordination might help in this respect. Trade is a case in point because it is an area of direct interaction between countries, where a number of binding agreements exist or are being negotiated, hence questions about the necessity to include in trade agreements commitments and disciplines regarding non-trade areas such as exchange rates, or social, environmental and fiscal rules.

The rationale to do so is twofold. Firstly, international trade can be used as a leverage to foster co-operation in other areas, because it lends itself comparatively well to valuable, verifiable and actionable commitments. As this leverage is potentially large given the intensity of international trade flows, not using it would mean missing a valuable opportunity. Secondly, there is a strong complementarity between trade policy and other areas, as lowering barriers to trade increases the leakage effects associated with other regulatory policies. Indeed, when a country engages in regulatory competition by relaxing its requirements to lower production costs, both the potential benefits and the costs involved for any partners increase as barriers to trade are lower. Put differently, less costly trade means easier regulatory arbitrage, so that liberalizing trade without taking other areas into account may create a risk of levelling down regulations, or at least exacerbating the perverse consequences of policy asymmetries.

Non-trade provisions entail risks, though. The most obvious is that overburdening trade policies may make it impossible to reach an agreement, thus paralyzing the instrument.[13] Non-trade issues should thus be restricted to areas where a significant result can reasonably be hoped for. An additional risk is intrusiveness and useless interference with national sovereignty. The Brexit vote has illustrated how these matters can be sensitive, and the legitimacy of trade agreements in non-trade issues only goes so far.

How to proceed, then? Concretely, non-trade provisions are already included in most trade agreements, especially those recently signed, and in particular in relation to social and environmental issues. In most cases,

[13] An additional complication in the EU case is that non-trade provisions are likely to reinforce the mixed nature of agreements, as opposed to purely trade agreements, which fall under the exclusive community competence.

though, their effective impact has remained limited so far. In rethinking their reach and design, the discussion above suggests a few principles. The first one is to favour an approach based on minima and guarantees. This makes it possible to prevent excessive gaps in practices, without impinging upon the expression of national preferences on the areas concerned. The second one is to focus upon verifiable commitments. It is noteworthy that tax policy is a very suitable area in this respect, even though tax bases are less easily codified and compared than tax rates. Where commitments cannot be verified and auctioned as needed, cooperation and information might be a more fruitful approach. The third principle is to favour automatic mechanisms. The "consistency plan" included for Vietnam's social commitment under the late TPP is an interesting example. However, dispute settlement has proved ineffectual so far in bilateral agreements, and is at risk of saturation in the multilateral arena. The fourth principle is that it should be more easily understood and accepted that commercial benefits should be foregone when they conflict excessively with other objectives. In other terms, this means wondering whether further trade liberalization is really desirable without agreements on basic principles. After all, trade is an instrument, not a policy objective *per se*.

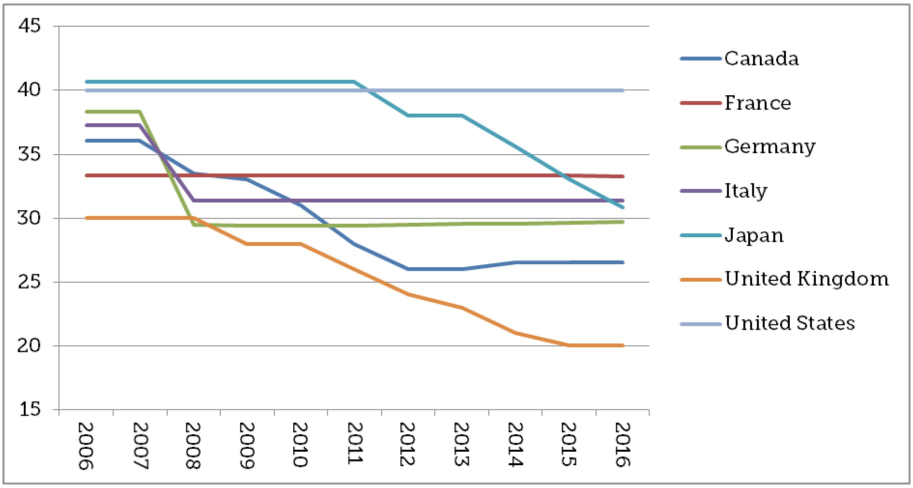
2. Profit shifting and tax competition

In December 2012, the G20 group of nations in Los Cabos supported the OECD "Base Erosion and Profit Shifting" initiative to address the issue of multinational profit shifting. Three years later, some progress has been made on the data sharing while important parts of the agenda still need to be implemented and enforced. In the meantime corporate tax reforms are being discussed in several G7 member countries at different stages of elaboration and the legislation process. Some proposals would have significant implications on trade and capital flows, the localization of multinational economic activity, and exchange rates. As a consequence, tax competition is still a mostly relevant international matter and multilateral coordination among G7 member countries on corporate tax is certainly required.

2.1 Why is the taxation of multinational corporations (MNCs) still on the international agenda?

At the aggregate level, increasing trade liberalization has led to a generalized gradual decrease in the corporate tax rate in advanced economies justified as to avoid a loss of national competitiveness in industrial recruitment and retention. This decline could still be ongoing: in fact, while the optimal tax rate has been estimated around 30 percent[14] several G7 countries have a higher corporate tax. This simple observation suggests that political pressures to reduce the corporate tax will continue to be strong (Figure 1).

Figure 1 – Statutory tax rates



Source: KPMG.

In several countries, the current dismantling of multilateral trade agreements goes hand in hand with the unilateral move of cross-border corporate taxation in several countries. On the one hand, following the Brexit referendum, the United Kingdom has used the corporate tax rate as leverage in their negotiations, a fact that has stirred tensions with EU members. The UK has stated that the failure to reach an agreement with the

[14] Alan J. Auerbach, James R. Hines Jr. and Joel Slemrod (eds.), *Taxing Corporate Income in the 21st Century*, Cambridge and New York, Cambridge University Press, 2007.

EU on the trade dimension would entail the UK lowering its tax rates to attract investors.[15] On the other hand, the economic agenda of the new US administration includes corporate tax incentives to bring manufacturing activity back to the US (more on the US corporate tax reform below).[16]

In addition to the political pressure to reduce the statutory tax rate, the effective tax rate has actually declined because of the practice of income-shifting by MNC. The term "income-shifting" generally entails both strategic transfer pricing (i.e. charging relatively low prices for goods and services transferred from high-tax to low- tax affiliates) and the strategic use of inter-affiliate debt (i.e. financing the activities of high-tax affiliates using debt issued by low-tax affiliates). The consensus of the recent literature is that a 10 percentage point increase in the tax rate difference between an affiliate and its parent would increase the pretax income reported by the affiliate by 8 percent. For example, if the tax rate in the affiliate's country falls from 35 to 25 percent, the pretax income reported by the affiliate is estimated to increase from 100,000 to 108,000 dollars.[17] As far as inter-affiliate debt is concerned, Mooij estimates that a reduction in the corporate tax rate from 35 to 25 percent reduces the debt-to-asset ratio by 2.8 percentage points.[18] In total, the OECD estimates that 240 billion dollars in global corporate income tax revenues are lost annually.[19]

Has income shifting grown over time? Several studies have found that tax-motivated income shifting within multinational firms has indeed increased over time: for example, Grubert showed that foreign income of more than 700 US MNCs has grown more than their foreign sales over

[15] George Parker, Jonathan Ford and Alex Barker, "Is Theresa May's Brexit Plan B an Elaborate Bluff?", in *The Financial Times*, 19 January 2017, https://www.ft.com/content/3501446a-de36-11e6-86ac-f253db7791c6.

[16] Chris Giles, "Prepare for Donald Trump's corporate tax revolution", in *The Financial Times*, 18 January 2017, https://www.ft.com/content/5b1c8314-d9a2-11e6-944b-e7eb37a6aa8e.

[17] Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature", in *Fiscal Studies*, Vol. 35, No. 4 (December 2014), p. 421-448, http://dx.doi.org/10.1111/j.1475-5890.2014.12037.x.

[18] Ruud A. de Mooij, "Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions", in *Fiscal Studies*, Vol. 33, No. 4 (December 2012), p. 489-512.

[19] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1. 2015 Final Report*, Paris, OECD, 2015 (OECD/G20 Base Erosion and Profit Shifting Project), http://dx.doi.org/10.1787/9789264241046-en.

1996-2004.[20] This might result from the dematerialization of the economy due to a growing service economy which increases the capacity of multinationals to exploit tax differences. Indeed Dischinger and Riedel find that intangible asset holdings are disproportionately concentrated among affiliates in low-tax jurisdictions: a decrease in the average tax difference to other affiliates of 1 percentage point raises the subsidiary's level of intangible assets by 2.2 percent.[21] The impact on intangible assets is even stronger: Karkinsky and Riedel estimate that an increase in the corporate tax rate of 1 percentage point reduces the number of patent applications by 3.5 percent.[22]

Lastly, from a political perspective, the current global macroeconomic context of tight fiscal space amplifies the public pressure to address multinational income shifting. In fact, there is a widespread public concern that fiscal revenues are lost from profit shifting activity. Subsequently, a tighter monitoring of MNCs' income tax collection is expected to enhance equity and social justice among taxpayers.

2.2 Why is G7 coordination required for the taxation of multinational corporations? The BEPS three years later

A set of policies implemented to address base erosion and income shifting has started to be implemented thanks to the coordination of the OECD BEPS program, supported by the G20 group of nations in Los Cabos. This initiative consisted of fifteen specific action intended to facilitate multilateral cooperation among governments with regard to the taxation of MNCs, with the general objective of seeking to "better align rights to tax with economic activity".

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[20] Harry Grubert, "Foreign Taxes and the Growing Share of US Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized", in *National Tax Journal*, Vol. 65, No. 2 (June 2012), p. 247-282. It is worth mentioning though that some studies find that the tax-sensitivity of reported income has fallen.

[21] Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets within Multinational Firms", in *Journal of Public Economics*, Vol. 95, No. 7-8 (August 2011), p. 691-707.

[22] Tom Karkinsky and Nadine Riedel, "Corporate Taxation and the Choice of Patent Location within Multinational Firms", in *Journal of International Economics*, Vol. 88, No. 1 (September 2012), p. 176-185.

It is important to underline that the BEPS initiative has been a major success as far as issue awareness and data sharing are concerned. Substantial progress has been made in data sharing with the MNCs' country-by-country reporting of indicators of economic activity.[23] In addition, automatic exchange of information is implemented across fiscal administrations on a bilateral basis.[24] We observe that the bilateral feature of automatic exchange of information introduces the possibility that small countries are treated unfavourably. Therefore we recommend making the automatic exchange of information a multilateral necessity. In addition, in order to enhance the monitoring and evaluation of effectiveness and impact of BEPS by the civil society, we recommend making reporting publicly available. This is particularly relevant to promote statistical research.

Last, the BEPS initiative upgraded rules for transfer pricing to align outcomes with economic reality. In fact up to 60 percent of international exchanges are intra-group exchanges, a fact that suggests the large use of strategic pricing and inter-affiliate debt to reduce the tax burden.

2.3 Unilateral tax reforms

In addition to the BEPS initiative, reforms are discussed at the national level to address the currently prevalent forms of income-shifting in different G7 countries. We want to warn here that some proposals may imply massive changes in the geography of international activity of multinationals and changes in relative prices. It seems key to us to identify the implications of each proposal and set up multilateral discussions.

Since June 2016, the United States House of Representatives has been examining a tax reform which would move the corporate tax from a source-based to a destination-based cross-border tax and from income to cash flow tax (companies are allowed to expense capital investments,

[23] Action 11 requires the MNCs country-by-country reporting of their foreign activity including their turnover, number of employees, taxes, profit and losses.

[24] Swiss Federal Department of Finance, *Questions and Answers on the Automatic Exchange of Information*, 14 January 2015, https://www.newsd.admin.ch/newsd/message/attachments/37903.pdf. See also Swiss Federal Department of Finance, *Questions and Answers on the Automatic Exchange of Information*, 29 September 2015, https://www.sif.admin.ch/dam/sif/en/dokumente/Automatischer-Informationsaustausch/AIA-QA-_29.09.2015_E.pdf.download.pdf/AIA-QA_29.09.2015_E.pdf.

i.e. they can write off capital investment on day one rather than gradually over a period of year. Interest payments are no longer deductible). It is named a destination-based cash-flow tax (DBCFT). An important provision largely debated in the United States is the border adjustment, i.e. the fact that the corporate tax is applied to all domestic consumption and excludes any goods or services produced in the United States, but consumed elsewhere. In order to make the corporate tax border adjustable, the revenue from sales to nonresidents are no taxable, and the cost of goods purchased from nonresidents are deductible. So if a business purchases 100 million dollars in goods from a supplier overseas, the cost of those goods are deductible against the corporate income tax. Likewise, if a business sells goods to a foreign person, the revenues attributed to that sale are added to taxable income.

An exhaustive analysis of the implications of such a reform is beyond the scope of this paper. However, we would like to point out potential issues as far as international cooperation is concerned.[25] The first issue that would need to be discussed is whether the US tax reform can potentially trigger a race to the bottom. Countries watching their tax bases drift to the US could be tempted and domestically pressured to adopt a similar system. The second issue is to determine whether the reform is WTO compatible. On the one hand, those in favour of this tax argue that the import tax is similar to the VAT tax already applied by a majority of countries; on the other hand, those against point out that the reform combines an import tax and an export subsidy, each of which justifies a case at the WTO. A last potential implication is the effect of the reform on factors allocation, relative prices and the exchange rate. On the one hand, US multinationals have a strong incentive to repatriate production to the US; on the other hand, the DBCFT provides a tax incentive to multinationals of any nationality to transfer headquarters to and produce in the US and export from there to the rest of the world. If these circumstances were to hold, i.e. a repatriation of production factors to the US, one could expect a significant appreciation of the US dollar.

[25] This reform “could be the biggest shake-up of cross-border taxation since the 1920s” according to Michael Deveraux, a tax expert and director of Oxford University Center for Business Taxation. See Barney Jopson, Sam Fleming and Shawn Donnan, “Trump and the Tax Plan Threatening to Split Corporate America”, in *The Financial Times*, 13 February 2017.

In the meanwhile, the European Commission has developed the proposal of a Common Consolidated Corporate Tax Base (CCCTB), first proposed in March 2011.[26] After stalling because of diverging interest among members, the proposal was relaunched by the European Commission in 2016.[27]

The European Commission proposal keeps the income for the tax-base and uses an apportionment formula based on factors of production. The European Commission proposal departs from separate accountings for each affiliate. Instead of separating out the activities of different legal entities within the same economic firm, the tax reform project consists in defining a consolidated entity, calculate an aggregate income and split profit according an economic activity criterion. More precisely, the tax base is consolidated and the allocation of corporate income is apportioned according to an apportionment formula.[28]

In addition several designs are discussed to reduce or eliminate the tax-induced debt bias in corporate taxation.[29] However it is important to have in mind that the tax base is not significantly changed in these different designs, i.e. a major difference with the cash-flow tax system proposed in the United States.

In sum, the current tax reform proposals may well reduce profit shifting but entail production shifting and exports subsidies. More generally, it is key to set up a multilateral coordination among G7 member countries to assess together the implications of such proposals and consider cooperation.

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[26] With the CCCTB, cross-border companies would comply with one, single EU system for computing their taxable income. Companies would file one tax return for all of their EU activities. Corporate tax rates in the EU would not be changed by the CCCTB, as EU countries would continue to have their own corporate tax rates. Allocated profits would be taxed according to the national tax rates. In sum, while addressing income shifting this new proposal introduces incentives to shift production factors to low-tax countries.

[27] See the European Commission Taxation and Customs Union website: *Re-launch of the Common Consolidated Corporate Tax Base (CCCTB)*, http://europa.eu/!bK83jP.

[28] More precisely, the new tax scheme would make it possible to consolidate EU taxes and the group income would be allocated to each member state according to the proportion of production factors located in these countries.

[29] The design of corporate tax systems in most countries allows for the full deductibility of interest payments, while preventing it for dividend payments.

3. MACRO-COORDINATION

Two features in the current macroeconomic context of the advanced economies call for coordinated policies to support and boost demand-side: (1) the persistence of a low activity growth and the inefficacy of the current policy mix to reverse the course; (2) the rising probability of a recession and the lack of room for rate-cutting if recession materializes. The current mix which mostly relies on unorthodox super accommodative monetary policy and in the Eurozone structural reforms is not sufficient. Policy measures need to be implemented to restore the demand for investment.

The main indicator suggesting a persistent deficient investment demand is the persistent decline of the real interest rates in the advanced economies. There is a common downward trend in interest rates of advanced economies since 1985. As a result the actual and potential GDP of the G7 countries have substantially declined. It is due to a combination of long term features and specific post-crisis features.

On the long term factors dimension, the rising inequality has shifted income to the wealthy households who have a lower marginal propensity to consume.[30] The IMF has estimated a resulting decline of global consumption by 3 percent. A demographic factor of ageing population is responsible for higher savings, lower consumption and lower demand for capital – basically, elderly buy less houses. The third factor is the *demassification* of the economy, i.e. the development of high value-added services with little traditional investment.[31]

On the post-crisis features dimension, an implication of this analysis is that the financial crisis cannot be held fully responsible for the current low growth environment. However the interaction of an unprecedented financial shock with these long run trends has resulted in a moving sand-like macroeconomic management situation. Advanced economies have implemented massive unorthodox monetary policies to force down the

[30] The real interest rates clear the market for loanable funds. Its equilibrium value is determined by the demand for funds to finance public and private investment and the supply of saving.

[31] AirBandB is the often-cited illustration of the low impact this surging tourism activity has had on the demand for real estate. Similarly, the average law firm uses half as much space per lawyer today because of the Internet Cloud, implying a lower demand for real estate investment.

nominal interest rate. While the short term objective was to address the global systemic risk and restore the financial sector balance sheets, the resulting negative real interest rates bring macroeconomic management to a deadlock. If real interest rates are low and even negative in normal times, there is no room left through forward guidance to address adverse macroeconomic shocks.

The current state of business and the financial cycles in advanced economies suggest that the probability of a recession in the next three years is sizeable (2020). More particularly, the fact that the US economy has been growing for the last five years suggests that the odds of a recession within the next three years are going up. The fact that the current interest rates are historically low in the advanced economies and the unorthodox monetary package still highly active implies minimal room for rate-cutting as a monetary response to a recession. In sum, the economic policy mix looks ill-prepared for the next recession. The inability of monetary policy to restore a full employment saving-investment balance in the case of an adverse shock calls for complementary policy instruments.

In sum there is a significant need for fiscal stimulus to restore the demand for investment. And the current global challenges entail a logic focus on greenhouse reduction technologies.

There is an urgent need for coordinated policies that can reverse the course of long term features responsible for low growth: the objective is to increase productivity and restore the demand for investment in advanced economies.

Empirical surveys find that different category investments have different long-term payoffs with investment in research and development performing best. Global greenhouse gas emissions, a main driver of climate change, continue to rise rapidly. Since its inception, the United Nations Framework Convention on Climate Change (UNFCCC) has emphasized the key role of technology development and transfer in helping to stabilize greenhouse gas concentrations (Article 4.5 UNFCCC). For this to happen, a global adoption of climate change mitigation and adaptation technologies as well as policies that support the effective transfer of technologies are crucial. Quantitative studies show that innovation is mostly occurring in non G7 countries except for Japan. For example, while Japanese companies continue to play a prominent role in the solar PV patent landscape, where the highest rate of technology investment is, China and the Republic of Korea have contributed most in recent years. In solar PV, the top 20 technology owners are based in Asia.

In conclusion, the current low-growth context calls for coordinated demand-boost policies and the current global warming makes it a natural candidate to focus on greenhouse reduction technologies.

Conclusion

The policy paper discusses three important areas of multilateral coordination in the context of widespread opposition to globalization forces, implying inward movements, i.e. international trade, financial stability and international coordination of macroeconomic policy.

International trade relationships are undeniably facing a tense situation and priority should be given to preventing the doom loop of protectionism and retaliation. Our main recommendation is to include commitments and discipline regarding non-trade areas such social, environmental and fiscal rules in trade agreements.

Regarding financial stability, we focus our discussion on the current tax competition across countries motivated by the need to address profit shifting of multinationals. Despite the progress accomplished by BEPS, we emphasize the risk of a race to the bottom that would be detrimental to all. We discuss the implications of the destination-based tax reform and advocate a need for multilateral cooperation on this issue.

As far as macroeconomic coordination is concerned, not only has the current policy mix been unable to reverse the trend of low activity growth but we argue that it leaves no room for addressing the future recession, the probability of which is dangerously on the rise. We advocate the need to restore the demand for investment, with a special focus on investments making globalization more sustainable.

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2.

The G7's Task for Restoring Growth and Stability

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1. Current challenges

The global economy is in a fragile state at the moment. The short-term outlook is reasonably positive, but there are substantial political and policy uncertainties in many regions of the world and the longer term economic outlook is for continuing weakness and turbulence. These uncertainties are particularly affecting advanced economies (and specifically most of the G7 countries).

2016 saw slow growth and stagnant employment in many advanced economies in particular, with a shortfall in demand as consumers and companies remained cautious, and fiscal consolidation remained the priority for governments. The US and UK were the major exceptions to this overall picture; although they both experienced large political shocks last year, their economies have so far proved resilient. However, the major Eurozone countries and Japan remain in a slow-growth rut, with banking problems contributing as a drag on growth. The accommodative monetary policies followed by most central banks, and continued strong growth performance in China and India, have helped to maintain a fairly stable global economic situation in the short term.

In the medium to longer term, however, some deep-seated structural problems in most advanced countries (including most of the G7 countries) will need to be addressed.

2. THE OUTLOOK

In the short term the Trump administration is planning to put in place policies that are good for US growth, and this could have a broadly positive impact overseas. If the US implements the promised fiscal expansion measures – spending on infrastructure and tax cuts – this could provide a near-term boost to demand. The Fed's policy response and the market reaction will be important. Any sign of inflationary pick-up is likely to result in a sharper tightening of monetary policy, which in the longer term will counteract fiscal policy. And the market response to higher fiscal deficits and debt levels is unpredictable.

So far the Brexit referendum result also appears to have had much less impact on activity in the UK than most forecasters were predicting. And the main emerging markets (especially China and India) are still growing quickly, generating more jobs and raising living standards, especially among the emerging middle classes.

But the longer term prospects over the next few years are more challenging, as Europe and the US continue to face uncertainties and potential shocks. Political uncertainties are now the norm, and these will spill over into policy uncertainty. Both the UK's vote in June to leave the EU (Brexit) and the US presidential election result – will have enormous, but unpredictable, consequences for the stance of government policy in these two countries.

The effects of Brexit on UK growth are highly uncertain, not least because (despite Prime Minister May's speech on 17 January) the UK government has yet to formulate a clear view of what it wants its future relationship with the EU to be. On the other side, the stance of the European Commission and Parliament, as well as that of other EU states, in the two-year negotiation with the UK is also very uncertain. So the final shape of post-Brexit Europe will only become clearer in 2019, leaving the prospect of two years of uncertainty for companies, consumers and governments.

There have already been strong market reactions, with the sterling exchange rate falling by around 15 percent since the referendum result; and more market volatility is to be expected while the policy uncertainty remains. There could also be political consequences in Europe, where the 2017 elections in France, Germany and the Netherlands will take place in a climate of rising popular discontent with the European Union. Although upsets as seismic as the Brexit result are unlikely, the demonstration effect of the Brexit vote could have unpredictable political consequences elsewhere in Europe.

The US is also facing a period of prolonged uncertainty over politics and policy. There is little clarity at this point about the broad thrust of future policy direction and priorities of the Trump administration. Markets are still searching for clues, based on scant concrete information.

But all the evidence so far indicates that the incoming administration will adopt a much tougher line on trade issues than the US has historically taken. During the election campaign much of the blame for the decline of many US manufacturing industries was placed on "unfair" trade arrangements. The implication is that not only would the US not be prepared to take forward existing trade negotiations (in particular TPP, which has already been shelved, and TTIP), but also that existing trade deals, including NAFTA, would be reopened. And the US is likely to take a tougher line on its arrangements with emerging markets (China especially), raising the possibility of higher tariffs, greater non-tariff barriers, and more anti-dumping actions through the WTO.

None of this will necessarily happen, especially as the US Congress will ultimately have to ratify new trade treaties. But any protectionist trade measures taken by the US (by renegotiating NAFTA, taxing US companies with operations abroad, or imposing punitive tariffs) will have direct negative effects on its trading partners, especially in emerging markets.

3. Underlying causes: inequality, polarization, and nativism

The political events of 2016 have longer term and deeper roots, extending back beyond the global financial crisis of 2007-2009.

These pressures are not restricted to the US and the UK, but have been evident to some degree in most advanced countries. Anti-European sentiment has been growing in many EU members for years. And anti-capitalist sentiment, such as was expressed through the "Occupy" movement, flourished in the wake of the banking crisis. Although most salient in relation to proximal causes, such sentiments are the product of many years of low growth, stagnating real incomes and living standards, rising inequality and technological change.

Although higher stocks of factors of production (labour and capital) add to growth, the main determinant of higher living standards is productivity growth. Since 1970 output per hour worked in the US has risen by just over 1.5 percent a year on average, compared with nearly 3 percent a year over the previous 50 years. And total factor productivity growth (at 0.4 percent a year on average) was lower in the last decade than over the previous 100 years.

In addition, the benefits from growth have accrued disproportionately to higher income groups and to owners of capital. Over the last 40 years real GDP per head in the US more than doubled, while median household real income grew by only 20 percent (and is now lower than it was at the end of the 1990s). In most OECD countries the income gap between the richest and poorest groups in society is wider now than 30 years ago, and inequality (as measured by Gini coefficients) is highest in the US and the UK. On average, the richest 10 percent of populations in OECD countries now earn nearly 10 times as much as the poorest 10 percent.

Not only has rising inequality damaged social cohesion, there is also strong evidence that it is bad for economic growth (mainly because it impacts negatively on educational attainment of the poor). Wealth is even more unequally distributed than income, and this also is likely to have had a negative impact on growth. The decision taken by most governments during the crisis to bail out their financial sector exacerbated these feelings of unfairness.

The resulting anger among the middle and working classes in advanced countries has fuelled rising political polarization, nationalism, anti-elitism and a loss of confidence that globalization and market liberalism will deliver benefits for all.

In the US election campaign last year, much was made of the impact of "unfair trade" on incomes and jobs. Although the rise in the trade deficit in many advanced countries has had some negative impact on manufacturing employment, technologically driven productivity growth has been a far more important factor. The secular shift from manufacturing to services in all advanced economies will not be reversed.

As the events of 2016 show, these pressures can have unpredictable consequences especially when voters are presented with binary – and divisive – choices. Markets have adapted to the post-Brexit and post-Obama worlds in a surprisingly orderly fashion, but if political pressures continue to push governments towards inward-looking and protectionist policies, the market reaction could be much more severe and volatile.

Emerging markets, especially in Asia, have largely escaped these pressures, with fast growth continuing, the benefits of growth more equally distributed, and the emergence of large middle classes. In the short term this dichotomy between the advanced and the emerging world is set to persist. So emerging markets will remain the major "engine" for the global economy for the moment.

But if advanced economies experience a substantial slowdown as uncertainty grows and/or there is a major dislocation in international financial markets, this would necessarily have consequences for emerging markets also, given their strong and growing international economic links. Trade conflicts would add to these negative forces.

4. The responses

The G7 therefore face challenges on multiple levels. First, they need to address the short-term weaknesses in most countries. Second, they need to try as far as possible to reduce the political and policy uncertainties facing companies, consumers and markets. But third, to achieve a more lasting and sustained improvement in economic performance, they need to tackle the longer-term problems which are at the heart of the loss of confidence in the mainstream economic model. Action on all three fronts should be mutually reinforcing, and would be more effective if taken across the G7 as a unit.

4.1 Short-term actions

"Conventional" economic policy actions in advanced economies can help boost growth in the short term. These should be focused on:

- fiscal stimulus;
- greater coordination of fiscal and monetary policy;

- completing financial regulatory reform; and
- outward-looking structural policies.

Although public debt and deficit levels are relatively high by historical standards, there is scope in most G7 countries to *boost demand through fiscal policy*. This would address some of the immediate societal concerns. The form of fiscal stimulus is best determined by each country depending on its circumstances. That said, infrastructure spending is likely to be fast-acting and have the maximum impact on jobs, and would be a rational strategy with interest rates still low in all G7 countries. Also acting together would magnify the impact in each of the G7 countries and minimize leakages, as well as reducing the risk of an adverse market reaction.

Fiscal action would also take the pressure off monetary policy. In recent years most G7 central banks have had, in the absence of fiscal actions, to act to counter the weakness of demand. This has pushed interest rates very low or even negative; and central banks have had to rely on greater levels of unconventional support, which has become less effective over time and has led to distortions. *Shifting the balance from monetary policy to fiscal policy* would allow central banks to move towards normalizing their policy instruments. In the first instance, reducing the stock of QE would be more appropriate than raising interest rates, even if inflation started to pick up. But to be effective this requires deeper coordination between national treasuries and central banks to manage the shift.

Measures to boost demand in the short term will also create jobs. Unemployment is a major issue in many G7 countries, and is contributing to the sentiment that the economic system is not delivering for all.

In addition to lack of demand, in most G7 countries continuing weakness in banking systems is constraining new credit issuance. This is not the time to let up on the international agenda of regulatory reforms coordinated by the FSB. Rather, *prompt completion of the financial regulation programme* would be beneficial since it would remove a negative factor weighing on confidence, and allow more rapid restoration of credit channels.

In the longer term, *boosting productivity* would be the most effective driver of higher living standards. There is no easy blueprint to achieve this, however. G7 countries have, individually and collectively, been trying to implement structural reforms in product, capital and labour markets for many years, but results have been patchy and reforms have often been seen to increase inequality domestically and have negative effects abroad. So governments have to continue to work together on outward-looking reforms that raise productivity while minimizing these consequences.

Taken together, a *G7 programme of action on these four "conventional" policy areas* should provide a short-term boost creating a better climate in which to tackle the longer term problems stemming from policy uncertainty and the underlying weaknesses.

4.2 Reducing policy uncertainty

Given the current high level of uncertainty, governments need to give a political lead. As is likely to be difficult for each country to act on its own, however, forging a consensus on a set of country-based policy positions which are mutually consistent across the G7 would increase the scope for each country to act.

An obvious place to start is to tackle the policy uncertainties arising from the change of administration in the US, and from the process of the UK leaving the EU. In each case there are elements where all G7 countries can assist:

- For the US, providing *greater certainty over the direction of trade policy* is clearly an area where its trading partners can help.
- For Brexit, while the UK has pledged to provide greater clarity about its desired long-term relationship with the EU, this needs to be matched by clarity about the EU's likely approach to the Article 50 negotiations which will take place over the next two years. The major European G7 members should take the lead in providing an early indication of the *direction of travel for the Brexit process*, although with elections due this year in Germany and France this may prove difficult to achieve.

The most significant contribution that the G7 together could make to reducing the major uncertainties would be to send a positive signal on their *willingness to cooperate on trade*. That will also be difficult to achieve, given the rhetoric of the US election campaign and the possibility of difficult Brexit negotiations over a UK/EU trade deal. But two areas where it may be possible to get G7 agreement are:

- A *code of practice to avoid countries using competitive exchange rate devaluations* as a policy instrument. As markets react violently to perceived policy uncertainties, a clear statement that countries will not act in this way could help stabilize expectations. The IMF could be tasked with leading this work, building on its analytical work on equilibrium exchange rates.
- *Tougher anti-protectionist tools at the WTO*, for example stronger sanctions against dumping and multilateral action on countries' failure to offer MFN terms to third countries. Again, this would be seen as a strengthening of G7 countries' commitment not to resort to protectionism and unfair trade behaviour.

Both these actions would be small but useful steps to strengthen the "rules of the game" for international trade. They would also help to address some of the criticisms which have (rightly or wrongly) been aimed at China and other emerging markets; but they would be seen as acting within a clear international context rather than as the unilateral actions of one country, and as strengthening rather than weakening the international institutions responsible for managing the international monetary and trade systems.

Ideally the G7 would go further than this, by supporting a positive pro-trade agenda. This will be difficult in the current political climate. But at the very least the G7 should signal that fair trading arrangements between nations provide economic benefits for both sides.

If there was appetite to go further, the G7 could work to broker agreement on a step forward in trade liberalization. The current mega Free Trade Agreements (including TPP and TTIP) will not make progress quickly, and may be stalled indefinitely. But the G7 could attempt to rescue some of the less controversial elements of these deals, including *developing common regulatory standards and encouraging mutual recognition*. These "soft" elements would be of significant benefit in reducing the non-tariff barriers to trade, and be particularly helpful in services. A commitment to working together within the G7 on these issues would probably be easier to obtain than in a wider context (for example at the WTO), given the similarities in economic structure within the G7 countries, and their greater dependence on services.

4.3 Addressing underlying issues of fairness

It is clear also that most G7 leaders will also want to discuss the underlying reasons for political polarization and loss of confidence in globalization and market liberalism. Having those discussions behind closed doors will be useful. But it would send a much stronger signal if leaders could agree on some basic propositions and work together to advance them.

A positive message on the benefits of *fair trading arrangements* and the value of the multilateral institutions which seek to ensure fairness would be one such signal.

Completing the financial regulation agenda has up to now been presented (correctly) as necessary for financial stability. However, many of the measures (for example, the requirement for banks to hold higher levels of capital and liquidity) also have the effect of reducing banks' profitability, at least in the short term, so could also be seen as fitting within the fairness agenda.

Another signal would be agreement among the G7 countries to *reach a comprehensive accord on international corporate taxation*, which is seen as another issue of fairness. Progress on the BEPS (base erosion and profit-shifting) agenda has been hampered by national interests. The US has tended to see any moves against big multinationals (primarily US corporations), and their aggressive tax avoidance strategies, as an attempt to erode their competitive advantage. The political climate in the US may be changing on this issue, as US-based multinational corporations are also criticized for relocating production to low-cost countries.

The G7 could use this shift in sentiment to put energy back into the question of *how the international community ensures that internationally active corporations pay their fair share of tax*, including moving towards consensus on BEPS, tax havens and corporate tax rates.

4.4 Why the G7?

G7 governments should take the lead on this agenda, since they have been hit hardest by these political and economic forces. Some of the actions required can only be taken by national governments, and need to be tailored to individual country circumstances. But acting together will likely be more effective and less risky; and some of these actions have to be taken in concert, involving other systemically important countries (e.g., through the G20) in some areas, but with the G7 playing a lead role.

3.

A Proposal for G7/G20 Policy Coordination to Strengthen Global Productivity and Output Growth

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Since the end of the Second World War, policies to integrate the global economy by fostering liberalization of international trade, unfettered movement of capital among countries, and internationally consistent regulation of financial institutions have contributed to massive increases in global output and have brought millions of people out of poverty. In recent years, however, public sentiment in a number of advanced countries has turned against this long-accepted consensus. Large swaths of the electorate in these countries are convinced that they have gained little from over 70 years of international economic policy cooperation, and US President Trump's administration has focused its early actions on "America First" and trade protectionism.

Yet, ironically, the present juncture offers a unique opportunity for new initiatives of international cooperation – if focused on the right economic policies – to be the most productive of any time in the past half century. This essay proposes that the leaders of the G7 and G20 adopt a specific set of internationally coordinated economic policies – a "blueprint" to accelerate global productivity and per capita GDP growth. If implemented consistently over the next decade, this programme could produce a historic "win-win" outcome, in the form of stronger long-term productivity growth, not only in the G20 countries but throughout the world.

Most discussions of international economic policy coordination focus on how monetary and fiscal policy in each country can be adjusted to the economic conjuncture in order to foster stronger global economic performance over the next year or two. But today the central macroeconomic policy issue is long term. It stems from the repeated failure of many national governments to renew and modernize the stock of basic infrastructure capital that supports productive activity in their economies. This failure has left a legacy of rusting bridges, obsolescent factories and deteriorating mass transit and freight transport systems.

In 2009 the G20 Summit leaders agreed to implement a structural development programme. Their Pittsburgh Summit declaration stated: "Our objective is to return the world to high, sustainable, and balanced growth, while maintaining our commitment to fiscal responsibility and sustainability, with reforms to increase our growth potential and capacity to generate jobs."[1] But as the IMF has noted, little of this programme has been implemented on the ground.[2] This essay is based on the conviction that a renewal of productive infrastructure is essential to fostering stronger long-term global growth, and that it would provide a large stimulus to both aggregate demand and productivity. Our policy recommendation is that governments in a large number of countries should cooperate to put a new internationally integrated network of basic productive infrastructure in place.

This essay first outlines the key policy elements that are needed within each country to implement a successful National Infrastructure Investment Programme (NIIP). It then outlines how these NIIPs could be integrated into an Internationally Coordinated Infrastructure Investment Programme (iCIIP) and the complementary roles the G7 and the G20 could play in carrying it forward as the key element in sustaining better global growth performance. We argue that the G20 is the appropriate body to set the broad course of global growth and development, while the G7, as a tightly knit group of advanced countries, can be instrumental in giving a clear impetus to key elements of the iCIIP, particularly address-

[1] See paragraph 3 of "A Framework for Strong, Sustainable, and Balanced Growth", G20 Summit Leaders' Statement, Pittsburgh, 25 September 2009, http://www.g20.utoronto.ca/2009/2009communique0925.html#growth.

[2] See International Monetary Fund (IMF), *Subdued Demand: Symptoms and Remedies. World Economic Outlook Update, January 2017*, http://www.imf.org/external/pubs/ft/weo/2016/update/01.

ing the international consistency and interconnectivity of the global infrastructure that will be constructed.

If the G20 countries are prepared to coordinate their national infrastructure investment strategies, macroeconomic policies and regulatory reforms internationally around a core set of agreed iCIIP policies, they will encourage much stronger long-term productivity performance, thus setting the global economy on a course of sustained non-inflationary output growth while simultaneously strengthening their long-run fiscal sustainability.

1. Addressing the obstacles to stronger global productivity growth

Over many years the network of basic infrastructure in the US and other advanced countries – on which productivity growth in innovative and rapidly expanding private sector firms depends – has been allowed to depreciate and become obsolete. Air traffic control systems, electricity grids, road and rail networks, bridges and tunnels, mass transit systems, port facilities and marine navigation aids, educational facilities and financial settlement systems are just some of the infrastructures that are crucial to underpinning productivity growth in the broader economy. But these infrastructures are crumbling – they have become “out of sync” with the infrastructure needs of the private sector and the larger economy.

The most obvious impediment to a sustained strengthening in productivity and output growth is the persistent weakness of fixed capital formation in the advanced countries since the Great Financial Crisis of 2007–09, and – the other side of the coin – excessive corporate sector saving. This weakness in turn has several underlying causes. The first is deep uncertainty among private-sector firms about how the regulatory framework governing their industries will change in the future. A second is high volatility in financial markets owing to uncertainty about whether the strategies used by reserve centre central banks to exit their highly accommodative monetary policies of the past nine years will be well coordinated, and how they will affect various countries’ interest rates and exchange rates.

Perhaps the key reason for low investment, at least in the "advanced" countries, is that the planning, financing, construction and operation of essential elements of each country's productive infrastructure network has been a government responsibility in the past, because it was difficult to charge user fees that could yield an adequate market rate of return on infrastructure investment and thereby make such investment attractive to private-sector firms.

Politicians have priorities other than modernizing the infrastructure the economy needs. Too often the horse trading that occurs when politicians try to deal with rising fiscal deficits has fallen disproportionately on the expedient of postponing or cancelling infrastructure projects that are needed to maintain and expand each country's national capital stock.

Years of such "bandaid" political solutions have led to inadequate and outmoded infrastructure. We face a paradox: on the one hand, there are few past historical periods when technological innovations have been brought to the marketplace as rapidly as now, in those industries where they can be quickly monetized for private profit. On the other, much of the network of basic productive infrastructure that is needed to support economic development has become decrepit and outmoded to such an extent that it comes nowhere near to matching what is needed to support expanding private-sector productive activity. This problem cannot be solved by marginal adjustments in demand management policies. Rather, it requires initiatives that act directly on the supply side of the macroeconomy.

Clearly, the way infrastructure is planned and put in place must change if this obstacle is to be overcome. The obvious conclusion is that the most pressing macroeconomic policy issue confronting global leaders today is not getting demand management policies right. Rather it is the need for renewal, modernization, expansion and integration of the global productive infrastructure – both hardware and software.

The main objection to a policy of strongly increasing investment in basic infrastructure is that many countries already have large fiscal deficits and high ratios of public debt to GDP – they cannot "afford" to undertake needed infrastructure investment without further damage to their long-run fiscal position.

However, this objection is much less relevant now than it would have been two decades ago. Today spending on basic infrastructure no longer requires a commensurate increase in the fiscal deficit. In times past it was difficult to charge for basic infrastructure through user fees. To take just one example, twenty years ago cars on US toll roads had to stop at frequent pay booths, causing massive traffic delays and congestion at times of heavy traffic. But modern technology has eliminated problems such as this by making it feasible and inexpensive to charge users of most types of basic infrastructure the full cost of the services provided. Examples abound – such as electronic systems that automatically charge vehicles for their use of the road without any significant slowdown in traffic circulation. One could point to dozens of similar innovations that have made it possible to charge for the services provided by basic productive infrastructure. This, in turn, means that while the government should be involved in determining what public infrastructure is needed, its construction and operation should be undertaken to the greatest extent possible by the private sector, and rendered profitable by levying user charges.

This essay proposes that each G20 country establish a National Infrastructure Investment Program (NIIP) and that the NIIPs be closely coordinated internationally through an Internationally Coordinated Infrastructure Investment Programme (iCIIP) in which the G7 and the G20 would play separate but complementary leadership roles. The next two sections describe the NIIP and the iCIIP.

2. National Infrastructure Investment Programmes (NIIPs)

The goal of each country's NIIP would be to focus on building an integrated state-of-the-art network of infrastructure in which the main projects support private-sector production, thereby establishing the basis for faster productivity growth in key sectors. Each NIIP should have the following essential elements:

1) The overall design of the NIIP – decisions on the blueprint for investments in productive infrastructure – should not be planned directly by politicians. Instead, the government should establish a high-level Commission of specialists in the design, construction and management of large integrated capital investment projects.

The Commission's first task should be to prioritize the types of infrastructure that are most productive for the economy as a whole, how much should be built each year, and the sequencing of construction of the key projects in the country's renewed and expanded productive infrastructure network.

2) Each national Commission would provide its government with recommendations on the priorities of the infrastructure investment programme for the NIIP and their sequencing, its proposals for how the private sector could finance the needed infrastructure projects, and the output pricing mechanisms that would induce private firms to undertake the projects of the NIIP in a coordinated fashion on a for-profit basis. Following receipt of the Commission's recommendations the government would have six months to approve or modify the proposed NIIP.
3) A crucial element of the government-approved NIIP is that it must give private-sector firms confidence that they can expect to earn an economic rate of return on their investment in basic infrastructure while meeting the performance requirements specified by the Commission. Contracts should be awarded by open tender. To the extent that each country's NIIP focuses on getting private-sector firms to build the key infrastructure projects, it can be implemented with a much smaller impact on fiscal deficits than in the past so that it does not impede fiscal consolidation.
4) Since the infrastructure investment projects will take several years to plan and a longer period to implement, construction of key pieces of infrastructure in each country needs to be carefully sequenced to avoid bouts of excess demand that could create unwanted surges in inflation and excessive weakening of the country's external current account. The Commission should also be responsible for proposing this schedule to the national government.
5) Another issue is the need to invest in basic infrastructure that is crucial for broad socio-economic development but where externalities make it difficult to find pricing mechanisms that will attract private-sector involvement in the project. Here the government's role in financing infrastructure is likely to remain central – examples are capital investments in education, resource management, pollution control, ba-

sic research, security and mitigating climate change. But even in these areas of basic infrastructure the government can use more novel pricing and financing mechanisms to increase private-sector involvement in infrastructure projects. For example, inducements could include public–private partnerships, "build, operate and transfer" arrangements, or government guarantees of private-sector debt issues.

6) Finally, to give the private sector the confidence it needs to build and operate a large portion of the NIIP infrastructure, the government must ensure that its legal and regulatory framework gives strong economic incentives for corporations to undertake the key fixed investments, as well as a commitment to a stable legal and regulatory environment that gives confidence to firms that the profitability expected at the time the project is initiated will not be undermined by unanticipated future changes in the legal and regulatory framework.

3. Proposal for an Internationally Coordinated Infrastructure Investment Programme (iCIIP)

In today's interconnected global economy it will be essential that the NIIPs of individual G20 countries are coordinated internationally.

First, given the tight production and communication linkages in the global economy, the infrastructure constructed in each country (freight and passenger transport systems; energy delivery; land, air and maritime transport facilities; telecommunications networks; physical and cyber security systems; financial system infrastructures, etc.) needs to interconnect with that in other countries as seamlessly as possible, and adopt consistent technical standards. The international network of infrastructure also needs to be designed with appropriate redundancy across countries, to assure the robustness of the overall production system.

Second, it will be essential for G20 governments to continue to coordinate their economic and financial policies to address the international spill-overs from differences in the pace of infrastructure investment and demand stimulus across countries and over time.

Third, international coordination will also be important to avoid stimulating demand excessively in a large number of countries at the same time, thereby intensifying global demand pressures, raising inflation and exacerbating the risk of an unsustainable boom in global output.

For these reasons it is essential that the renewal, expansion and modernization of global productive infrastructure is coordinated under an iCIIP. This will increase the efficiency of the global economy and optimize the stimulative effects of infrastructure investment on global productivity and output growth.

During the period of a decade or more when major national infrastructure investment projects are being put in place more or less simultaneously in a large number of countries, national implementation rates will need to be sequenced internationally through the iCIIP. Otherwise, the stimulus to aggregate domestic demand in those countries that are implementing the most ambitious infrastructure initiatives could push up their real exchange rates, sucking in more imports and reducing the stimulative demand effects of their infrastructure investment programmes on their domestic economy, causing their external current account position to weaken, and increasing their reliance on foreign capital inflows.

For example, the new Trump administration in the US is committed *both* to implementing a very large project to renew and expand basic infrastructure, *and* to a policy of "America First" and increased trade protectionism. These policies are mutually inconsistent. If the Trump administration embarked on a massive infrastructure renewal programme while simultaneously tightening restrictions on imports into the US, the domestic demand stimulus would likely result in a large appreciation of the US dollar against other currencies. This would offset the positive employment and output effects of the infrastructure initiatives and increase inflationary pressures that could price US labour out of world markets. In sum, for the US to combine massive infrastructure investment with increased protectionism would be exactly the wrong policy mix, both for the US and for the global economy. The sorely needed renewal of *global* infrastructure must be internationally coordinated under an iCIIP agreed by global leaders at the Summit level.

4. The roles of the G7 and the G20 in the design and implementation of the iCIIP

This brings us to the question of the governance of the iCIIP. The G7 and G20 are the obvious groups where the key decisions on iCIIP can be taken, and the G7 and G20 Leaders' Summit meetings should have complementary roles in the governance of the international infrastructure renewal process.

The complementarities of the G7 and the G20 in this area are clear. Since the G7 is a small, close-knit group of the largest advanced economies, G7 Summits should focus on the framework policies for international consistency and connectivity in the iCIIP. Examples of issues the G7 leaders could address are: (i) ensuring consistent international standards for interconnectivity; (ii) outlining the modalities for international coordination of basic infrastructure investments; and (iii) building up the international consistency of legal and regulatory frameworks both across countries and over time.

Taking account of the general principles discussed in the G7, the G20 Leaders' Summit process would agree on the modalities for overseeing the planning and implementation of the iCIIP. It would require considerable resolve on the part of the G20 leaders to reach agreement on how to design and oversee the operational structure needed to implement such a vast internationally coordinated network of infrastructure investment projects. However, the G20 has experience in this area through its programme to reform the global architecture of financial regulation, which has been progressing since the first G20 Leaders' Summit was held in November 2008.[3]

A particular challenge will be for the G20 leaders to reach a shared view on the appropriate ways of inducing the private sector to build, finance and operate the new infrastructure network. Since infrastructure projects take a long time to plan and build, another key challenge for the G20 will be to maintain its focus on these issues throughout the life of the iCIIP, which is likely to be a decade or more. The financing of the projects

[3] See Malcolm D. Knight, "Reforming the Global Architecture of Financial Regulation: The G20, the IMF and the FSB", in *CIGI Papers*, No. 42 (September 2014), https://www.cigionline.org/node/8318.

in the iCIIP will need to be phased in over an extended period to avoid a bubble of corporate bond issues and other private-sector financing, and to mitigate global inflationary pressures. The G20 Programme also needs to be flexible enough in its implementation that it can incorporate new productive technologies as they come on stream. Successive G20 Leaders' Summits will give political impetus to the design of the iCIIP at the highest level, and to the oversight of its implementation over the next decade or more.

The detailed technical work of sequencing the key projects in the iCIIP and the task of keeping its implementation on track should be undertaken by an International Forum of experts in the management of complex infrastructure programmes, appointed by the G20 Leaders' Summit. This Forum would then have a mandate to call on the relevant official international economic, financial and development institutions to assist with elements of the iCIIP in their specific areas of competence.

Finally, since it will take at least a decade to bring the iCIIP to fruition, it will be essential to coordinate policies internationally in other areas – particularly macroeconomic policies, trade liberalization and regulation. There is not space here to discuss these supporting policies, although they will be crucial to the ultimate success of the iCIIP. Other papers in this publication deal with the roles of the G7 and the G20 in coordinating these supporting policies.

Conclusion

The need for renewal, modernization and expansion of the global productive infrastructure – both hardware and software – is the biggest macroeconomic policy coordination issue confronting global economic policy makers at the present time. A successful renewal and expansion of the global network of infrastructure would improve employment, productivity growth, per capita GDP and human welfare at the global level over the long term. Designing and implementing a massive renewal of the global infrastructure network will require intensive international cooperation, so it is the major issue of macroeconomic policy coordination that the leaders of the G7 and G20 need to address.

This essay has proposed comprehensive new arrangements for National Infrastructure Investment Programmes (NIIPs) in each G20 country to be embedded in an Internationally Coordinated Infrastructure Investment Programme – the iCIIP. Such a proposal is obviously highly ambitious. But, as this essay has argued, an internationally coordinated infrastructure programme of this sort will be essential if the broad goal of strengthening long-run productivity and output performance in the global economy is to have a reasonable chance of success.

References

G20 Summit Leaders' Statement, Pittsburgh, 25 September 2009, http://www.g20.utoronto.ca/2009/2009communique0925.html#growth

International Monetary Fund (IMF), *Subdued Demand: Symptoms and Remedies. World Economic Outlook Update*, January 2017, http://www.imf.org/external/pubs/ft/weo/2016/update/01

Malcolm D. Knight, "Reforming the Global Architecture of Financial Regulation: The G20, the IMF and the FSB", in *CIGI Papers*, No. 42 (September 2014), https://www.cigionline.org/node/8318

4.

A Coordinated Approach to Foster Sustainable Growth and Financial Stability

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1. Macroeconomic policy coordination

At the onset of 2017, the global macroeconomic outlook is uncertain. Economic activity in emerging markets is expected to pick-up and in advanced economies a modest and uneven recovery is expected to continue. Nonetheless, almost a decade after the outbreak of the financial crisis, economic performances remain unsatisfactory and below potential in many advanced economies. Despite the favourable conditions created by expansionary monetary policies and the fall in commodity prices, growth in many of the seven lacks momentum and appears fragile, with many downside risks looming on the horizon.[1] Persistent high unemployment, stagnating real incomes and living standards, low levels of investment and declining productivity are only some of the key issues which G7 economies need to address, although with a different level of priority in each nation.

Among the most urgent issues, growing inequality has become particularly worrisome because of its economic and political implications. Empirical evidence shows an increase in both income and wealth inequality in recent years, although with important differences across countries.

[1] IMF, *Subdued Demand: Symptoms and Remedies. World Economic Outlook, October 2016*, http://www.imf.org/external/pubs/ft/weo/2016/02; IMF, *A Shifting Global Economic Landscape. World Economic Outlook update, January 2017*, https://www.imf.org/external/pubs/ft/weo/2017/update/01.

Inequality hampers economic growth[2] as it negatively affects the lower middle classes, which are the backbone of aggregate demand in advanced economies.[3] Furthermore, inequality worsens expectations, contributing to a spiral of low levels of investment and deflation. Thirdly, it spreads dissatisfaction and scepticism, causing a strong and widespread backlash in civil society against globalization and political elites. This, in turn, leads to a rise in protectionism and populism, adding uncertainty and complicating further the overall situation.

Against this background, there is consensus among international organizations that resolute policy actions are needed, as the risk of "hysteresis" is real, now more than ever: high unemployment and low investment, if not addressed promptly, could become structural, undermining in a permanent way the productive capacity of the economy.[4]

So far, the burden of stimulating aggregate demand and economic activity has fallen almost exclusively on Central Banks, with the risk of paving the way for financial bubbles and distortions. Moreover, the forecasted decoupling of US monetary policy from the European and British ones, due to different cyclical conditions, could provoke destabilizing capital flows and worsen global imbalances. A more balanced policy mix is needed, using all available policy tools (monetary as well as fiscal policy and structural reforms): it should aim at sustaining a cyclical recovery and at strengthening the potential output by addressing structural problems such as the low productivity growth. To achieve this balanced policy mix, a more positive fiscal stance is needed, considering that fiscal space has been growing in some of the G7 economies.[5] A more active fiscal policy, if

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[2] "Rising inequality by 3 Gini points, that is the average increase recorded in the OECD over the past two decades, would drag down economic growth by 0.35 percentage point per year for 25 years: a cumulated loss in GDP at the end of the period of 8.5 per cent." OECD, *Does Income Inequality Hurt Economic Growth? Focus on Inequality and Growth*, December 2014, p. 2, https://www.oecd.org/social/Focus-Inequality-and-Growth-2014.pdf.

[3] Ibid.

[4] Olivier J. Blanchard and Lawrence H. Summers, "Hysteresis in Unemployment", in *European Economic Review*, Vol. 31, No. 1-2 (February-March 1987), p. 288-295; Marco Buti and Lucía Rodríguez Muñoz, "Why We Need a Positive Fiscal Stance for the Eurozone and What It Means", in *VOX*, 28 November 2016, http://voxeu.org/node/61309.

[5] "Fiscal space is assessed to have increased significantly in many advanced economies from 2014 to 2016, as the impact of the reduction in interest rates outweighs the estimated fall in potential output growth and the increase in debt limits is larger than the changes

well designed, will also provide stimulus and incentives for much needed structural reforms.[6] Several factors at work in the present economic environment enhance the effectiveness of fiscal policy: persistent low borrowing cost due to the actions of Central Banks, idle savings and labour force and financially constrained consumers.[7] All these factors reduce the opportunity cost of public spending, removing the likelihood of crowding out.[8] At the same time though, fiscal sustainability has to be ensured, as some of the G7 economies have reached record high levels of public debt in recent years.

A coordinated approach, both at a national and international level, would increase the effectiveness of the policy mix. At a national level, this implies stricter coordination among fiscal measures designed to support structural reforms, exploiting their mutually reinforcing interactions. At the international level, coordinating these national policy mixes, particularly in support of transnational investment infrastructures and technological innovation, will enhance considerably their effectiveness.[9] This implies responding to global problems with global and shared strategies but, at the same time, tailoring national policies to each country's public finance status.

Countries with more fiscal space should use it to finance growth-boost-

in the debt-to-GDP ratio. The magnitude of the estimated increase in fiscal space varies widely across countries. It was above 20% of GDP in seven OECD countries, including Germany and the United Kingdom." OECD, "Using the Fiscal Levers to Escape the Low-Growth Trap", in *OECD Economic Outlook*, Vol. 2016, No. 2 (November 2016), p. 71.

[6] European Commission, *Towards a Positive Fiscal Stance for the Euro Area* (COM/2016/727), 16 November 2016, http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:52016DC0727.

[7] Giancarlo Corsetti, André Meier and Gernot J. Müller (2012), "What Determines Government Spending Multipliers?", in *Economic Policy*, Vol. 27, No. 72 (October 2012), p. 521-565; Alan J. Auerbach and Yuriy Gorodnichenko, "Fiscal Multipliers in Recession and Expansion", in Alberto Alesina and Francesco Giavazzi (eds.), *Fiscal Policy after the Financial Crisis*, Chicago and London, University of Chicago Press, 2013, p. 63-98, http://www.nber.org/chapters/c12634.

[8] Menzie Chinn, "Fiscal Multipliers", in Steven N. Durlauf and Lawrence E. Blume (eds.), *The New Palgrave Dictionary of Economics*, Online ed., Palgrave Macmillan, 2013.

[9] "Collective fiscal action among the large advanced economies is estimated to bring additional output gains of about 0.2 percentage point on average after one year (through international trade linkages), compared with a scenario where countries act individually." OECD, "Using the Fiscal Levers to Escape the Low-Growth Trap", cit., p. 65.

ing but non-permanent programmes. Public investment in infrastructure, research and development and education help to bolster aggregate demand in the short run and to foster higher productivity in the long term.[10] If the nations with fiscal space act collectively, this will bring additional output gains through mutually reinforcing spillovers, compared with a scenario where fiscal expansion is left to individual countries.[11] The old "house in order approach", albeit necessary, has in fact proved to be insufficient to restore sustainable growth. Furthermore, coordination should aim at supporting much needed cross-border investment in infrastructures (transport, energy, ICT).

The positive transnational effects stemming from this shared fiscal boost will benefit growth in other countries as well.[12] Countries with higher public debt, in turn, should refrain from engaging in expansionary fiscal policy, continuing with their debt consolidation. They should reorganize their tax and expenditure programmes towards a more growth-friendly set up, in a budget neutral way, for example by shifting tax burden from labour and enterprises to corporate profits, leaving the deficit unchanged.[13]

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[10] Ibid.

[11] Jan in 't Veld, "Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers", in *European Economy Economic Briefs*, No. 16 (August 2016), http://dx.doi.org/10.2765/413616.

[12] Olivier Blanchard, Christopher J. Erceg and Jesper Lindé, "Jump-Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?", in Martin Eichenbaum and Jonathan A. Parker (eds.), NBER *Macroeconomics Annual 2016*, Vol. 31 (2016), http://www.nber.org/chapters/c13784. For example, at a Euro zone level, Jan in 't Veld finds that a fiscal stimulus taking the form of a 1 percent GDP increase in public investment, if pursued simultaneously in Germany and the Netherlands, would raise GDP by 0.85 percent in Germany and 0.7 percent in the Netherlands within that same year, for a total of 1.3 percent over 10 years. The effect on the economies of other European countries, such as France, Spain or Italy, will be positive as well, with a boost of 0.3 percent of their GDP or higher. Jan in 't Veld, "Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers", cit.

[13] The need for a fiscal stimulus to be credible represents a further reason for countries with high public debt to avoid engaging in expansionary fiscal measures. Empirical evidence shows that if economic agents expect an increase in government spending to be coupled in the near future with a more than proportional increase in taxes or public expenditure retrenchment, as it is more likely to happen in countries with high levels of public debt, the effect of the fiscal stimulus is detrimental. Lilia Cavallari and Simone Romano, "Fiscal Policy in Europe: The Importance of Making It Predictable", in *Economic*

The G7 countries have the opportunity to take the lead on promoting an internationally coordinated policy mix which exploits the interaction among fiscal policies, structural reforms and monetary policies, on both national and international levels. This will have a beneficiary impact on growth and will help to tackle the problem of inequality. A quicker economic pace would in fact entail lower levels of unemployment, higher public revenues and lower public expenditures. This would provide more space for redistributive programmes and structural reforms aimed at reducing inequality without jeopardizing the economic activity. These measures have to be designed and implemented primarily at a national level. Nonetheless, international coordination is crucial as well. Moreover, there is a concrete opportunity for agreement on specific deliverables with a huge impact: G7 countries should lead the international effort to tackle base erosion, tax avoidance and profit shifting.[14] These practices, that favour the wealthiest to the detriment of the poorest part of society, can be tackled only through an international effort. Taking a clear stand in this direction will help to reduce inequality by providing more resources for public programmes such as health care, education and transfer which, in turn, would foster aggregate demand and productivity.

2. International trade

The deceleration of trade growth in recent years is a cause for concern that should be addressed by the G7. Recent research by the IMF[15] and the Bank of Italy[16] shows that between 1985 and 2007 real world trade grew on average by 7 percent, twice as fast as global GDP, whereas since 2011 the volume of world trade in goods and services has grown by around 3 percent, barely keeping pace with real GDP growth. Moreover, world trade growth fell short of expectations in each year of the period 2011-

Modelling, Vol. 60 (January 2017), p. 81-97.

[14] François Bourguignon, "Inequality and Globalization: How the Rich Get Richer as the Poor Catch Up", in *Foreign Affairs*, Vol. 95, No. (January/February 2016), p. 11-15, http://fam.ag/1QqWXgn.

[15] IMF, *Subdued Demand: Symptoms and Remedies*, cit.

[16] Alessandro Borin et al., "The Cyclicality of the Income Elasticity of Trade", in *MPRA Working Papers*, updated March 2017, https://mpra.ub.uni-muenchen.de/77418.

15, as systematic forecast errors were made by the IMF, the OECD and the WTO.

According to the IMF, the causes of the trade slowdown lie in the "overall weakness of economic activity and, in particular, the slowdown in investment growth".[17] Other factors, however, have also played a role: "the slowdown in the pace of trade liberalization and the recent uptick in protectionist measures are holding back international trade in goods" and "the apparent decline in the growth of global value chains".[18] Similar conclusions are reached by the Bank of Italy's economists who have found that "income elasticity of trade is affected by business cycle conditions" and that the recent weakness of trade (slower pace of trade growth) can be explained by the reduction in income elasticity of trade "because the secular decline of trade barriers has been gradually fading away in the last 15 years".[19]

The outlook for international trade is not very encouraging. Current projections by the IMF and other international institutions envisage only a moderate pickup of economic activity and weak investment growth over the medium term due to both cyclical and structural factors; slow trade growth is thus likely to continue. Little support is to be expected from multilateral trade liberalization agreements. The Doha Round of negotiations under the WTO aegis has been stalling since 2009 with limited prospects of a revival. Trade restrictive measures have increasingly been taken in the recent past even by G-20 countries, despite their repeated commitment to resist protectionist pressures in any form. A joint monitoring report to the G20 by the OECD, the WTO and UNCTAD (21 June 2016) indicated that 145 new restrictive measures had been introduced by G20 countries in the previous six-month period, the highest number since the global financial crisis.[20] The report further recalled that the Group had introduced a total of 1,583 new measures since 2009, covering 6 percent of their total imports, and removed only 25 percent of previously introduced measures. The outlook for regional trade agreements has been fur-

[17] IMF, *Subdued Demand: Symptoms and Remedies*, cit., p. 65.

[18] Ibid.

[19] Alessandro Borin et al., "The Cyclicality of the Income Elasticity of Trade", cit., p. 26, 27.

[20] OECD, WTO and UNCTAD, *15th Report on G20 Trade and Investment Measures*, June 2016, http://www.oecd.org/daf/inv/investment-policy/15th-G20-Report.pdf.

ther clouded by the failure of the negotiations between the US and the EU on the Trans-Atlantic Trade and Investment Partnership (TTIP), as well as by the decisions of the UK to exit the European Union and of the new US Administration to withdraw from the Trans Pacific Partnership (TPP) with a number of Asian countries. A more fundamental disruption of the world trading system cannot be ruled out at this stage, if the US were to introduce new high tariffs on trade with China and Mexico, and possibly with other important trading partners. This may trigger retaliations of various kinds, potentially leading to the cancellation of the North American Free Trade Agreement (NAFTA) by Mexico and, possibly, Canada.

The policy implications of this scenario are complex. As trade is linked to the overall level of economic activity, a macroeconomic strategy focusing on the promotion of growth and investment, as outlined in Section 1 of this paper, would lay the foundations for a sustained recovery in international trade. However, a more determined effort would also be needed to stop the spread of protectionism and to rebuild a more efficient and equitable world trading system. Following the failure of the Doha Development Agenda, after 14 years of inconclusive negotiations because of deep disagreements among developed and developing countries on a broad range of issues, there is a need to redefine the post-Doha agenda for the WTO. While the Nairobi Ministerial meeting of the WTO in December 2015 de facto ended the Doha negotiating process, there are strong indications that the WTO, thanks to its institutional structure and legal foundations, should remain the negotiating framework for the multilateral trading system and that new ways should be found to continue with a more focused and pragmatic approach to pursue the objective of trade liberalization.[21] This new approach should take into account the lessons of past mistakes and promote a greater political and social consensus on the benefits of free international trade.

Under these circumstances, there is an opportunity for the G7 to try to forge a common position on the trade agenda in view of the next WTO Ministerial Meetings scheduled for December 2017 in Argentina. A first item on the agenda could be the ratification and full implementation of the Trade Facilitation Agreement already negotiated under the Doha

[21] Simon Lester, "Is the Doha Round Over?", in *Free Trade Bulletin*, No. 64 (11 February 2016), https://www.cato.org/node/62813.

process: it would make a significant contribution to reducing trade costs by cutting tariffs and other barriers. Moreover, while the position of the US on trade issues is still unclear, the other G7 countries should commit themselves to an early conclusion of the trade agreements between the EU and Canada (CETA) and between the EU and Japan. This would give a strong signal to the markets that the EU, in particular, is not resigned to remaining passive in the face of mounting protectionist pressures and is ready to negotiate free trade agreements with any willing partner. It is however crucial that any new such agreement is accompanied by explicit and concrete measures to protect the affected segments of society from the impact of liberalization on their jobs and living standards. An active employment policy which includes social shock-absorbers, re-training programs and tax incentives to mobility should be pursued; moreover, consumer protection measures should ensure adequate health and safety standards are adequately implemented. In addition, any dispute among partners in the agreements should be brought before a supranational arbitration body (such as the World Bank Centre for the settlement of investment disputes) rather than before national jurisdictions of either partner.

The spread of protectionist measures would inevitably have repercussions on the exchange rates of the countries involved, raising the risk of competitive devaluations and currency manipulations in the current context of large and growing global balance of payment imbalances. If unchecked, destabilizing exchange rate movements could trigger sudden capital outflows leading to trade retaliations and financial restrictions, thereby undermining the flow of trade and investment. The IMF has the mandate to exercise surveillance over the exchange rate policies of its members. Surveillance should be conducted in a truly multilateral context, identifying the direction and intensity of external spillovers of exchange rate movements of major currencies and promoting cooperative strategies to carryout needed exchange rate adjustments while avoiding destabilizing overshootings from agreed equilibrium levels. The G7 could take the initiative to achieve a more effective cooperation on exchange rate policies among its members and with key members of the G20 within the IMF surveillance procedures.

3. Global financial stability

Since the Global Financial Crisis (GFC), the restoration of financial stability has been treated in the fora of international cooperation as an issue to be addressed through a fundamental reform of the global financial architecture, i.e. by strengthening the regulatory system covering the activity of banks, non-bank financial intermediaries and financial markets. The Financial Stability Board (FSB), established at the initiative of the G20, has been in charge of the formulation and implementation of financial reform and has achieved substantial results in enhancing the resilience of financial systems and in removing their main weaknesses and vulnerabilities. There is widespread agreement among policy-makers that the progress has been significant, although additional work remains to be done, such as completing the reform program. It is however essential that at some point the reform process comes to an end and that the global regulatory regime is stabilized. Although financial activity is constantly evolving, regulatory uncertainty can be detrimental to the supply of credit to real economy. Recent developments, at both international and national levels, point to the need for an agreed clarification of future regulatory changes.

Reform of the financial architecture is necessary but not sufficient to ensure global financial stability. In the prevailing regime of free capital mobility that has been in force since the inception of financial globalization in the 1980s, the strategy to cope with financial boom and bust was essentially the traditional "house in order approach" as embodied in the so called "Washington consensus". This implies the pursuit by each country of sound non-inflationary monetary and fiscal policies, accompanied by deep structural reforms to ensure the proper functioning of markets for goods, services and factors and the resilience of banks and financial intermediaries; freely floating exchange rates would take care of any remaining external imbalance. The G7 countries have traditionally been the staunchest supporters of this approach, periodically reaffirming that fiscal and monetary policy should be oriented towards meeting domestic objectives using domestic instruments and that countries should not target exchange rates. In this context, the absence of institutional arrangements to promote ex-ante, stability-oriented and compatible macroeconomic policies by the major countries has left to financial markets the task of promoting, ex-post, adjustment of payments disequilibria through changes in exchange rates enforced by capital movements. In other words, the post-Bretton Woods International Monetary System (IMS) has become dependent on the behaviour of the global financial markets.

Following the financial crises in Asia, Latin America, Russia and eventually in the core of the world financial system, the United States, the attitude towards the house-in-order-approach has changed considerably. Moreover, new problems have emerged as a result of the policies followed by the major countries to cope with the impact of the GFC: monetary spillovers, boom and bust, and currency wars have become the main focus of the debates on global economic governance.[22] Most emerging market economies (EMEs) have openly adopted a more interventionist approach. While aiming at keeping their house in order, they have resorted to capital controls and foreign exchange market interventions to limit capital inflows and undesired movements of their currencies; they have also accumulated large holdings of foreign reserves as a precautionary buffer against sudden capital outflows.[23] The G7 countries have also recognised that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability and efforts have been made by G7 Central Banks to improve transparency and communication in order to limit external spillovers of their monetary policy actions and destabilizing capital flows.

International financial organisations have increasingly focused their attention on the issue of capital flow management. In an important policy document the IMF thus formulated its "institutional view" on the subject: "Capital flows can have substantial benefits for countries […] At the same time, capital flows also carry risks". The IMF recognized that "rapid capital inflow surges or disruptive outflows can create policy challenges. Appropriate policy responses […] involve both countries that are recipients of capital flows and those from which flows originate". The policy advice was the following: "a key role needs to be played by macroeconomic poli-

[22] Fabrizio Saccomanni, *Monetary Spillovers? Boom and Bust? Currency Wars?, The International Monetary System Strikes Back*, Speech at the BIS Special Governors' Meeting, Manila, 6 February 2015, http://www.bis.org/publ/othp22.htm.

[23] Julia Leung, *The Tides of Capital. How Asia Surmounted Financial Crisis and Is Guiding World Recovery*, London, OMFIF Press, 2015.

cies, including monetary, fiscal and exchange rate management as well as by sound financial supervision and strong institutions. In certain circumstances, capital flow management measures can be useful."[24]

The BIS has concentrated its analysis on financial cycles in major countries and their international repercussions, pointing to the "excessive financial elasticity" of domestic monetary and financial regimes, which is amplified in the context of the current IMS because of its "inability to prevent the build-up of financial imbalances, in the form of unsustainable credit and asset price booms that overstretch balance sheets, thereby leading to serious (systemic) banking crises and macroeconomic dislocations".[25] The BIS advice is to incorporate financial cycles systematically in national policy frameworks; this implies that: "policies – monetary, fiscal and prudential – should respond more deliberately to financial booms, by building up buffers, and respond less aggressively and persistently to busts, by drawing the buffers down. This calls for longer policy horizons than those currently in place".[26]

So far only limited progress has been achieved in establishing a comprehensive policy framework for the management of capital flows. Research has been focused on reviewing the experience of countries: (i) in the use of capital flow management measures (CFM), i.e. of measures designed to limit capital flows with various administrative measures (including taxes and regulations) and (ii) in the use of macroprudential measures (MPM) designed to limit systemic risks with prudential measures to increase resilience of the financial system to shocks.[27] These surveys have been valuable because they have, *inter alia*, stressed the need for additional work on the integration of CFM and MPM and to ensure their international consistency.

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[24] IMF, *The Liberalization and Management of Capital Flows: An Institutional View*, 14 November 2012, p. 1-2, https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/The-Liberalization-and-Management-of-Capital-Flows-An-Institutional-View-PP4720.

[25] Claudio Borio, "The International Monetary and Financial System: Its Achilkes Heel and What to do About It", in *BIS Working Papers*, No. 456 (August 2014), p. 1, http://www.bis.org/publ/work456.htm.

[26] Jaime Caruana, *Global Economic and Financial Challenges: A Tale of Two Views*, Lecture to the Harvard Kennedy School, Cambridge, 9 April 2014, http://www.bis.org/speeches/sp140409.htm.

[27] IMF, FSB and BIS, *Elements of Effective Macroprudential Policies. Lessons from International Experience*, 31 August 2016, http://www.bis.org/publ/othp26.htm; IMF, *Subdued Demand: Symptoms and Remedies*, cit.

However, in recent contributions to the preparatory work of the G20, international organizations have once again stressed the need for a broader approach to the issue. In particular:

1) The IMF calls for a more consistent global approach to handling capital flows to improve the effectiveness of national policies, noting that more work is needed to gauge spillovers and the potential to minimize them. Strengthening the Global Financial Safety Net (GFSN) is also important, ensuring adequate resources to the IMF and addressing the sizeable financing gaps affecting many countries.
2) The BIS reiterates its suggestion to control financial cycles through a macro-financial stability framework, encompassing prudential, monetary and fiscal policies. In the context of the monetary policy strategies, the special responsibility of large jurisdictions that are home to international funding currencies is to be taken into account.
3) The OECD maintains that the benefits of free capital mobility outweigh the cost of financial instability and puts the emphasis on structural reforms to enhance the resilience of economic systems and their productivity. In this context, the OECD Codes of liberalization of capital movements could be considered a valuable instrument of international coordination to avoid negative spillovers.

Against this background, it should be possible to design a unified approach – taking into account the proposals of the three institutions – to monitor potential sources of international financial instability and to promote coordinated policy responses to forestall the impairment of the global financial system. As noted by Timothy Geithner, financial systems have become more resilient since the GFC, but the world is not really safer vis-à-vis the dangers and the costs of systemic crises.[28] Geithner makes the case for "strengthening the Bagehot arsenal" by which he means "to rebuild more room for discretion in the emergency tool kit, and keep that in reserve, not as a substitute for strong prudential safeguards, but as a complement".[29]

The institutional context for the performance of monitoring and co-

[28] Timothy F. Geithner, *Are We Safer? The Case for Strengthening the Bagehot Arsenal*, Per Jacobsson Lecture at the 2016 Annual Meetings of the International Monetary Fund and World Bank Group, Washington, 8 October 2016, http://www.perjacobsson.org/lectures/100816.pdf.

[29] Ibid., p. 27.

ordination functions can only be within the G20, possibly delegated to a more restricted and streamlined sub-set of members with systemic responsibilities, with the analytical support of the IMF, the BIS and the OECD. The G7 can obviously play an important role in this exercise. This issue goes beyond the purpose of this paper. But it is important that international cooperation to ensure global financial stability should not limit its role to advising countries on the design and implementation of capital flow management or macroprudential measures. Cooperation should also be extended to orienting global financial markets towards monetary and financial stability; this would imply that the G7/G20 provide some form of "multilateral forward guidance", signalling to markets the determination to counter unwarranted changes in market interest rates and exchange rates, which may give rise to destabilizing capital flows.

Conclusion

At the G7 meetings to be held under the Italian presidency, the leaders and Finance Ministers of the Seven should aim at reducing the current high level of policy uncertainty on a global scale, which is bound to have a depressing impact on economic activity, trade and employment. After Brexit, the election of Donald Trump and with the prospect of unsettling electoral developments in Europe, there is a need for clear signals as regards the risks to the macroeconomic outlook, international trade negotiations and global financial stability.

Regarding the macroeconomic outlook, this paper proposed that a more balanced and coordinated macroeconomic policy mix should be adopted to lift up the burden of stimulating the economy from Central Banks' shoulders. To this end, fiscal incentives should be used to promote productivity-enhancing reforms and investment in infrastructures and new technologies, using these policy tools in order to exploit their mutually reinforcing effects. The coordination of these national policy strategies on an international level is advisable in order to enhance their effectiveness.

With respect to international trade, we argued in favour of a new generation of multilateral trade agreements with significant social shock absorbers, adequate health and safety standards and independent arbitration procedures. These trade agreements will contribute to set a base of common rules to better govern globalization, protecting the ones who are negatively affected by it. This is necessary to resist and fight back rising protectionism and the backlash against globalization that is spreading in advanced economies.

Finally, we noted that reform of the financial regulatory system is a necessary but not sufficient to ensure global financial stability and advocated the establishment of a comprehensive framework for the management of capital flows, involving monetary, fiscal and macroprudential policies.

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5.

Reconfirming the Very Basis of G7 Cooperation

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1. Overview of general perspective

In view of increased uncertainties caused by the political events taking place in the G7 member countries since the Ise-Shima Summit, "stability" has become even more important.

At the same time, in order to solve the existing socio-economic issues, in particular unemployment as well as distribution of incomes and wealth, enhancement of growth potential should continue to be pursued.

The G7 have a special responsibility to lead international efforts to tackle major global economic and political challenges. Therefore, in the realm of "global economic governance," issues relating to sustainable growth and development will have to be addressed by the leaders of the G7 countries.

In particular, climate change (the implementation of the Paris Agreement) and global health require priority attention. (However, these issues are not covered in the present contribution).

2. Focus for the G7 Summit discussions

Since the first Summit at Rambouillet in 1975, the G7 have taken various initiatives to coordinate economic policy tailored to the then prevailing economic situation, although not all of the outcomes of their efforts have lived up to their original intentions. However the G7 have demonstrated their potential leadership in this field based on their strong commitment to the market economy as well as an open and free trade system.

At present the fundamental value of the market economy system itself seems to be challenged, especially in the field of trade and investment.

There is no need to dwell upon the theory of "comparative advantage" nor to draw attention to the irreversible development of global and regional value chains. However, with a view to demonstrating the potential for the G7 to lead on global economic governance, the upcoming G7 Summit should send a strong message reaffirming the G7 countries' firm commitment to the value of the market economy.

Given the points above, special attention should be paid to the field of trade and investment.

3. Trade and investment

Value of free trade

Although the importance of trade for global growth is evident and was confirmed by the previous G7 and G20 summits, some worrisome statements were made recently.

Obviously, free trade alone will not result in increased employment or better income distribution, appropriate domestic policy measures including tax policies are needed.

Fight against protectionism

In the midst of the economic crisis, we have so often witnessed the introduction of measures restrictive of trade and investment. Therefore, at the first G20 summit, Japan and the US proposed the "standstill" commitment which further evolved to the "roll back" commitment, which sought to remove such restrictions. The effects of the commitments are far from satisfactory, but they have been useful to some extent.

Measures to be avoided are not only those that are inconsistent with the WTO legal commitments, but also other measures aimed at increasing barriers for the cross border flows of goods and services.

Despite this, many restrictive measures were introduced by G20 members. Against this background, the G7 should show leadership in this regard.

WTO

Within the role of the WTO, the importance of its dispute settlement and regular work including trade policy monitoring should be highlighted, given the current concerns about negative developments in the trade field.

On the negotiating role of the Organization, little can be expected in the near future after the failure of the Doha Development Agenda (DDA). In the meantime, new approaches for trade liberalization (e.g. the “Trade Facilitation Agreement” approach, the soft law approach) will have to be sought.

The members of the G7 have to contribute in a realistic and pragmatic way to the eleventh Ministerial Conference (MC 11) this December to ensure its success.

Regional and plurilateral trade agreements

In the absence of “low hanging fruits” for the WTO negotiations, regional trade agreements and plurilaterals are expected to play a precursor role in multilateral trade liberalization.

However, apart from the Japan and EU Economic Partnership Agreement (EPA), there seems to be little expectation that other mega free trade agreements will be concluded / implemented in the near future.

The risks and costs of increasingly complex trade rules, including rules of origin, must once again be addressed in order to avoid unduly burdening the business sector, especially small and medium sized enterprises.

Exchange rate

Among the members of the G7 and of the G20, there already exist some agreed guiding principles on exchange rates, which bear in mind various perspectives, not only the trade policy point of view. To avoid sending the wrong signals to the market, the G7 leaders should instruct their Finance Ministers and Central Bank Governors to reconfirm these principles.

Investment

With the rapid development of global and regional value chains, the role of the government in the investment decision making processes of the private sector should be kept to the minimum, except when national security is at stake.

In line with the previous G7 and G20 discussions and commitments, infrastructure investment by Governments in terms of both quantity and quality should however be further encouraged and promoted.

4. ECONOMIC POLICY COORDINATION

In light of the increased uncertainty of the prospects for global growth, confirmation of the policy framework for strong sustainable and balanced growth is essential.

To prepare for market turbulence, more emphasis should be put on the monitoring and peer review processes (e.g. G20's Mutual Assessment Process).

With the inherent and realistic limits of the effects of fiscal and monetary policies, further efforts must be made on the structural reform front. OECD efforts (e.g. "Going for Growth") can certainly make a useful contribution in this area.

6.

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

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In May 2017 Italy will host the Group of Seven (G7) summit while in July 2017 Germany will host the Group of Twenty (G20) summit. Both summits will take place against a background of persisting economic challenges and political uncertainties. The WTO notes that 2016 marks "the slowest pace of trade and output growth since the [global] financial crisis."[1] Unemployment or underemployment, particularly among young persons, is still high in many parts of Europe and neighbouring developing countries. Risks to financial stability have risen as a result of record-high private and public debt, growing risks of asset bubbles and slow output growth. The monetary policy of leading central banks is still far more expansionary than in the past, relying mainly on unconventional measures, while fiscal policy has been on a consolidation or neutral path. The shaping of US domestic and foreign policy following the recent US presidential inauguration is contributing to ongoing economic and political uncertainties.

Against this background, this policy paper attempts to provide the German perspective on (i) the importance of an open rule-based, mul-

[1] WTO, *Trade in 2016 to Grow at Slowest Pace Since the Financial Crisis*, 27 September 2016, https://www.wto.org/english/news_e/pres16_e/pr779_e.htm.

tilateral trading system, (ii) the stability of global financial markets and regulation and (iii) international coordination of macroeconomic policy.

1. The importance of an open rule-based multilateral trading system from a German perspective

For decades, the EU and the US have acted as a driving force in multilateral trade liberalization. The Blair House Agreement of 1992 between the two parties paved the way to the last multilateral round which was successfully concluded, the Uruguay Round. It also opened the door to an agreement on the World Trade Organization integrating the old agreement on trade in goods (GATT) into a broader system with multilateral agreements on trade in services (GATS) and intellectual property rights (TRIPS) plus a number of plurilateral agreements. In all these agreements, Germany acted as an active supporter. Since 2001, the successor agreement to the Uruguay Round, the Doha Round – labelled and promoted strongly by Germany as a "Development Round" – has been in limbo and is now very likely a "dead horse". As an early alternative, the US and the EU went their own ways in concluding bilateral agreements with third countries. The US has labelled its switch from multilateralism to bilateralism as "competitive regionalism", a policy designed to achieve a level playing field with the EU as the traditional forerunner of such agreements. Parallel to the ongoing bilateralism of the two parties and of China in East Asia, since 2013 the EU and the US have been negotiating TTIP, a new type of agreement which concentrates on cooperation and convergence in regulations for trade and investment. Unlike old agreements focusing on liberalizing border measures, these regulations aim at "behind the border" measures, i.e. national regulations which discriminate against foreign suppliers in favour of domestic suppliers, and thus violate so-called national treatment rules. The outcome of TTIP is not settled but strong civil protests against a feared "race to the bottom" in environmental and social standards, plus the fear that bodies and private dispute settlement schemes embedded in TTIP curtail democratic rights of parliaments, stand firmly against a straightforward conclusion. These protests have not stopped the much less controversial CETA agreement between the EU and Canada.

The message from such stock taking thus far is sobering. Neither multilateral nor new types of bilateral agreements can be concluded. Trade-restricting measures have grown in number more than twice as fast as trade-liberalizing measures. This is not to deny that there has been some success in multilateral trade facilitation (i.e. acceleration in customs clearance), especially in less advanced countries, and progress in some plurilateral sector-specific agreements. However, for the time being, the momentum of stimulating trade through global agreements is stifled by extreme concern in civil society that globalization has gone too far.

It seems paradoxical that the German electorate is in the eye of the storm against transatlantic trade liberalization since it is this electorate which to a large extent is employed in export-oriented SMEs. These SMEs are estimated to be the major beneficiaries of dismantling technical barriers to trade and other obstacles. To them, such barriers are particularly costly. Yet, both potential consumer gains and prospects of becoming more competitive from the removal of trade obstacles have been overshadowed by two concerns. First, it is feared that any mutual recognition of environmental, phytosanitary and sanitary standards or an ex ante harmonization of such standards would lead to a race to the bottom, thus undermining already high German standards. Second, private arbitration panels to settle investment disputes behind closed doors are perceived as a violation of democratic principles.

The electorate is widely split in its stance on trade liberalization and German policymakers have contributed to such ambivalence by paying only lip service to the conclusion of trade agreements. For a long time, Germany has played a more passive than active pro-trade role in the EU. In the German Ministry of Economic Affairs, the focus on designing liberal trade policies beyond the traditional mercantilist preference of export promotion has been much weaker than the focus on other domestic economic issues, and the price of the Ministry for its support of CETA (after the Canadian side conceded many open issues to the EU) has been an implicit death-sentence for the TTIP.

In the chancellery there is no representative in charge of furthering global trade and investment relations. In the trade directorate of the EU Commission, Germany has also been largely voiceless. Given the conflicting positions in the grand coalition on the merits of greater freedom in international trade and investment, it is unlikely that the German G20 presidency in 2017 ahead of federal elections will provide much impetus for bringing pending or ongoing negotiations to a successful end. Instead, conflicting positions within the grand coalition on issues like a firmer stance against China's recent investment outflows to Germany, assumed discrimination of German investment in China, and controls to tackle a feared "technology sell out" to China, are likely to prevent Germany from strongly promoting trade and investment liberalization in international fora. Moreover, the massive uncontrolled influx of refugees in 2015 was seen by many Germans as a threat to their own well-being and thus provoked resistance against further opening of markets.

2. Global financial markets' stability and regulation from a German perspective

Although the global financial crisis originated in the US mortgage market, the consequences for European banks have been disastrous. Public German Landesbanken as well as private banks like Commerzbank had to be rescued by taxpayers' money and the stress in the financial markets had to be alleviated by an immense supply of liquidity by governments and central banks. In the aftermath of the crisis, German politicians agreed that taxpayers' money must not be used to rescue banks in future crises. Thus, after the required actions to tackle the crisis had been taken, the search for appropriate reforms to increase the financial sector's stability began.

As modern financial markets are globally integrated, supranational reforms were necessary. Firstly, the G20 members agreed on Basel III as a comprehensive set of reform measures which began to be implemented in 2013 and are continuing in phases until full implementation is complete in 2019. The main aim of Basel III is to improve the banking sector's resilience against shocks. Banks' capital requirements have been substantially increased to improve their loss-absorbing capacity. The minimum common equity ratio, for example, has been doubled. Further, the first common international liquidity requirements have been introduced to reduce banks' dependence on short-term external financing. Although these regulations have improved the stability of financial markets, it should be mentioned that equity ratios are calculated based on risk-weighted assets which are computed by banks' risk management and there is no guarantee that they represent the actual risk of a bank's operations.

German regulators addressed the too-big-to-fail problem in 2011 with a national law for restructuring troubled banks. Regulators can force troubled banks to restructure or liquidate. All potential expenses should be paid by the banking sector. Therefore, a restructuring fund was established which claims a bank levy. The levy a bank needs to pay increases with its size and the level of risk at which it operates. In 2015 the "European Bank Recovery and Resolution Directive" (BRRD) was implemented to produce a common regulatory framework across the Euro area. A "Single Resolution Fund" (SRF) was created which by the end of 2023 will contain 55 billion euros to enable it to guarantee or buy the assets of troubled banks. All institutions falling under the legislation need to contribute according to their systemic relevance and risk profile. If a bank needs to be rescued because its shareholders and creditors cannot accommodate losses or additional capital requirements, the SRF intervenes, not the taxpayer. The second pillar of the BRRD, the "Single Supervisory Mechanism" (SSM), established common supervisory standards and put systemically relevant banks in the Euro area under direct control of the ECB. The regulatory measures of the US Dodd-Frank Act of 2010 are comparable to the BRRD. A first real test was the troubled Italian Monte dei Paschi di Siena bank. Because Italian retail investors had heavily invested in the bank, the Italian government invoked exceptions for emergency cases in the BRRD legislation to recapitalize the bank with taxpayers' money so as not to also bail out investors. Such exceptions when used in times of stress will raise doubts that the BRRD will be robust enough to protect Euro area taxpayers' money.

Further regulatory actions have been implemented recently. European regulators extended the BRRD by setting a minimum liquidity requirement (MREL) for all banks. This requirement is calibrated for each bank individually by national regulators and is to be implemented into legislation in 2019.

On a global level, the Financial Stability Board (FSB), which was established in 2009 at the G20 summit, published standards for the minimum total loss-absorbing capacity (TLAC) of global systemically important banks (G-SIBs) which are to be maintained from 2019. The minimum TLAC can be extended by regulators for individual banks if it is assessed to be necessary for financial stability. These measures should be transposed in a timely and consistent manner into national law as they help substantially in mitigating the "too-big-too-fail" problem.

No international agreement has been achieved for market-based regulations such as financial transaction taxes or short selling constraints. The main objective of a financial transaction tax suggested by the German government is to dampen potential destabilizing dynamics of high frequency trading. An attempt to establish a common framework in the European area was not successful. However, the European Union allowed eleven of its member states to implement national financial transaction taxes. Short selling constraints have been introduced temporarily during the financial crisis by the USA and other advanced economies to relieve stock markets of the downward pressure due to short selling. The first reasoning against unilateral implementations of such measures is that they distort competition between different economies as well as different asset categories. The second is that under current legislation they affect all traders equally. Therefore, these measures should only be implemented if they are established in all major economies and if they address financial institutions according to the risk they constitute towards financial markets' stability.

These regulatory actions across the globe were accompanied by an immense supply of liquidity and a zero interest rate policy of central banks across the globe. While the US Federal Bank is about to reduce its "quantitative easing" (QE), the ECB's operations are expected to be long lasting given the small growth and inflation rates in the Euro area. However, QE does not come without risk. Firstly, low interest rates impair banks' traditional business models of mobilizing savings and allocating loans to the private business sector and private households as the net interest margins between mobilization and allocation and the possibilities of maturity transformation shrink. This especially affects the large cooperative and savings banks sector, which rely heavily on these more traditional but robust business models, which are especially widespread among German banks. Further, a low interest rate environment encourages risk-taking by economic agents because safe investments are no longer profitable. This increases the risk of asset price bubbles. Therefore, although QE of central banks was necessary to stabilize financial markets when the crisis broke out, now economic reforms need to be implemented to improve the outlook for the Euro area and the world economy as a whole. Monetary policy cannot be a long-term substitute for supply-side structural economic reforms.

3. International macroeconomic policy coordination from a German perspective

Germany, Europe's largest economy and an export powerhouse, has come out of the Great Recession relatively unscathed and currently enjoys strong economic fundamentals. Unemployment stands at a historically low 6.1 percent, while during the Great Recession it never rose above 10 percent. Its GDP is expected to increase by 1.9 percent in 2016, higher than the EU average of 1.6 percent. The economy has an ongoing current account surplus (with a record high of 8.5 percent of GDP in 2015) while federal government finances look more solid, partly aided by the current low interest rate environment and favourable labour market conditions. The debt-to-GDP ratio is projected to fall below the Growth and Stability Pact's 60 percent threshold by 2020.

Germany's economic success can be attributed partly to the wage moderation introduced in the early 2000s, at a time when unemployment was close to 14 percent and some commentators labelled it the "sick man of Europe". The labour market reforms of 2003, undertaken under the umbrella "Agenda 2010", and rising labour productivity have also supported employment growth and improved Germany's competitiveness by reducing unit labour costs. These reforms started a downward trend in German unemployment that was only briefly interrupted by the Great Recession. The success of these reforms is partly shaping the perception of the current crises, explaining the strong German emphasis on structural reforms.

Recent German data indicates that domestic private consumption and housing investment have become the main drivers of GDP growth. This reflects a combination of solid employment numbers, the return of wage growth after years of wage moderation and low consumer price inflation, despite the ECB's monetary policy. In contrast, the contribution of exports to GDP growth has become more muted. The increased reliance on domestic demand to spur GDP growth, if sustained, will be a welcome development since it contributes to reducing global macroeconomic imbalances. Increased government expenditure related to the integration of refugees into the German society will also complement the inward orientation of the economy. However, despite favourable financing conditions due to very low interest rates, the contributions of corporate and public investment to growth have been minimal.

The current global macroeconomic discourse is centred on the slow recovery from the global financial crisis and the need for action involving monetary policy, fiscal policy and structural reforms, coordinated across and within countries. The IMF has repeatedly called for a coordinated response – using monetary policy to raise below-target inflation using available fiscal space to boost public investment and structural reforms to raise potential growth. More recently, the European Commission, which sees Germany's current account surplus as persistently too high, argues that there is fiscal space to boost the currently low public investment without breaching the rules of the Stability and Growth Pact, and that there is scope for further wage growth without endangering export competitiveness. Such proposals to boost Germany's public investment echo those coming from inside Germany. For instance, the Joint Economic Forecast Project Team, an advisory group to the German government, has recently called for a budget-neutral realignment of fiscal expenditures away from consumption and redistribution and towards investment in human capital and infrastructure.[2] Even though more public investment on the part of Germany will likely not have large cross-border spillovers it could be part of a collective effort to address global demand weakness while addressing long-term growth challenges through structural reforms.

The narrative coming from German policymakers is that the factors

[2] Joint Economic Forecast Project Group, *German Economy on Track – Economic Policy Needs to Be Realigned. Joint Economic Forecast Autumn 2016*, 29 September 2016, http://www.cesifo-group.de/ifoHome/facts/Forecasts/Gemeinschaftsdiagnose/Archiv/GD-20160929.html.

behind the slow global growth are structural. Accordingly priority should be given to structural reforms so as to boost potential growth. Germany's high savings rate and the associated current account and fiscal surpluses are seen as reflections of long-term demographic trends related to an ageing population. There is emphasis on fiscal discipline given the perceived risks to financial stability from the currently high public and private debt levels at the global level. In light of this, the continuation of the ECB's quantitative easing program is seen as counterproductive, discouraging structural reforms by releasing fiscal pressure from governments, and there is little appetite for a globally coordinated fiscal stimulus similar to the G20 stimulus package of 2009. Instead, the German authorities defend the ongoing fiscal consolidation, within the framework of the debt brake rule approved by the German parliament in 2009, as creating room for manoeuvre in response to future adverse shocks. The German focus on fiscal discipline, monetary order and structural reforms and scepticism of aggregate demand management is rooted in the still popular theory of Walter Eucken, a German economist who was instrumental in shaping Germany's post-war economic policy.

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7.

G7 Economic Cooperation in the Trump Era

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G7 economic cooperation has pursued three main objectives: macroeconomic policy coordination (either in response to global shocks or to reduce large external imbalances among its members), the promotion of an open, rule-based multilateral trading system, and the promotion of global financial stability through common regulatory standards and common institutions such as the IMF. The views of US President Donald J. Trump appear to conflict with all three objectives. His "America First" philosophy and apparent belief that current account imbalances must be addressed by renegotiating trade agreements rather than through macroeconomic policies appear to leave little room for macroeconomic coordination. His trade views directly contradict the G7 agenda so far, and his intention to roll back financial regulation in the United States seems difficult to reconcile with regulatory cooperation. Furthermore, key congressional Republicans have been highly critical of US participation in the Basel Committee on Banking Supervision and the Financial Stability Board (FSB), and have also opposed "IMF bail-outs" and IMF quota increases.

At the same time, it is not yet clear to what extent – and how – President Trump's views will translate into policies of the new US administration. For example, Treasury Secretary Steven Mnuchin appears to have

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affirmed the IMF's role in crisis prevention and management and the role of international cooperation in addressing financial stability risks, in separate conversations with IMF Managing Director Christine Lagarde and FSB Chairman Mark Carney almost immediately after his confirmation.[1] President Trump himself, while pursuing an "economic nationalist agenda", has recently stated that "global cooperation, dealing with other countries, getting along with other countries is good, it's very important".[2] This posture could give members of his economic team political cover to continue the US postwar tradition of international economic cooperation, particularly with its allies.

This note explores how G7 cooperation could be maintained in the Trump era. It proceeds on the assumption that the US administration will *both* remain open to international cooperation in principle *and* feel constrained by Trump's economic nationalism as well as by specific campaign promises, such as reducing trade imbalances. Furthermore, the US administration has just announced that it will cut spending related to international cooperation – the State Department's budget, and foreign aid – to make room for higher defence spending. The central issue is how, in light of these constraints and potential contradictions, the non-US members of the G7 can best influence the ongoing policy debate in the United States in a constructive direction. Leaders and senior policymakers of other countries should seek to convince the US administration that G7 economic cooperation is in the interests of each member, including and particularly the United States. But they also need to be prepared to proceed on their own if their efforts at persuasion fail.

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[1] See US Department of Treasury, *Readout from a Treasury Spokesperson of Secretary Mnuchin's Call with International Monetary Fund Managing Director Christine Lagarde*, 21 February 2017, https://www.treasury.gov/press-center/press-releases/Pages/sm0010.aspx; and *Readout from a Treasury Spokesperson of Secretary Mnuchin's Meeting with Mark Carney, Governor of the Bank of England (BOE) and Chair of the Financial Stability Board (FSB)*, 23 February 2017, https://www.treasury.gov/press-center/press-releases/Pages/sm0013.aspx.

[2] The first quotation is from Trump's chief strategist, Stephen Bannon. See Benjy Sarlin, "Steve Bannon Touts Trump's 'Economic Nationalist Agenda'", in *NBC News*, 23 February 2017, http://nbcnews.to/2mq8D6L. The second quote is from President Trump's CPAC speech, 24 February 2017, http://time.com/4682023/cpac-donald-trump-speech-transcript.

1. Macroeconomic and tax policy

Three elements of Trump's campaign platform could potentially have a major fiscal impact. By far the most important is a large tax cut encompassing personal income, estate and particularly business income taxes.[3] Second, a plan to stimulate infrastructure investment by offering tax credits of 82 percent of the equity that private investors commit to infrastructure projects.[4] Third, a large increase in defence spending to the extent that it is not fully offset by reductions in other spending items.

The net effect of these policies would be expansionary at least in the short run, but its magnitude and timing is highly uncertain due to uncertainty about both the proposed policies and offsetting revenue and expenditure measures. President Trump has signalled that he intends to balance the budget within the ten-year budget window. This is also a long-standing goal of the Director of his Office of Management and Budget, Mick Mulvaney, a feature of House-passed budget resolutions, and a more moderate goal than Trump's campaign pledge to eliminate the federal debt. Consistent with this goal, on 27 February the administration announced that it will seek both a 54 billion dollars (about 0.3 percent of GDP) increase in defence and security spending in the coming year's federal budget and non-defence cuts of the same magnitude. Furthermore, leading House Republicans have pledged to reduce taxes on business and top individual income tax rates as part of a revenue-neutral tax reform package.[5] Possible offsetting components include limits to individual tax expenditures – for example, the tax deduction for State and local taxes – as well as a "border adjustment tax" (BAT, also referred to as "destination based cash flow tax", DBCFT) which would eliminate both exports and the deductibility of imports from business income taxation. According to Secretary Mnuchin, the administration has not yet decided whether to include this proposal in its tax reform package, which it hopes to get passed by August.

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[3] Alan Cole, "Details and Analysis of the Donald Trump Tax Reform Plan, September 2016", in *Tax Foundation Fiscal Facts*, No. 528 (September 2016), https://taxfoundation.org/?p=43502.

[4] Peter Navarro and Wilbur Ross, *Trump Versus Clinton on Infrastructure*, 27 October 2016, http://peternavarro.com/sitebuildercontent/sitebuilderfiles/infrastructurereport.pdf.

[5] Tax Reform Task Force, *A Better Way. Our Vision for a Confident America*, US House of Representatives, 24 June 2016, http://abetterway.speaker.gov.

Independent estimates have put the fiscal cost of the Trump tax plan at about 2.6 percent of GDP on average over the next decade, leading to an increase of the US federal debt by about 25 percent of GDP by 2026.[6] However, these estimates assume a reduction of the corporate income tax from 35 to 15 percent, whereas the politically more likely outcome is 20 percent or higher. Furthermore, they do not consider offsetting spending cuts or destination basis border adjustment, which would in effect tax the US trade deficit (currently just under 3 percent of GDP) at a 20 percent rate. The macroeconomic impact of the infrastructure plan is even less clear. Its authors claim that it would be fiscally neutral over time. Even if this is not the case, its fiscal cost would be relatively limited, however,[7] and the same is likely for its overall impact, particularly since it is not clear what portion of the investment projects financed by the tax credit would have happened anyway.[8] Finally, while the intentions of the administration on the spending side have now become clearer, it is not at all clear how this proposal will fare in Congress, where it may well face opposition from members of both parties.

President Trump's fiscal plans could impact the remaining G7 members through three channels:

1) Higher US demand and higher US interest rates (indeed, long-term US interest rates have already risen in reaction to Trump's election). In an environment of low global growth and extremely low interest rates, these effects should be welcome. This said, if there is a quick increase in interest rates that carries over to other currencies, particularly the Euro, this could have adverse effects on G7 members with high debt burdens, such as Italy.
2) Current account balances and President Trump's reactions to trade imbalances. Expansionary fiscal policies and higher interest rates in

[6] Jim Nunns et al., *An Analysis of Donald Trump's Revised Tax Plan*, Washington, Urban-Brookings Tax Policy Center, 18 October 2016, http://tpc.io/2cNp4G7. See also Alan Cole, "Details and Analysis of the Donald Trump Tax Reform Plan, September 2016", cit.

[7] The example given in the proposal is that of a 137 billion dollars tax credit (about 0.75 percent of 2016 GDP) required to finance an infrastructure gap of 1 trillion dollars over several years. See Peter Navarro and Wilbur Ross, *Trump Versus Clinton on Infrastructure*, cit.

[8] Paul Krugman, "Build He Won't", in *The New York Times*, 21 November 2016, https://nyti.ms/2ljLeVf; Alan S. Blinder and Alan B. Krueger, "Trump's Infrastructure Mistake", in *The Wall Street Journal*, 18 December 2016.

the US will likely lead to a further widening of the US trade deficit vis-à-vis most G7 members. The Trump administration may react to such a development through protectionist measure such as safeguards. While these measures would be ineffective and surely subject to legal challenge, litigating these challenges could take years.

3) Tax competition and – depending on exchange rate reactions – competitiveness effects. Depending on the magnitude, a move to low corporate tax rates in the United States may tilt the playing field against, or create additional profit-shifting incentives for, companies based in high tax rate countries, such as France. The imposition of border adjustment would further complicate this picture. For given exchange rates, the introduction of a BAT is discriminatory, as it imposes a higher tax burden on imports than on domestically produced goods.[9] While appreciating exchange rates can offset this effect, the extent of exchange rate movements in reaction to the border adjustment is unclear.[10]

1.1 Coordination options

Coordination might help to diffuse the adverse consequences of Trump's plans on current account imbalances and tax competition – and indeed do some good beyond that.

First, the longstanding and so far unsuccessful idea of coordinated increases in public investment could conceivably experience a comeback, as a compromise between Germany – which has taken steps to raise its public investment but not to a degree that would threaten its balance budget – and the United States, which could otherwise react to its widening trade

[9] William R. Cline, "The Ryan-Brady Cash Flow Tax: Disguised Protection, Exaggerated Revenue, and Increased Inequality", in *PIIE Policy Briefs*, No. 17-4 (January 2017), https://piie.com/node/12408.

[10] Caroline Freund and Joseph E. Gagnon, "Effects of Consumption Taxes on Real Exchange Rates and Trade Balances", in *PIIE Working Papers*, No. 17-5 (April 2017), https://piie.com/node/12546; Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, "Border Tax Adjustments: Assessing Risks and Rewards", in *PIIE Policy Briefs*, No. 17-3 (January 2017), https://piie.com/node/12374; Willem H. Buiter, "Exchange Rate Implications of Border Tax Adjustment Neutrality", in *CEPR Discussion Papers*, No. 11885 (3 March 2017), http://willembuiter.com/BTAlong.pdf.

deficit by imposing "safeguards" directed against Germany among others. The remainder of the G7 would have an obvious interest in supporting such an outcome. The main problem is that not all have the fiscal space to make a significant contribution themselves. Partly for this reason and partly to diffuse trade conflicts between the United States and emerging market countries, it would be desirable to extend the initiative to G20 members. This may be feasible if public investment is defined broadly to include social infrastructure and education.

Second, a case for tax policy coordination would arise particularly if the US does decide to impose a border adjustment tax. While a unilateral border adjustment tax may be discriminatory in both intent and impact (depending on exchange rate reactions), a coordinated introduction of a BAT/DBCFT[11] – should have no adverse impact on trade, as the tax burdens of importers and exporters would remain unchanged. This said, such a move would ceteris paribus benefit deficit countries fiscally (the United States) and hurt surplus countries. At the same time, it would also reduce incentives for profit shifting, and certainly be preferable to a trade war. In countries that have a VAT, a US tax reform that reduces or eliminates the corporate income tax and replaces it by a DBCFT could be implemented using existing tax instruments, by lowering the corporate tax rate, increasing the VAT, and lowering payroll taxes.[12]

Even if the DBCFT is not adopted in the United States, greater coordination with respect to business income taxation would limit the negative tax competition impact of unilateral reductions across members. This could aim at establishing common standards or procedures for the tax base and minimum tax rates. Although it should not supplant the G20, the G7 is a good forum for pushing this process forward since it includes only large countries at similar stages of development. As such it is not susceptible

[11] Alan Auerbach et al., "Destination-Based Cash Flow Taxation", in *Oxford University Centre for Business Taxation Working Papers*, No. 17/01 (February 2017), http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf.

[12] Both the VAT and the DBCFT are destination-based taxes. The main difference is that the latter allows the wage bill to be deducted from the tax base but not the former. Let R denote revenues, W the wage bill and I the cost of intermediate inputs. Then $VAT = \tau_{VAT}(R - I)$ while $DBCFT = \tau_{DBCFT}(R - I - W)$. Hence, an introduction or increase in τ_{DBCFT} is equivalent to a combined increase in VAT and a reduction in payroll taxes.

either to free riding by small countries or to arguments that countries at earlier stages of development need to use low corporation taxation to as a way of compensating for other weaknesses in the business environment.

2. Trade policy

The backlash against globalization represents the central, perhaps existential, threat facing the G7. It could reverse 70 years of painstaking efforts to create an open and cooperative world economy, with unforeseeable but potentially disastrous consequences. The backlash is partially motivated by identity politics and other non-economic factors but economic, especially trade, issues are among its most important causes and will certainly bear much of its consequences.

To this point, however, the international trading system has been performing remarkably well. Four major plurilateral negotiations, covering the bulk of world trade in key sectors, have either been concluded successfully (Information Technology Agreement II, revised Agreement on Government Procurement) or are nearing completion (Trade in Services Agreement, Environmental Goods Agreement). The dispute settlement mechanism at the WTO is held in high regard everywhere and is threatened only by excessive demand for its services (though Trump staff are reportedly looking for alternatives). There was no major outbreak of protectionism during the Great Recession, or thereafter despite the tepid recovery. Several new megaregional agreements were concluded in 2016, such as the Trans-Pacific Partnership (TPP) or the EU-Canada Comprehensive Economic and Trade Agreement (CETA), or advanced a considerable distance, such as Asia's Regional Comprehensive Partnership Agreement (RCEP), and the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the United States. The slowdown in trade growth since the Great Recession mainly reflects changes in the pace and composition of GDP growth and the slowing growth of global value chains rather than protectionism.[13]

[13] International Monetary Fund (IMF), "Global Trade: What's Behind the Slowdown?", in *World Economic Outlook*, October 2016, p. 63-119, http://www.imf.org/external/pubs/ft/weo/2016/02.

This picture is threatened by the advent of the Trump administration in the United States, against the backdrop of antiglobalization sentiment in the Democratic Party and much of the Congress, and coupled with the Brexit vote in the United Kingdom and similar views elsewhere in Europe. The risk of an outbreak of protectionism has already created international tensions, which may hurt investment. The broader implication, of a possible breakdown in cooperation among the major (mainly G7) countries and even a breakup of the European Union and multilateral trading system, adds considerably to the negative impact of such fears.

The G7, and perhaps subsequently the G20, can play a major role in countering these threats. Possible avenues include new initiatives in trade policy, within the new political constraints, and mounting a backlash against the backlash. Their implementation can revive the momentum toward trade liberalization, which is essential to resisting the spread of protectionism.

2.1 A "better trade agenda"

The advent of the Trump administration in the United States may alter the course of global trade policy but need not derail it. We do not yet know the contours, let alone the details, of Trump's trade policy. Sharp differences have already surfaced within the administration on trade (as on many other issues). As of late February, Trump's only specific step has been to withdraw the United States from the Trans-Pacific Partnership. Throughout his campaign and the transition period, however, Trump has said that he wants "better deals" for the United States, loosely defined as reducing bilateral trade deficits (creating jobs and avoiding excessive shocks to incomes). He favours bilateral over multilateral or regional approaches. He sees currency issues as an integral part of trade policy (as do many members of Congress). He does not oppose trade or trade agreements, however, so the task before the international community is to modify its traditional strategies to accommodate these proposed amendments – if they actually begin to eventuate – without compromising their basic principles.

The G7 should thus advocate, and actively promote, a "better trade agenda" among its member countries (for which Trump could claim at least partial credit). This could encompass plurilateral agreements that include the United States and that the new US administration might be willing to support, multilateral and bilateral agreements that do not include the United States, and new bilateral agreements involving the United States. Such an initiative would enable the G7 to take the offensive against the backlash against globalization by restarting the momentum toward liberalization and rule-making, suitably amended to incorporate the several legitimate complaints that have been revised. The main components could be:

- Reaffirmation of the traditional standstill on WTO – inconsistent measures, extension of that standstill to rule out *all* new trade barriers, and addition of a commitment to roll back at least the G7 portion of the 1,500 or so new impediments imposed by G20 countries since they pledged to avoid such actions in 2009 (all G7).
- Full implementation of the Trade Facilitation Agreement already negotiated in the WTO (all G7).
- Completion of the two major plurilateral agreements, the Trade in Services Agreement (TISA) and the Environmental Goods Agreement (EGA), being negotiated around the WTO (all G7, hopefully with G20 support).
- Implementation of CETA (EU-Canada).
- Completion of the pending EU-Japan agreement (EU-Japan).
- Completion of the pending Canada-Japan agreement (Canada-Japan).
- Institution of a US-Japan bilateral agreement to replace the TPP, most of whose economic impact in any event came from creating free trade between those two countries (US-Japan).[14]
- A revived and re-named TTIP, (European Union-United States) framed as a "bilateral" (since the EU is a single trading entity), – probably shorn of its ISDS chapter and perhaps with other modest revisions (President Trump has *not* criticized TTIP).
- After Brexit, FTAs between the United Kingdom and other G7 members: EU, US, Japan, Canada (EU-UK, US-UK, Japan-UK, Canada-UK).

This is a potentially very rich trade liberalization agenda, some of which is already ongoing, that could be reinforced, and indeed extended even

[14] Japan is also participating in negotiations for a Regional Comprehensive Partnership Agreement (RCEP) with eleven other Asian countries. Also, some TPP member countries would like to go ahead and implement the TPP without the United States.

further, by a reaffirmation at the May meeting. Such a reaffirmation (especially by the new US administration) would have a very positive effect on confidence around the world, and thus global economic prosperity, by countering fears of an outbreak of protectionism and disruption of the international trading system. The G20, some of whose members would of course be involved in important parts of this agenda, could amplify these effects by adding its endorsement in July.

2.2 Direct responses to the anti-trade backlash

Some of the needed responses to the backlash are idiosyncratic to individual countries. For example, the United States has failed to provide adequate safety nets to enable workers to absorb trade-induced (and other) shocks, and effective training programmes to foster real adjustment for them. And there is a major domestic political barrier to overcoming this problem: the most active supporters of globalization (traditional Republicans) oppose such programmes almost as much as they support free trade. An especially peculiar US policy is *trade* adjustment assistance, with expanded unemployment insurance and other benefits made available only to workers adversely impacted by trade, which does not exist in any other G7 country.

The G7 should nonetheless make an effort to establish consensus around a cooperative (and possibly coordinated) programme of "Supporting the [American/British/Canadian/French, etc.] Worker" that responds to concerns raised about globalization. This could include three components: measures to improve disposable incomes specifically in the lower-middle income brackets in which wage growth has slowed over the past two decades, strengthened safety nets (such as wage insurance) to address the costs of unemployment and wage reductions, and better education and working training initiatives to foster real adjustment. These measures would preferably apply across-the-board, rather than only to trade-related developments, both because causality is so hard to identify and because globalization tends to be blamed for problems whose sources lie elsewhere. There should also be joint efforts to address major issues that have been identified as contributing to an unequal international playing field, such as currency manipulation (currently in remission in China and almost everywhere else) and China's desire to be accorded market economy status.

The international cooperation could come through the creation of G7 task forces or working groups, preferably to include representatives from the private sector as well as governments, in each of these areas to share information, national experiences and new ideas (whether or not previously adopted) among the member countries. The goal would be the development of international best practices with respect to all these issues. It would not be necessary, or even desirable, for all countries to adopt the same measures but each should become aware of the full spectrum of possibilities and reinforce each other's efforts wherever possible.

Whatever the G7 countries do on these specific issues, they should agree to launch a major concerted effort to educate their publics (and the world more broadly) on the benefits of globalization. They should of course acknowledge that there are costs and losers, and point to their new efforts (as needed) to address them. But the focus should be on the huge net economic gains to each country from the process along with the unquantifiable, but probably even greater, gains for international security and world peace. The G7 governments can no longer assume that open trade and globalization will command support from their electorates and should make it a top-priority to recover this support.[15]

3. Global financial stability[16]

A central lesson from the global financial crisis of 2007-2009 is that crises of a significant scale in one economy and financial system affect many countries' economies and financial systems. If such financial crises are to be contained and global financial stability enhanced, international fi-

[15] A new study by the Peterson Institute for International Economic, to be published shortly, shows that the US economy is about 2 trillion dollars richer per year as a result of the globalization of the past 70 years. This equates to more than 10 percent of total national income and almost 18,000 dollars per household. The new study updates a well-known analysis by the Institute published in 2005 that showed net US gains of almost 1 trillion dollars annually. Similar studies should be conducted (for example, by the OECD) for all G7 and other countries.

[16] This section is based in part on Edwin M. Truman, "International Financial Cooperation Benefits the United States", in *PIIE Policy Briefs*, No. 17-10 (March 2017), https://piie.com/node/12488.

nancial cooperation on both crisis prevention and crisis management is essential and benefits all countries.

The Trump administration's policies in these areas are unclear and may not yet be determined. If the new administration pulls back from proactive involvement with the institutions of international cooperation crisis prevention and crisis management, global financial stability would be weakened. If the United States were to pull out of these organizations entirely, it would be a disaster.

3.1 Crisis prevention

Reforming and replacing the Dodd-Frank Act is likely to weaken the US financial system. The new US financial regulatory framework could conflict with some of the provisions of international standards that have been agreed since the global financial crisis of 2007-2009, as well as some still under discussion.

The implications of a breakdown of negotiations over the final chapter in Basel III and a halt to cooperation on other aspects of the international financial regulatory regime that has been substantially strengthened in the 10 years would endanger global financial stability. If the United States were to scale back its participation in FSB and related activities, the post-crisis regime would be incomplete. If the United States were to discontinue playing a proactive role in international standard-setting bodies and the FSB, international financial reform could start to unravel. At worst, there would be a race to the bottom; at best, other countries would struggle on with a more fragmented system, with unnecessary opportunities for regulatory arbitrage, and hope that the United States comes to its senses.

The first best option for the responsible authorities in other countries is that they should impress upon the Trump administration the importance of continuing the process of global financial reform. Based on reports of Treasury Secretary Mnuchin's conversation with FSB chair Mark Carney, this effort seems to be underway. As a second-best option, they should try to convince the new US administration not to abandon the existing institutions and agreements of crisis prevention in support of global financial stability. If they fail, other countries should carry on without the United States and resist a race to the bottom. However, they can be expected to protect their financial systems against US financial institutions that they conclude are under-regulated and under-supervised. The United States itself has an established precedent for keeping foreign institutions from operating in the United States, via the legal requirement enforced by the Federal Reserve that such institutions be subject to comprehensive consolidated supervision. In the future, the shoe may be on the other foot. Either way, the mechanisms of crisis prevention in support of global financial stability could be weakened.

3.2 Crisis management

The IMF, the institution at the centre of managing international financial crises, has been weakened relative to the plans laid down in the wake of the crisis. Initial agreements to enhance the resources of the IMF were successfully implemented, but subsequent initiatives were delayed and finally ground to a halt.

Although the IMF does not face an immediate need for additional financial resources, the Trump administration will soon have to decide its posture with respect to the review of IMF quotas to be completed by 2019. If this review is to produce a further step forward on reform of IMF governance, total quotas must be increased substantially. The Trump administration must decide whether to agree to an increase in the US quota to maintain its capacity to block or veto major decisions in the IMF, or to step aside and allow the US veto to disappear.

What the administration decides on IMF quotas will have implications for US participation in the new arrangements to borrow (NAB) after 2022. Continued participation after that date will require Congressional authorization, and a decision on whether to seek such an authorization will need to be made early in the next administration, either a second Trump administration or another president's administration. The groundwork will have been laid before the 2020 presidential election. If the United States does not renew its 38.5 billion dollars commitment to the NAB, it would be a severe blow to international monetary cooperation and the capacity of countries to manage crises that threaten global financial stability.

It is also reasonable to expect the Trump administration, following Republican views in the Congress, to be reluctant to support large IMF lending programmes. In the past, the United States has strongly supported most of these so-called bail-out programmes, finding their contribution to the stability of the countries involved in the interest of the United States. Going forward, we may see fewer such large programmes. Regional financial arrangements may have to step into the void. But in many regions, these do not exist or are underequipped financially. And even where large arrangements exist, such as the European Stability Mechanism and the Chiang Mai Initiative Multilateralization, their governance mechanisms are underdeveloped or untested, and they would be more exposed financially because of the preferred creditor status enjoyed by the Fund itself.[17]

A useful way to strengthen the global financial safety net could be (i) to expand the existing, unlimited bilateral swap arrangements among the central banks issuing reserve currencies[18] to include other countries such as large emerging market economies and (ii) to tie the qualification of these other participating countries to their having received a commitment from the IMF for a flexible credit line as a back-up arrangement.[19] It would be in the US interest, as well as in the interest of the other countries whose central banks now participate in the unlimited swap network, to pursue this proposal, for example at upcoming G7 and G20 meetings, with or without the support of the Trump administration.

In summary, if future US support for the institutions of international

[17] See International Monetary Fund (IMF), "Adequacy of the Global Financial Safety Net", in *IMF Policy Papers*, 10 March 2016, https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Adequacy-of-the-Global-Financial-Safety-Net-PP5025; Beatrice Weder di Mauro and Jeromin Zettelmeyer, "The New Global Financial Safety Net: Struggling for Coherent Governance in a Multipolar System", in *CIGI Essays on International Finance*, No. 4 (January 2017), https://www.cigionline.org/node/12335.

[18] In post-crisis period, the central banks of Canada, euro zone, Japan, Switzerland, United Kingdom, and United States established swap lines the size of which is unlimited, but the central bank wanting to draw must receive the permission of the central bank making its currency available.

[19] Beatrice Weder di Mauro and Jeromin Zettelmeyer, "The New Global Financial Safety Net", cit., building on Truman. See Edwin M. Truman, *Three Evolutionary Proposals for Reform of the International Monetary System*, Extension of prepared remarks delivered at the Bank of Italy's Conference in Memory of Tommaso Padoa-Schioppa, Rome, 16 December 2011, http://www.bancaditalia.it/pubblicazioni/altri-atti-convegni/2011-conf-memoria-padoa-schioppa/Truman.pdf; Edwin M. Truman, "Enhancing the Global Financial Safety Net through Central-bank Cooperation", in *VoxEU.org*, 10 September 2013, http://voxeu.org/node/9708.

monetary cooperation that are central to crisis management – the IMF in particular – is minimal at best and negative at worst, the inevitable financial crises will be more challenging to handle. Other countries must either strengthen those institutions without the United States or persuade the United States to step aside from its dominant role in the IMF. They could also seek to strengthen regional institutions in which the United States is not a member.

Conclusions

This paper has analyzed how the G7 can make the best of the new US administration policies.

Regarding *macroeconomic policies*, the likelihood of fiscal stimulus out of the US and a recent uptick in global growth make coordination for the purposes of overcoming weak growth in the short run somewhat less urgent than it has been in the past. At the same time, international coordination has a role to play to diffuse the adverse consequences of Trump's plans on current account imbalances and tax competition. This could include coordinated increases in public investment and common or minimum standards for the corporate tax base and corporate tax rate. While it should not supplant the G20, the G7 is a good forum for pushing this process forward since it includes only large countries at similar stages of development.

With regard to *international trade*, the G7 should attempt to coalesce around a "better trade agenda" to counter the risk of an outbreak of protectionism while taking the backlash against trade and the constraints of the Trump administration into account. This could encompass plurilateral agreements that include the United States and that the new US administration might be willing to support, multilateral and bilateral agreements that do not include the United States and new bilateral agreements involving the United States, including a refocused and reframed free trade agreement between the US and the EU. They should also begin a cooperative (and possibly coordinated) programme that responds to concerns raised about globalization, including measures to improve disposable incomes specifically in the lower-middle income brackets, strengthened safety nets (such as wage insurance) and better education and working training initiatives to foster real adjustment.

Finally, on *global financial stability*, G7 leaders should impress upon the Trump administration the importance of continuing the process of global financial reform, since a breakdown of negotiations over the final chapter in Basel III and a halt to cooperation on other aspects of the international financial regulatory regime would undermine progress on crisis prevention and endanger global financial stability. International cooperation should concentrate its efforts not only on crisis prevention but also on crisis management. The IMF, the central institution managing global financial crises, has been weakened after the global financial crisis and US support for the Fund is in doubt. G7 leaders should emphasize to the Trump administration the importance they attach to the IMF and ask the administration to step out the way if it is not prepared to join them.

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PART II

COMMENTS BY DISCUSSANTS

1.
Macroeconomic Policy Coordination

Comments by Menzie D. Chinn

Themes

These studies present thoughtful proposals for managing the global macroeconomy. Several common themes present themselves. Key among these are the importance of boosting investment of either the conventional sort (business fixed investment) or less conventional (infrastructure, R&D, human capital), and the need for enhanced productivity growth as the primary requisite for sustainable growth. Interestingly, structural reform appears in only a couple of cases, and in fairly specific contexts.

I think that these points are well taken. As aggregate demand increases so that the G7 economies near full employment, the need for boosting aggregate supply and hence long-term growth becomes more prominent. To the extent that structural reforms have an imprecisely measured impact, with uncertain lags, it makes sense to be as concrete as possible.

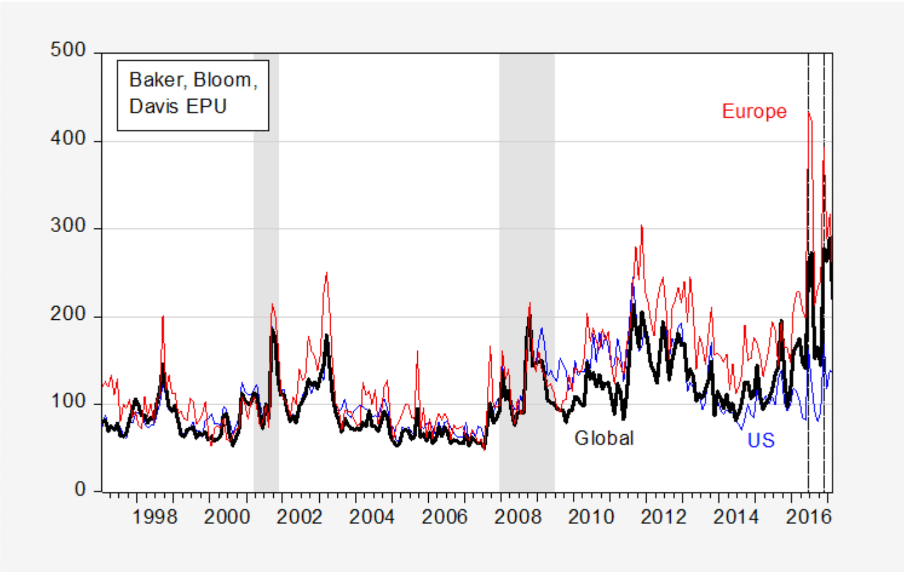
Macroeconomic coordination under economic policy uncertainty

One of the challenges we face is coordinating these policies. It's likely that the impact of these policies with respect to investment would be maximized – or at least the undesirable collateral effects would be minimized – if coordination were pursued. But here we encounter the key constraint in these times.

Typically, when we talk about macro coordination in formal terms, it's in the context of a fiscal cooperation game (e.g., locomotive game), or perhaps monetary policy games (e.g., currency wars). In such discussions, model uncertainty complicates matters enormously. How can parties cooperate if the nature of the set of payoffs cannot be agreed upon?[1]

The current situation is characterized by a high degree of economic policy uncertainty, as highlighted in Figure 1.

Figure 1 – Economic policy uncertaint in the US (blue), Europe (red), and globally (black)



Notes: Dashed lines at Brexit (June 2016), and US Presidential election (November 2016). NBER defined recession dates for the US shaded gray.
Source: Scott R. Baker, Nick Bloom and Steven J. Davis, *Economic Policy Uncertainty Index*, http://www.policyuncertainty.com.

According to this metric, policy uncertainty, particularly in Europe and globally, is at unprecedentedly high levels. Now, it's true that financial indicators of uncertainty (for example the VIX) do not signal similarly high levels of uncertainty. However, the VIX, and other spreads, also failed to anticipate the global financial crisis of 2008.

[1] For a recent discussion, see Jeffrey A. Frankel, "International Coordination", in *NBER Working Papers*, No. 21878 (January 2016).

The key question then is how to coordinate if policy directions cannot be predicted, nor credibly committed to?

Returning to the common thread of in the studies – enhancing infrastructure investment, whether private or in public–private partnerships, is going to be particularly problematic in a period of heightened economic policy. Economic uncertainty is likely to depress investment, at least until the uncertainty is resolved. And it's likely that the uncertainty will persist for some time. Hence, even if in the past low aggregate demand was the major drag on capital investment, faster growth in the near future will partly be offset by heightened policy uncertainty.[2]

Hence the plea:

> Given the current high level of uncertainty, governments need to give a political lead [to address policy uncertainty]. As is likely to be difficult for each country to act on its own, however, forging a consensus on a set of country-based policy positions which are mutually consistent across the G7 would increase the scope for each country to act.[3]

Concrete Steps

Since it's likely that elevated economic policy uncertainty will be with us for some time, the question is what policymakers should focus on. My view is that it's best to be realistic, and accept the very limited ability of certain parties to implement even those policies they desire to implement. The failure of the Republicans to pass a new health care revision, despite control of both the executive and legislative branches of government, is highly instructive in this regard.

A corollary of this theorem is that it's important to focus in on policy areas where the various parties can easily implement policy measures. In

[2] It is too early to clearly discern whether elevated economic policy uncertainty has led to decreased investment. Business fixed investment in the UK declined in the 4th quarter, even has GDP rose. See Menzie Chinn, "How Well Is UK Business Fixed Investment Holding Up in the Brexit Era?", in *Econbrowser*, 31 March 2017, http://econbrowser.com/?p=29691.

[3] See Pickford and Subacchi (Part I, Chapter 2) in this volume.

the case of the United States, because of how trade powers have been delegated to the executive branch, trade policy is one of the areas for movement in either direction.

This means there might be a way to deflect trade protectionism in the form of wholesale rejection of the WTO, to a less damaging sort, with countries implementing protection in ways consistent with WTO principles (anti-dumping duties, countervailing duties).

The management of currency values to prevent a resurgence of protectionism is another issue area where some progress can be made. The likely combination of fiscal and monetary policy in the United States – tax cuts, elevated defence spending and rising policy rates – promises a stronger dollar, greater trade friction and larger US trade deficits. Continuous and high level dialog signalling the desired levels of currencies, while perhaps not terribly effective, might serve to mitigate any further dollar appreciation.[4]

Moreover, continuing dialog on what does – and does not – constitute currency manipulation might also help build a consensus. The US already has in effect legislation which constrains what countries the executive branch can declare as manipulators. However, the current administration has evidenced some dissatisfaction with the criteria used to define currency manipulation. The challenge will be to convince interested parties, including the US administration, that declarations of currency manipulation need to be backed by convincing evidence.

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[4] See further discussion of steps from the US side in Menzie Chinn, "The Big Picture. America Needs a Growing Global Economy", in *First Year 2017, Vol. 10: The Uncertain Future of Globalization*, April 2017, http://firstyear2017.org/essay/the-big-picture.

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2.
Macroeconomic Policy Coordination

Comments by Giancarlo Corsetti

Outline

1) Diffuse skepticism on international policy coordination: lessons to keep in mind.
2) Common elements in the papers: (i) the challenge of managing the Great Rebalancing; (ii) shaping a G7 initiative on investment in infrastructure, technology and human capital.

Diffuse skepticism on international policy coordination

Four arguments:

1) "Too little too late": response to oil shocks in the 1970s.
2) Agreements are not sustainable for the presence of strong incentives to deviate ex post: US-Japan relation.
3) Cooperation can be counterproductive: cooperation among discretionary government may exacerbate domestic inefficiencies.[1] E.g.: agreements that keep prospective aggregate demand high may reduce incentives for union to moderate wage demand.
4) Gains of cooperative approach relative to non-cooperative policy setting are too small to bother: keep your house in order.[2]

[1] Kenneth Rogoff, "Can International Monetary Policy Cooperation Be Counterproductive?", in *Journal of International Economics*, Vol. 18, No. 3-4 (May 1985), p. 199-217, https://scholar.harvard.edu/files/rogoff/files/51_jie1985.pdf.

[2] Maurice Obstfeld and Kenneth Rogoff, "Do We Really Need a New International Monetary Compact?", in NBER Working Papers, No. 7864 (August 2000), http://www.nber.org/papers/

Several lessons:

1) "Too little too late": timing and instruments.
2) Agreements are not sustainable, incentive to deviate ex post: credible plans.
3) Cooperation can be counterproductive: governance, domestic and international.
4) Gains relative to noncooperative policy setting are small: risk of underestimating the potential disruptive effects of attempts to pursue beggar-thy- neighbour policy.

Shift from coordination on specific actions in response to shocks to coordination on policy regimes and institutions, setting the "rules of the game" (reflecting distaste for discretionary action and fine tuning).

Common elements in the papers

The coming global rebalancing

Across the papers, the challenge to global macroeconomic policy consists of managing a great rebalancing of: (i) external accounts; (ii) monetary and fiscal policy mix; (iii) private and public debt; (iv) income distribution and unemployment within advanced countries; (v) productivity growth and looming ecological/global health risks.

The process is already happening, but at risk of feeding disruptive conflicts on modalities. Most papers insist on the "faulty lines" due to the political implications of income distribution and unemployment.

The coming policy rebalancing: policy context

Bergsten et al. emphasize the specific risks from the US presidential program: (i) spending and tax policies leading to stronger dollar/higher deficits may elicit (ii) protectionism and aggressive corporate tax reforms at the same time in which (iii) the US promotes financial deregulation and depowering of international financial institutions.[3]

w7864; Giancarlo Corsetti and Paolo Pesenti, "The International Dimension of Optimal Monetary Policy", in *Journal of Monetary Economics*, Vol. 52, No. 2 (March 2005), p. 281-305.

[3] See Part I, Chapter 7 in this volume.

Comment: this program foreshadows a drift towards an international regime with trade restriction and financial deregulation, if you think about this, the *opposite of Bretton Woods* (more tomorrow).

Infrastructure investment

Substantial agreement on a G7 initiative on investment in infrastructure/technology innovation and human capital.

Benefits across different dimensions of the great rebalancing: (i) increases demand in the short run, taking off pressure from central banks; (ii) enhances productivity; (iii) balances cross-border demand and hence reduce the risks of protectionism; (iv) locks in government cooperation on cross-border projects; (v) investment in infrastructure is already in the cards in many countries, and may rely on instruments and policies such as industrial policy, private-public partnership etc. that are currently enjoying a revival.

Financing:

- Need not worsen fiscal outlook and deficits: (i) public-private partnership; (ii) enhanced possibilities to charge user fees open by ICT;[4] (iii) budget neutral consistent with the need to shift tax burden away from corporation.[5]
- Could fill the "fiscal space" for low-debt countries.[6]
- From the "German perspective", the G7 should not promote discretionary fiscal stimulus.[7] Yet fiscal space means that there are opportunities for sensible intertemporal smoothing in support of efficient investment projects.

Scope and content:

- Long list in Knight: Air traffic, electricity grids, road and railways, bridge and tunnels, mass transit, port facilities and marine navigation, educations, financial settlement, etc.[8]

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[4] See Knight (Part I, Chapter 3) in this volume.

[5] See Saccomanni and Romano (Part I, Chapter 4) in this volume.

[6] Ibid.

[7] See Langhmmer et al. (Part I, Chapter 6) in this volume.

[8] See Part I, Chapter 3 in this volume.

- Delatte and Jean: Green-house reduction technologies (rebalancing innovative research now mostly occurring in Asia, that is, non-G7 countries but Japan).[9]

Clearly a divisive issue: choice of projects may elicit competition among regions. Otabe stresses that with the rapid development of the global and regional value chains, a role of the government in the private investment decision making can only be justified for national security reasons.

At a deeper level: governance. Knight proposes to delegate the identification of projects to technical experts.[10] But see Börjesson and Eliasson in the 2015 Swedish Fiscal Policy Report: Sweden implements projects which on average do not score high in the cost-benefit assessment.[11]

Timing: Temporary (Saccomanni and Romano)[12] or long-term project (Knight).[13] Timing is also a sticky issue. Difficult to envisage a quick deployment unless projects already in an advanced state of definition.

Knight also proposes the management of a common calendar, which prefigure fine tuning at regional and global level (quite complex to achieve).

Conclusion

Overall, a good idea to pursue "reasonable plans" over different horizons.

- An initiative on global infrastructure and productivity to be implemented at the G20 level could make room for some short-term initiative on human capital.
- Not to be envisioned as fine tuning of fiscal stimulus. It may imply monetary tightening at some point.

[9] See Part I, Chapter 1 in this volume.

[10] See Part I, Chapter 3 in this volume.

[11] Maria Börjesson and Jonas Eliasson, *Kostnadseffektivitet i valet av infrastruktur-investeringar*, background paper for the 2015 Swedish Fiscal Policy Report, Stockholm, The Swedish Fiscal Policy Council, 2015, http://www.finanspolitiskaradet.se/download/18.3b8016af14d904ea4e8cbdd7/1432902696452.

[12] See Part I, Chapter 4 in this volume

[13] See Part I, Chapter 3 in this volume.

Overall, however, the programme is fully exposed to the risks of financial instability, if international policy coordination fails in its basic role – to elicit crisis prevention and crisis management.

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Maria Börjesson and Jonas Eliasson, *Kostnadseffektivitet i valet av infrastrukturinvesteringar*, Stockholm, The Swedish Fiscal Policy Council, 2015, http://www.finanspolitiskaradet.se/download/18.3b8016af14d904ea4e8cbdd7/1432902696452

Kenneth Rogoff, "Can International Monetary Policy Cooperation Be Counterproductive?", in *Journal of International Economics*, Vol. 18, No. 3-4 (May 1985), p. 199-217, https://scholar.harvard.edu/files/rogoff/files/51_jie1985.pdf

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3.

Macroeconomic Policy Coordination

Comments by Douglas Laxton

Thank you for the opportunity to talk about policy coordination issues. My remarks today will be based on an IMF Staff Discussion Note that we have recently published, named "*Macroeconomic Management When Policy Space Is Constrained*".[1] In addition, we have included a few other supporting papers in the presentation, which are referenced at the end of this document.

Recovery in GDP growth since the global financial crisis has been halting and weak. In 2016, the output gap in the large advanced economies has remained open, with inflation below target. With the effective-lower-bound constraining policy interest rates, a deflationary cloud threatens as weak growth looms. Concern is widespread that countercyclical policies have run out of space or lack the power to raise growth or deal with the next negative shock. Proximity to the effective-lower-bound constraint, as noted, has narrowed the room for conventional monetary stimulus in most economies. And this constraint is more serious given the evident steep drop in the global real equilibrium interest rate since the crisis. The range of estimates for the US equilibrium real rate in 2016 is wide, but most are below 1 percent. Alongside the decline in expected inflation, this is reflected in the trend decline of long-term interest rates to unprecedented lows. Thus, in 2016, a policy rate even as low as zero may not provide much demand support.

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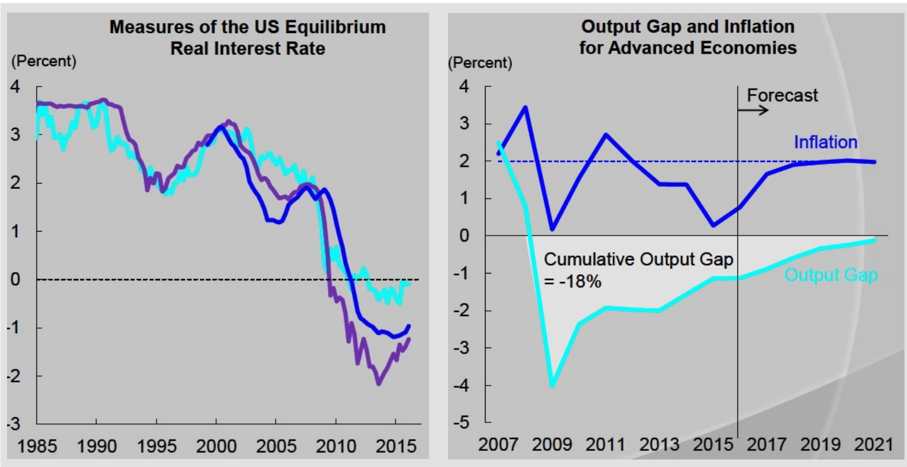
[1] Vitor Gaspar et al., "Macroeconomic Management When Policy Space is Constrained: A Comprehensive, Consistent and Coordinated Approach to Economic Policy", in *IMF Staff Discussion Notes*, No. 16/09 (September 2016), http://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Macroeconomic-Management-When-Policy-Space-is-Constrained-A-Comprehensive-Consistent-and-44196.

To address these challenges, we propose in the paper a general framework to design comprehensive, consistent and coordinated macroeconomic policies. Such an approach taps the synergies of different policies working together, within a country, across countries, and over time. It allows policymakers to better align instruments and objectives, helps them deal with shocks when they materialize, and improves economies' resilience. The approach can be used to support growth at the current juncture but more so in the event of a negative shock to global conditions. Applying this approach implies benefits far above those accruing from a similar set of measures applied piecemeal.

Figure 1 – Lower global equilibrium real interest rate challenges monetary policy

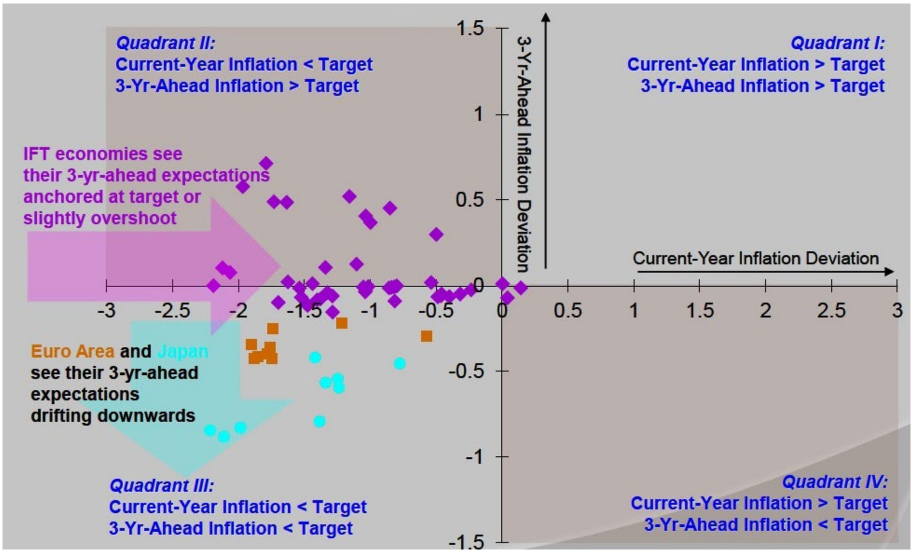


Source: Laubach and Williams (2015); Obstfeld et al. (2016); Nomura (2016).

Source: IMF, *World Economic Outlook*, April 2016.

Monetary policy has an important, proactive role to play in influencing inflation expectations and real interest rates under the comprehensive, consistent and coordinated approach. In this context, an inflation forecast targeting (IFT) framework can make a difference. Under IFT, monetary policy can credibly commit to a temporary period of inflation somewhat above target without undermining its medium-term goal of price stability. Data on inflation expectations suggest that IFT has, in fact, provided a firm nominal anchor. In the chart on Figure 2, the horizontal axes plot the expected deviation of this year's inflation from the official target for two groups of countries, one a group of inflation forecast targeters, and the other, non-IFT advanced economies. The surveys were conducted in 2015 and 2016. In almost all the economies covered, expected inflation is below target, largely because of known factors at the time of the survey (such as low energy prices and economic slack). The vertical axes plot the inflation rate expected three years ahead. There is a remarkable difference between the two groups. In the non-IFT advanced-economy group, expectations for a negative deviation persist at least until the third year ahead, and there is a distinct positive correlation between the expected deviation in this year's inflation and that in three years' time. In contrast, the expected three-year-ahead deviation from target in the IFT group is near zero, with no such correlation. Thus, whereas in non-IFT economies negative inflation shocks tend to shift medium-term inflation expectations downward, in IFT economies medium-term expectations remain stable at the target rate.

Figure 2 – Deviation of headline inflation expectations from target (percentage point)

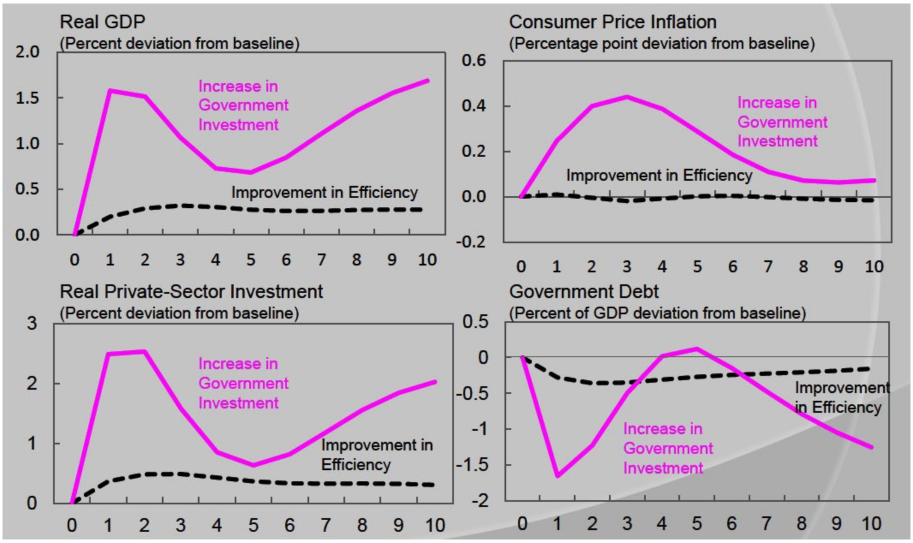


Note: IFT economies: Canada, Czech Republic, New Zealand, Sweden, US.
Source: Consensus Economics, Long-Term Economic Forecasts, 2015-2017.

When accommodated by monetary policy, the structural, productivity-enhancing case for a permanent increase in government investment is strong. To illustrate, we report model simulation results for a permanent increase in government investment equal to 1 percent of baseline GDP, a relevant scenario for countries that need to address sizable infrastructure gaps (Figure 3). This leads to higher productivity in the private sector, resulting in permanently higher private investment and consumption. At the same time, a higher level of imports implies positive spillovers to other countries. The increased growth rate of potential output would create future policy space by raising government revenues, reducing debt-to-GDP ratios, and raising the neutral interest rate.

Under current circumstances, a large new global contractionary shock would raise the risk that economies might fall into a deflation (or low-inflation) trap. Such a negative shock to demand, in an economy already operating below potential, could do long-term damage. A timely and coordinated policy response could, however, jump-start a permanent and offsetting increase in employment and output. An example of such a response is the G20 stimulus package after the global financial crisis, which saved the global economy from a much more severe recession.

Figure 3 – Increase in government investment



Note: Horizontal axis indicates the year. Both simulations show the effects of one country acting alone, under two years of monetary accommodation. Increase in government investment is equal to 1% of baseline GDP permanently. Improvement in efficiency is modeled as a permanent shift from government consumption to government investment equal to 1% of baseline GDP. Results based on the GIMF model.

Table 1 – Effects on real GDP level in year 1 (percentage deviation from baseline)

Effects on	When each region stimulates on its own	When stimulus is coordinated in all regions
World	--	2.4
United States	1.1	1.6
Euro Area	0.9	1.5
Japan	1.1	1.8
Emerging Asia	2.0	3.4
Latin America	1.5	2.4
Remaining countries	1.4	2.3

Note: The size of the three-year fiscal stimulus is equal to 1 percent, 1 percent, and 0.5 percent of each region's baseline GDP, respectively. It consists of government investment, government consumption, and targeted transfers, with their respective share being ¼, ¼, and ½ of the total stimulus. Monetary policy in all regions accommodates the fiscal expansion by keeping nominal policy interest rate unchanged for two years.

The GIMF model illustrates the plausible global effects from a coordinated international response to a hypothetical negative demand shock. The first column of Table 1 shows the impact on each region's GDP if each region does its fiscal stimulus alone. The second column shows the number when the stimulus is coordinated in all regions. The simulation shows that, in response to a hypothetical negative global shock, an internationally coordinated stimulus would boost global GDP sizably and, importantly, benefit each country individually. These increases represent a powerful multiplier effect: through positive spillovers, simultaneous international action can substantially amplify the effectiveness of national policy actions. Without coordination, governments might fail to act, because from their individual viewpoints the spillovers constitute leakages of spending that reduce the multiplier and, hence, the perceived benefits of a fiscal expansion.

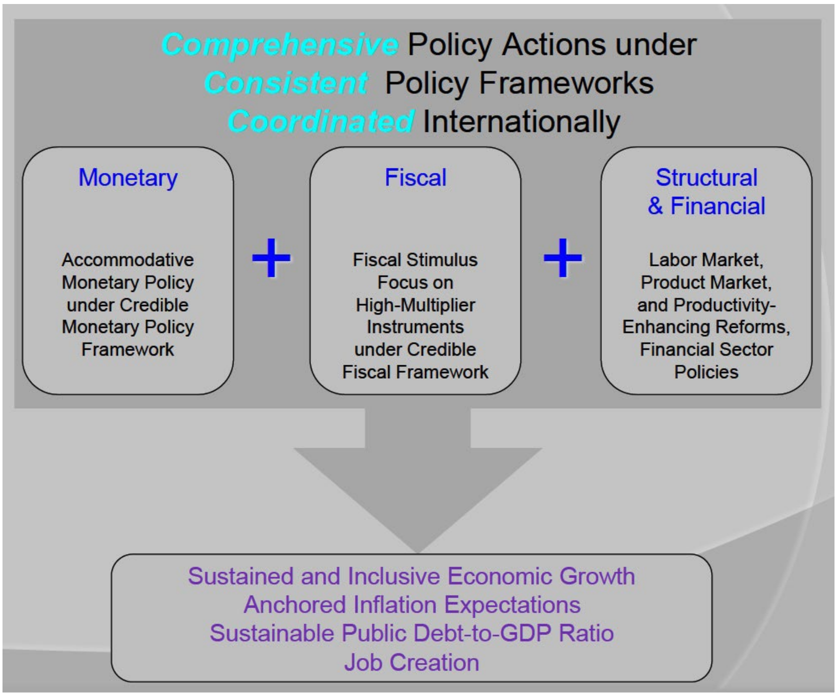
As global fiscal and monetary coordination permanently raises nominal GDP, the debt-to-GDP ratio is eventually lower for all regions, notwithstanding the initial increase in budget deficits. This fiscal dividend is illustrated by negative numbers in the second column of Table 2, which shows estimates of the change in the debt ratio in year 4. These improvements are achieved only with global fiscal and monetary coordination.

Table 2 – Effects on debt/GDP ratio in year 4 (percentage deviation from baseline)

Effects on	When each region stimulates on its own	When stimulus is coordinated in all regions
World	--	-0.7
United States	0.8	-0.4
Euro Area	0.9	-0.3
Japan	0.2	-1.8
Emerging Asia	0.2	-1.4
Latin America	0.7	-0.6
Remaining countries	0.5	-0.7

Note: The size of the three-year fiscal stimulus is equal to 1 percent, 1 percent, and 0.5 percent of each region's baseline GDP, respectively. It consists of government investment, government consumption, and targeted transfers, with their respective share being ¼, ¼, and ½ of the total stimulus. Monetary policy in all regions accommodates the fiscal expansion by keeping nominal policy interest rate unchanged for two years.

To conclude, in the event of a renewed global slowdown, a comprehensive, consistent and coordinated policy approach could move the global economy well away from a possible danger zone. Policy needs to be ready for comprehensive action using all three policy prongs – monetary, fiscal



and structural – because applying them in combination overcomes apparent constraints faced by these policy instruments individually. Such a comprehensive approach, tailored to specific country circumstances, has been central to the IMF's policy advice to its member countries. Consistent policy frameworks can provide the policy space to deliver decisive short- to medium-term support to an economy, for example, by holding long-term inflation expectations to target rates and committing fiscal policy to an eventual sustainable downtrend in government debt-to-GDP ratios. Coordinated policies across major economies can amplify the effects of individual policy actions through positive cross-border spillovers. This holds in normal times but is particularly relevant when the world is faced with a large global shock. International coordination of fiscal and monetary stimulus can also boost global nominal GDP, helping to keep debt-to-GDP ratios in check. Overall, the approach helps dispel perceptions that there is only limited policy space.

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4.
Financial Stability

Comments by Claudio Borio

I very much enjoyed reading the various contributions. In my discussion, I would like to address two questions: What are the major threats to financial stability and their policy implications? What specific role could the G7 play?

As a preamble – and probably this is my most important point – let me note that reading the contributions I was struck by one thing: the neat and convenient separation between financial stability and macroeconomic issues. This is true of most of the contributions, except those from the IAI and, to a lesser extent, the Peterson Institute and Kiel Institute.[1] What I mean is that when talking about macroeconomic cooperation, the discussion is all about growth, inflation and current account imbalances, and hence about fiscal, monetary and exchange rate policies; when talking about financial stability cooperation, by contrast, the discussion is all about bank failures and hence about prudential regulation and supervision.

To my mind, this separation is part of the problem. And it is symptomatic of the way the economics profession and policymakers, by and large, are still viewing these things. As the IAI's contribution makes clear, at the Bank for International Settlements (BIS) we tend to see macroeconomic and financial stability issues as inextricably linked, as two sides of the same coin. The implication is that all policies – prudential, monetary, fiscal and structural – should, to some extent, take financial stability considerations into account, nationally and internationally.

[1] See Part I, Chapters 4, 6 and 7 in this volume.

The element that ties macroeconomic and financial stability together is what, historically, has been the main – not the only, but the main – source of financial crises with serious macroeconomic costs ie, the financial cycle, or outsize financial booms and busts.

The financial cycle has three key features. It is best characterized by joint unsustainable expansions and subsequent contractions in credit and asset prices, especially property prices. It is longer than the "traditional" business cycle – some 16-20 years since the early 1980s, compared with 8–10, which is the way economists and policymakers interpret and measure the business cycle (the filters used, etc.). And it causes huge economic damage, in the form of deep and protracted recessions as well as slow and drawn-out recoveries. The Great Financial Crisis (GFC) is just the latest example, probably the most striking one alongside the Great Depression.

In a recent speech,[2] I used this lens to interpret the plight of the global economy, contrasting this perspective with one that has gained currency and that makes an appearance in some of the contributions to this event: secular stagnation. While in the time available I cannot develop the arguments in detail, I will draw on some of them to answer the two questions I am addressing today.

Diagnosis

So, if you take the financial cycle perspective, what are the implications for the diagnosis of the global economy ills? Let me make just two points to provide the big context.

First, the emergence of outsize and growing financial cycles since the early 1980s is no coincidence: it reflects an inadequate response to three changes that, individually, have been forces for the good, but that, collectively, have raised new risks from unsuspected quarters. The first is financial liberalization, which has allowed credit, asset prices and risk-taking to feed into each other and stretch balance sheets much further than in

[2] Claudio Borio, *Secular Stagnation or Financial Cycle Drag?*, speech at the National Association for Business Economics, 33rd Economic Policy Conference, Washington, 5-7 March, http://www.bis.org/speeches/sp170307.htm.

the past. The second is the establishment of credible anti-inflation monetary policy regimes, focused on near-term price stability but oblivious of the behaviour of credit aggregates, which has allowed central banks not to tighten even when financial booms got into full swing as long as inflation remained low. And the third is the globalization of the real economy, which pre-crisis raised growth expectations, providing fertile ground for financial booms while at the same time putting downward pressure on inflation, thereby reducing the need to tighten monetary policy. Think especially of the entry of former communist countries and other emerging market economies (EMEs) into the global trading system.

Second, the response to the GFC no doubt succeeded in containing the damage, but was less successful in promoting a sustained and robust recovery. Over time, it ended up relying too much on monetary policy, which became "the only game in town", and too little on balance sheet repair and structural policies. By the way, I have a less positive view of fiscal policy than many of the contributions to this conference. While clearly there is a role for fiscal policy, especially in facilitating balance sheet repair of banks and even of non-financial borrowers, or in supporting structural policies or promoting *judicious* and *well executed* public investments, the effectiveness of pump-priming beyond the short term is more dubious. This risks undermining the sustainability of government balance sheets, with public sector debts that are already at peace-time record highs in many countries.

Risks

All this raises a number of risks – conjunctural, structural and institutional. Before I turn to them, though, let me stress one thing: current developments, in terms of growth and unemployment, are significantly better than what one reads in the contributions to this conference.

The *conjunctural* risk is that of further episodes of serious financial stress. These can be of two types.

On the one hand, a number of countries not affected by the GFC have been exhibiting symptoms of the build-up of financial imbalances – symptoms that are qualitatively similar to those seen pre-crisis in those countries subsequently hit by it. I have in mind several EMEs, including some of the largest, but also some advanced economies, and not just commodity exporters, such as Australia, Canada, Norway, Sweden and Switzerland. An important contributing factor has been the very easy monetary policy adopted in the largest countries, especially those home to international currencies, coupled with resistance to exchange rate appreciation elsewhere.[3] This is what Rajan has called "competitive easing" and what we at the BIS have labelled a process through which "easing begets easing". In this context, given the rapid post-crisis growth in international dollar lending, the risk of serious funding strains in the dollar market merits particular attention. We should remember that the US dollar's dominance in financial markets is undiminished.[4]

On the other hand, we could again see stress in crisis-hit countries where banks' balance sheet repair has been incomplete and fiscal policy space is limited.[5] I hardly need to say to you which countries are relevant here, but obviously the statement applies to some in the euro area.

The *structural* risk is that of entrenching instability in the global economy. Asymmetric policies over successive business and financial cycles – failing to constrain the booms but easing aggressively and persistently during busts, with monetary policy and, to some extent, fiscal policy – could lead to a sequence of crises, a loss in policy ammunition and a "debt trap". By "debt trap" I mean that this sequence imparts a downward bias to interest rates and an upward bias to (private and public) debt that at some point makes it hard to raise interest rates without damaging the economy. From this perspective, there is nothing particularly "natural" about the decline in real interest rates we have seen: rather than being an equilibrium phenomenon, it is closer to a disequilibrium one.

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[3] Claudio Borio, "The International Monetary and Financial System: Its Achilles Heel and What To Do About It", in BIS Working Papers, No. 456 (August 2014), http://www.bis.org/publ/work456.htm; Bank for International Settlements, "The International Monetary and Financial System", in *85th BIS Annual Report*, 28 June 2015, p. 83-100, http://www.bis.org/publ/arpdf/ar2015e5.htm.

[4] Claudio Borio, *More Pluralism, More Stability?*, presentation at the Seventh high-level SNB-IMF Conference on the International Monetary System, Zurich, 10 May, http://www.bis.org/speeches/sp160510.htm.

[5] Claudio Borio, *The Banking Industry: Struggling to Move On*, speech at the Fifth EBA Research Workshop on "Competition in Banking: Implications for Financial Regulation and Supervision", London, 28-29 November, http://www.bis.org/speeches/sp161128.htm.

There are signs that a debt trap may be threatening. Monetary policy has been hitting its limits; a number of countries face unsustainable fiscal positions, especially if one consider the looming ageing-population burdens – as a rule, surprisingly excluded from current measures of fiscal space – and aggregate (public plus private) debt-to-GDP ratios have continued to rise post-crisis, for the world as a whole but also for advanced economies and EMEs taken as a group.

The *institutional* risk is, ultimately, that of a rupture in the open global economic order, as some of the contributions have noted. Countries would then retreat into financial and trade protectionism. To my mind, the open trade and financial order has been remarkably resilient to the GFC, but I doubt that it could survive other crises. The latest political developments exacerbate this risk.

Policies

What would need to be done to limit these risks, domestically and internationally? And, more to the point, what can one realistically expect?

Domestically, a precondition for progress is to implement policies that address the financial cycle more systematically, rather than relying exclusively on prudential policy – let alone just macroprudential policy – to ensure financial stability. I am not optimistic about this.

Internationally, let me just make three points.

First, there is an urgent need to complete the financial (prudential) reforms, as highlighted in several contributions. The reforms are by no means perfect, but this is no time to weaken prudential safeguards. I am particularly concerned about the huge pressure to dilute minimum capital standards on the false belief that this can support growth.[6] And let me note that, here, so far the main responsibility is not with the United States. We could definitely get a Basel III, but the question is: “At what price?”

Second, there is a need to ensure that global safety nets are kept and, if possible, strengthened. As the Peterson Institute’s contribution indicates, central bank swap lines are critical, although I am not sure how realistic some of the suggestions made there are (e.g., tying them closely to IMF ar-

[6] Ibid.

rangements). My main concern is to save what we have, i.e., the option of activating the existing central bank arrangements. A question is whether this might be politically harder with the new US administration.

Third, as regards macroeconomic cooperation, there is a need to shift the emphasis from *current account* imbalances to *financial* imbalances.[7] Critically, financial imbalances build up also in current account surplus countries. In fact, historically some of the most disruptive ones have done so; think of Japan in the late 1980s and, going back in history, the United States before the Great Depression. Indeed, this pattern has been *the* most common post-GFC; examples include China, Australia, Canada, the Nordic countries, Switzerland and Korea. Moreover, recommending to boost demand in current account surplus countries where financial imbalances are building up can be counterproductive, as it could simply fuel the imbalances further. Japan in the 1980s is a cautionary tale. The IAI's contribution supports this shift in perspective, including a greater focus on how to deal with *gross* capital flows, which can exacerbate financial imbalances. To my mind, the timid shift I have seen at the G20 falls way short of the mark.

Is there a specific role for the G7 in all this? Clearly, the G7 can act as a catalyst, leading by example, as it includes the jurisdictions with the largest international financial players and markets and those that issue the main international currencies. The G7 could spearhead efforts to safeguard the multilateral approach underpinning the open global economic order that has served the world so well in the postwar era. This is a crucial role. The G20 remains the more natural forum for final agreements.

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5.
Financial Stability

Comments by Luigi Guiso

I agree with the presenters in these sessions that after the US elections and the victory of Donald Trump, the G7 will not be the same. Indeed, the world will not be the same. It seems that we are seeing a great political reversal in relation to openness and trade compared to the past 20 years. Only 17 years ago, Bill Clinton stated clearly what has been for many people – for most mainstream economists – an obvious truth: "[W]e have got to reaffirm unambiguously that open markets and rules-based trade are the best engine we know of to lift living standards, reduce environmental destruction, and build shared prosperity".[1] This belief has since constituted a shared principle within the G7. In his inaugural speech Trump has overturned this paradigm and defined a new one:

> We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs. Protection will lead to great prosperity and strength. […] We will follow two simple rules: Buy American and Hire American.[2]

In my comment I want to raise two questions. First, why this reversal? Second, what will be the actual consequences? Is this just "cheap talk" or is this rather the demise of globalization?

Let me start first of all by noticing that the political move against glo-

[1] Bill Clinton, *Remarks to the World Economic Forum and a Question-and-Answer Session in Davos*, 29 January 2000, http://www.presidency.ucsb.edu/ws/index.php?pid=58714.

[2] Donald Trump, *Inaugural Address*, Washington, 20 January 2017, https://www.whitehouse.gov/inaugural-address.

balization is not just a US phenomenon but is much broader as it is shared by all populist movements on both sides of the Atlantic. To understand what they have in common and thus try to answer the first question – “Why the political reversal?” – notice that all these movements share three common traits.

First, they promise protection against some source of insecurity. The specifics depend on the particular country: it could be protection against import penetration, or against he threat of competition from immigrants or even from new technologies that can displace jobs in an industry or sector (e.g., Uber). “Protect our borders” and “Protection will lead to prosperity” are the keywords in Trump’s speech. Protection also figures prominently in the manifestos and speeches of European populist parties.

Second, populist parties rely on anti-elite rhetoric and often anti-corruption rhetoric.

Third and importantly, the protection that these parties promise seems to be cost-free, that is populist parties shroud the long-term costs of protection policies. Protection tends to focus on the proximate cause of people’s insecurity and the policies are meant to tackle this proximate cause directly. The lifting of import tariffs, the building of a wall along the Mexican border, the ban of eastern European immigrants are examples of such policies. They are the answer that populist parties offer to a true malaise that hits a relevant part of the population and that induces economic insecurity. Globalization and the huge competitive pressure that it brought to bear on several segments of western countries’ populations is one source of insecurity but it has been greatly amplified by the global financial crisis and the long-lasting scars that it has left, both in Europe and in the US. Globalization has lost appeal and support among the citizens of western countries, together with the financial crisis it has created scepticism on the ability of traditional parties to address a pervasive sense of economic insecurity, opening the door to the rise of populist movements. This is remarkably visible particularly in European data. Following the financial crisis, people’s trust in political parties drops dramatically, consensus on populist parties emerges and new populist parties enter the political market. Individual voting data show clearly that economic insecurity has two effects: it leads people to revise their confidence in political parties and it takes them away from active participation in elections, lowering electoral turnout. At the same time, insecurity increases voting for populist parties among those who still choose to vote, thus creating support for populist movements and protectionist policies. Are these promised policies just part of a strategy to gain cheap consensus or will they result in an actual reversal of the globalization process that has characterized the past 20 to 30 years?

As I have argued, the success of populist politics reflects a true demand for economic security in the western world that is partly the reflection of the transformations induced by the globalization process. Yet, in my view populist policies are unlikely to reverse globalization. There are at least three reasons why this is so.

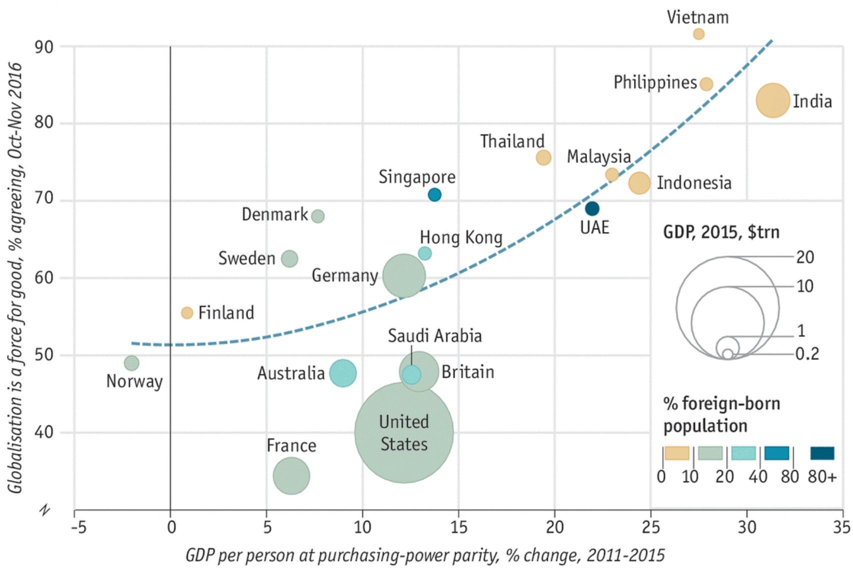
First, the transformation in the way production takes place worldwide with the rise of the global value chain has an obvious element of irreversibility. Too many production systems require the input of goods produced in a large variety of countries. This process of global specialization can only be possible if trade can take place relatively smoothly across countries; the explosion of trade agreements in all areas of the planet, the abatement of trade barriers, the growth in the number of WTO participants, are all necessary for the international division of labour. The international division of labour is now too advantageous to be dismantled. Put differently, the concurrent participation of several countries in the production of a single good, is too costly to revert. The production of a Boeing 787, just to provide an example, requires that the US imports parts that are produced by highly specialized (and thus difficult to substitute) firms located in Italy (Alenia), France (Latecoere), the UK (Roll Royce), Japan (Mitsubishi), Korea (AL-ASD), etc., just to mention a few.

Second, globalization has lost traction in the West but is very popular in the eastern countries of Asia (see Figure 1). While less than 50 percent of western countries' citizens think that globalization is a force for the better, the share can exceed 80 percent and even 90 percent in Asian countries. Because of this it finds political sponsors among Asian leaders. Many were surprised when Chinese President Xi Jinping spoke in defence of globalization at the G20 meeting in Germany by arguing that

> blaming economic globalization for the world's problems is inconsistent with reality […] Economic globalization has powered global growth and facilitated movement of goods and capital, advances in science, technology and civilization, and interactions among peoples.[3]

[3] Xi Jinping, *Keynote Speech at the Opening Session of the World Economic Forum An-*

Figure 1 – Attitudes towards globalization against change in GDP per person



Sources: YouGov/*The Economist;* World Bank; UN

Third, globalization is characterized by strong multinational firms – large innovative firms that rely on global markets not only for their material inputs but also for their human capital – that can only prosper in open markets. Not surprisingly, the first to speak against Trump's travel ban were the CEOs of global companies such as Facebook, Google and Apple. Does this mean that the political reversal will have no consequence? I think the most likely outcome will be a slowdown of globalization but not its reversal. Meanwhile, if my reading of the political reversal is correct, leaders will have to understand that the economic insecurity that western citizens suffer and that is at the root of the populist success, needs to be dealt with. Its nature however, suggests that the standard tools that are available in our countries – unemployment insurance programmes, retraining programmes and tax transfers and redistributive policies – are probably inadequate not only in scale but also in nature to tackle todays insecurity problem. They were designed to deal with the distress induced by the business cycle fluctuations; they are unfit to deal with the insecu-

nual Meeting 2017, Davos, 17 January 2017, http://news.xinhuanet.com/english/2017-01/18/c_135991184.htm.

rity produced by the displacement of human capital in turn generated by rapid changes in industry structure and in patterns of specialization. This requires a re-thinking of the welfare state. This problem is shared by all G7 countries and should thus appear high in their agenda.

The following figures show the evolution of economic activity, trust in political parties, electoral turnout and consensus to populist parties in Italy, Greece, Spain and France. Economic activity (measured by the index of industrial production), the share of votes to the populist parties and electoral turnout are on the left scale; trust in political parties on the right scale.[4]

Figure 2 – Drop in industrial production, turnout and trust; and rise of populism – Italy

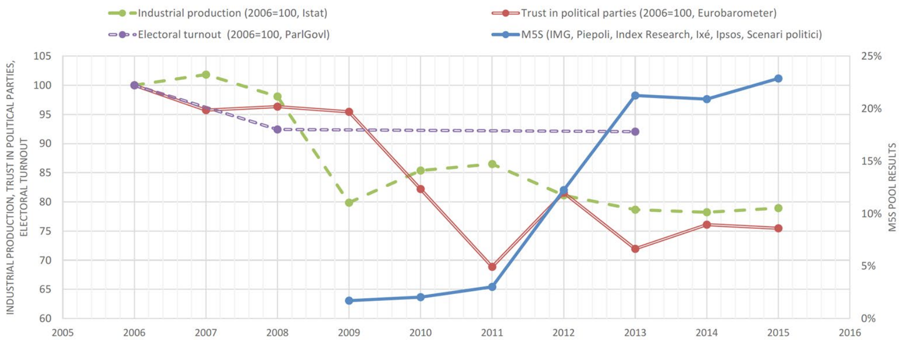
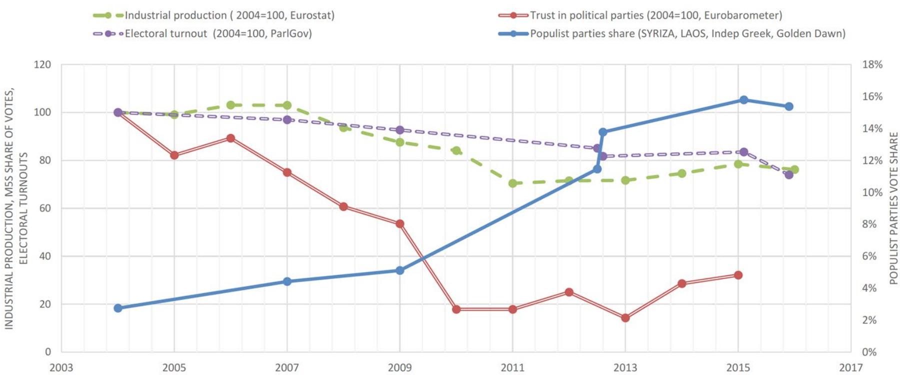


Figure 3 – Drop in industrial production, turnout and trust; and rise of populism – Greece



[4] See also Luigi Guiso et al., "Demand and Supply of Populism", in *EIEF Working Papers*, No. 17/03 (20 February 2017), http://www.eief.it/files/2017/02/wp-173.pdf.

Figure 4 – Drop in industrial production, turnout and trust; and rise of populism – Spain

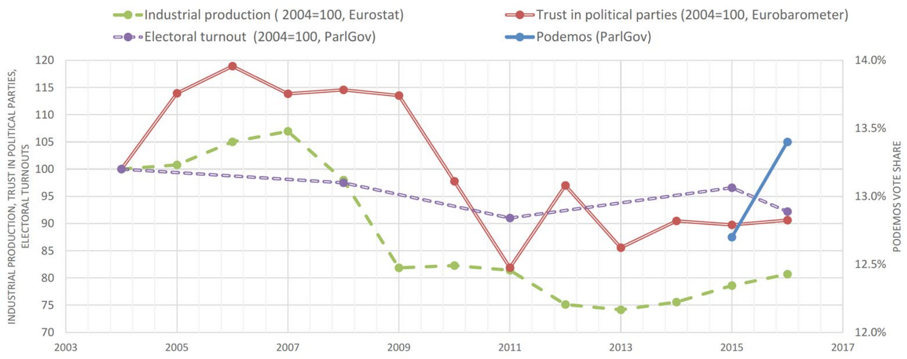
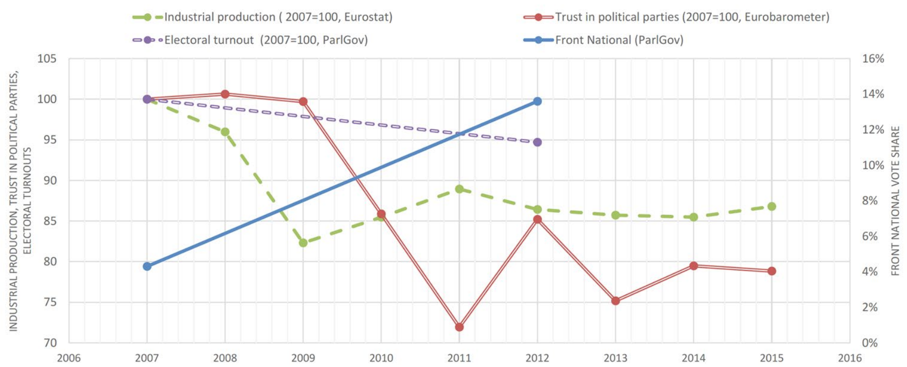


Figure 5 – Drop in industrial production, turnout and trust; and rise of populism – France



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6.

The Role of the G7 in the Global Governance

Comments by Iain Begg

The core challenge confronting the G7 is to provide a governance steer to other policy actors on how best to manage globalization. For this purpose, it is helpful to take a sufficiently broad view of, first. What constitutes globalization and second, the dimensions of globalization of most concern in the present international climate. Hence:

- The most familiar interpretation of globalization is open flows of trade and investment. Although under some pressure, the G7 policy stance should be to mobilize support for maintaining openness.
- Financial spillovers are more of a risk, especially if over the medium-term there is a substantial unwinding of central bank asset holdings.
- Global governance has yet to find convincing answers to how to manage flows of people – not just displaced persons/refugees, but also those disposed to be economic migrants.
- More thought also needs to be given to the medium- and longer-term approaches to governance of flows of knowledge and technology.
- And, building on comments by Governor Visco in his dinner speech,[1] management of the causes and consequences of political uncertainty needs to improve.

It is worth looking, too, at the global problems "G" configurations were originally established to resolve and new ones on the horizon:

[1] See Part III, Chapter 1 in this volume.

- The impossible trinity (Mundell onwards) has seen acceptance of the imperative of free financial flows, leaving other arms of the trinity to take the strain, but could it be time to re-think the extent and mix of financial flows. Although Saccomanni and Romano mention the OECD view that the "benefits of free capital mobility outweigh the cost of financial instability",[2] there must now be doubts about whether all capital flows are beneficial and thus whether some could reasonably be diminished – what Rolf Langhammer et al. refer to as putting some sand in the system.[3]
- Could the carry-trade, in particular, be slowed by some kind of transactions tax to curb its destabilizing effects?
- Global inequality is undeniable and it links to concerns about not just the moral case for more effective efforts to reduce inequalities of different sorts (income, well-being, health, economic opportunity, gender, environmental conditions), but also their indirect effects on the security agenda.
- Is a new phase of exchange rate volatility in prospect, and can anything be done about it? The unwinding of QE is likely to occur at different times and at different speeds among major currencies, and there may be a case for looking for novel ways to mitigate possibly damaging consequences.

On these and other themes there is often plenty of analysis of *what* needs to be done and *why*, but less clarity on *how* to make change happen. A focus on the political economy of "*how*?" would be worthwhile, not least in developing counter-arguments to those so glibly put forward by populists.

Turning to what next for the G20 and, more generally, for global governance, the five scenarios set out in the recent European Commission White Paper on the Future of Europe[4] could offer some pointers:

- Status quo is always tempting, especially when immediate crisis is not looming, but the certainty is that a new crisis will emerge, so that muddling though is not an appealing scenario.

[2] See Part I, Chapter 4 in this volume.

[3] See Part I, Chapter 6 in this volume.

[4] European Commission, *White Paper on the Future of Europe. Reflections and Scenarios for the EU27 by 2025* (COM/2017/2025), 1 March 2017, http://eur-lex.europa.eu/legal-content/en/TXT/?uri=COM:2017:2025:FIN.

- Equally, a global equivalent of EU federalism (implicitly the fifth of the scenarios) i.e., some form of global government (as opposed to governance) is too remote a notion to be worth considering.
- Retrenching to a more limited global agenda is an option, but raises the question of, to what?
- That leaves two of the Commission concepts that could be worth pursuing. First "doing less better" could be useful guidance for international financial institutions (IFIs).
- Most tempting is a variant on "those who want to do more go ahead", keeping doors open to others to join. For example the G20 in considering how to deal with climate change, infrastructure need or refugees could advance proposals such as China's belt and road.

Two possible aphorisms to consider:

- Build new coalitions of the willing to counter the coalitions of the "unwilling" exploited by populists.
- Change the expression attributed to James Carville (the ragin' Cajun) to "It's the political economy, stupid".

7.

The Role of the G7 in the Global Governance

Comments by Domenico Lombardi

First, let me commend the IAI for spearheading this inaugural meeting of the T7. CIGI greatly values this initiative, particularly as Canada will succeed Italy in chairing the G7 summit next year.

In my remarks today, I shall summarize the thrust of the discussion I have been hearing so far, and in doing so, I shall add some thoughts of my own.

It is quite clear what the G7 cannot do under the current circumstances. It cannot promote macroeconomic cooperation, as that would require trust and legitimacy, as well as an engaging leader. The leader, moreover, ought to be ready to sacrifice some gains in the broader interest of the overall group. This would obviously apply to other members as well.

Given the current setting, the G7 cannot pursue exchange rate cooperation, as it quite successfully did in the late 1980s with initiatives that culminated in the Plaza Agreement of September 1985, and the Louvre Accord of February 1987. The euro zone and Japan would be hesitant to embark on any plan that might affect their already modest growth prospects through, for instance, a relative appreciation of their currencies vis-à-vis the US dollar.

As for the euro zone, the European Central Bank is an independent, multinational central bank with a clear but narrow mandate centred on price stability. Joining any currency plan agreed to by the G7 governments might look problematic, especially if such a plan were to further compromise the attainment of the ECB's goal of an inflation rate close to two percent.

Even on trade, the G7 is unlikely to make any progress under the current circumstances. Negotiations between the United States and the EU on the TTIP have stalled, and Germany continues to be included in a special monitoring list drawn up by the US Treasury in its semi-annual report to Congress of countries that are close to meeting all the criteria for being labelled an exchange rate manipulator.

The only reason why Germany has not been labelled as such – and will not be in the future – has to do with an apparent oversight in the underlying framework that requires the central bank of the country in question to engage in protracted, one-sided interventions on the foreign exchange rate markets. As a member of the euro zone, Germany relies on the ECB, which is, in fact, independent.

That said, a country running a current account surplus with the rest of the world in the order of eight to nine percent of GDP is not a particularly enticing trading partner for the US – the economy with the strongest knowledge, technology and market infrastructures in the world.

Other compelling policy issues such as migration and climate change are too politically charged for the forthcoming G7 summit to make any difference. There are, however, other items on which the G7 could make a difference.

One of them is investment, as my CIGI colleague Malcolm Knight has suggested in his proposal. To start with, investment sounds sufficiently technical and technocratic to diffuse the political charge now surrounding more confrontational items, such as macro, exchange rate or trade policies.

In addition, (more) investment is appealing to those economies where there is slack in demand, like Italy, for instance. But it is equally appealing to other economies that are running at full potential, like Germany or the United States.

In the latter case, increased investment shifts the aggregate supply in a non-inflationary way. And, for both types of economies, investment may contribute to raising productivity, being thus akin to a politically feasible structural reform.

In any case, we should bear in mind that this is the first summit that President Trump will attend. Regardless of any tangible, significant outcome at the Taormina summit in May, the most important accomplishment of all will be for the other political leaders to build a *rapport* with the new president and "socialize" him to the international agenda.

8.

The Role of the G7 in the Global Governance

Comments by William R. White

I will restrict my remarks to the role of the G7 in global governance in the economics sphere. That is to say in the three areas of economics – international trade, financial stability and macroeconomic policy coordination – covered in the three previous sessions of this conference. How might changes in the way the G7 functions improve the overall process of international cooperation in the economics sphere? How might this in turn produce better policies in the support of the "strong sustainable and inclusive growth" desired by the G20? In pursuing answers to these questions, I take as given the wide variety of other structures available for pursuing international cooperation.[1]

The global economy is a complex, adaptive system like many others in nature and society. In all such systems, the agents involved evolve over time in response to changes in their environment. They either evolve,

[1] Some of these structures are public. Among those established by treaties and imposing international obligations ("hard law") are the United Nations and its agencies, the Bretton Woods institutions (the IMF and World Bank group), the Regional Development Banks and the European Union and its various institutions. Other public sector structures that support international cooperation are the OECD, the Bank for International Settlements and the Financial Stability Board. These latter institutions operate in the realm of "soft law". That is, they can make policy recommendations to member states (generally based on negotiations and agreements among them) but they have no force of law. National legislation is subsequently required. A wide variety of private structures also exist to foster international cooperation. These include technical standards for data exchange (e.g., UN/EDIFACT and SWIFT), codes of conduct (say for foreign exchange dealers), harmonized accounting and disclosure agreements and many more.

showing their fitness to survive, or they die.[2] The G7 seems to me to be facing such an existential treat in the form of the G20, a much more inclusive grouping that also includes the important emerging market economies. These non-G7 economies are growing fast and are increasingly interrelated among themselves and with the G7. In short, the G7 can neither "call the shots" nor can it "go it alone". The threat, as the G20 cooperative process improves with time, is that the G7 structure and meetings will seem increasingly irrelevant.

This would be a pity, since the G7 working together still have a lot to offer in terms of policy advice. They have been developed economies for a long time and have a long history of analytical reflection on the difficulties of achieving "strong, sustainable and inclusive growth". Moreover, they remain an important part of the global economy, indeed still a dominant part in the financial area. In short, the reflections of the G7 still need to be listened to. Further, their capacity to lead by example still remains a significant source of influence on others.

How might the G7 evolve to maximize its contribution to the global policy debate on economic issues? I suggest the G7 should withdraw from the business of offering short- to medium-term policy advice about macroeconomic issues. They should leave this to the G20. Rather, the G7 should focus on identifying the longer-term problems common to almost all of the G20, along with suggestions as to how cooperative actions might serve to mitigate these problems.

An explicitly longer term focus – essentially on improving rules and frameworks – would provide a useful counterbalance to the "short termism" seen almost everywhere in the economics sphere. This longer term focus would also increase the attention paid to the unintended consequences of short-term policy "fixes". Finally, a longer term focus would increase the likelihood of an early response to problems that might otherwise prove unmanageable over time. Inadequate private pension funding and the off balance sheet obligations of government promises are important examples. Issues arising from the G7 process would then be suggested for the G20 agenda. Implementation would be a matter for the G20.

[2] Two interesting examples of such evolution are the BIS and the IMF. In both cases, the original reason for their existence disappeared, yet both quickly found alternative and internationally useful roles to play.

A useful organizing principle is that all government institutions should have an explicit mandate, a set of powers or instruments that can be used in pursuit of the mandate,[3] and a process for ensuring democratic accountability. This principle guides the following reflections on how the role of the G7 in the process of international cooperation might be improved.

A new mandate for the G7

It is important to note that to implement agreed policy solutions actually requires meeting at least three challenges to international cooperation. These I refer to as the "should", "could" and "would" challenges.[4] The first of these is in the realm of economics. Identify common, longer term economic problems, along with cooperative policy solutions that might help to alleviate them; what *should* you do? The second requirement is in the realm of law. Identify national regulatory and legal impediments to achieving the desired degree of international cooperation, along with suggestions as to how they might be removed; what *could* you do? The third requirement is in the realm of politics and likely the most intractable. Identify factors impeding the will to act, along with suggestions for dealing with them; what *would* you do?

What should be done?

Identifying not only problems that are common to many countries, but also problems of long standing, is not difficult. Virtually all of the G7 share

[3] As a corollary, in most instances the use of the available powers (instruments) should be "independent" from short-term political pressures. This is generally what is meant when we talk about central bank independence or the independence of financial regulators. Note that this independence is commonly granted freely by legislators (politicians) who rightly fear that their own search for short-term solutions might prove counterproductive over time. For example, excessive monetary stimulus might lead to inflation and subsequent recession.

[4] Nick Veron of the Breugel Institute refers to the same issues in a European context. He say the EU suffers from an analytical deficit, an executive deficit and a democratic deficit.

the list of ailments identified below, as do (and increasingly) many of the non-G7 members of the G20:

- bad demographics;
- declining employment rates for those of working age;
- declining growth rates of total factor productivity;
- low rates of capital investment;
- fears of deflation;
- low interest rates;
- skewed factor shares (high profits and low wages);
- rising national inequality;
- imbalances in financial markets;
- high levels of both private and public debt;
- highly volatile international capital flows;
- global trade imbalances;
- slowing global trade.

Moreover, most of these common problems have been evident for years and sometimes decades. Thus, they cannot be ascribed to recent developments such as uncertainty about the economic policies of the new Trump administration in the United States. As well, it must be recognized that the global economy is now so interdependent that, should crises emerge anywhere, they are likely to have implications everywhere. This provides a further impetus for identifying the underlying economic processes that have produced these undesirable results, and for trying to find cooperative solutions. We are all in the same boat together.

Before turning to the three economic issues identified above, it is important to begin by highlighting a popular fallacy; namely, that a clear distinction can be made between shorter run policy issues and longer term policy issues. Put otherwise, the assumption that macroeconomic policies do not affect longer term growth, and that structural policies do not affect the economic cycle, is simply wrong.

The former proposition has been proven false by an expanding literature pointing out how financial "booms" can generate "busts" that last a decade or longer. Indeed the empirical literature indicates they can sometimes permanently reduce the level of output and even its future growth rate. What this insight also implies is that the many items on the above list are not independent but are jointly driven by underlying processes.

The proposition that structural policies do not affect the nature of economic cycles is also wrong. Consider the role of interest rate deductibility in encouraging leverage and speculation, and the effect of labour market legislation on wage price dynamics.

What should be done with respect to *international trade*? Aside from some elements of the Trump administration, there seems to be almost universal support for maintenance of an open trading system and the crucial role to be played by the WTO. That said, there is recognition that multilateral agreements have faced strong headwinds for over a decade and that the way forward (while less than ideal) is likely to be bilateral and plurilateral deals. In the face of the Trump challenge, and the recognition that further trade liberalization might in fact be subject to decreasing returns, the strongest efforts should go into maintaining the system we have.

However, great care should be taken in invoking the threat of trade retaliation in the face of unilateral actions. Should such retaliation actually occur, threatening still further rounds of retaliation, the events following the introduction of the Smoot-Hawley Act might well be repeated. The underlying fragility of the world economy is arguably greater now than it was then. As noted just above, changes to structural policies can have important macroeconomic effects.

There also seems general agreement that *financial stability* would be best promoted by completing and then implementing the policy suggestions made by the Financial Stability Board. This should be done as quickly as possible, and the regulatory framework stabilized, to reduce the uncertainty now faced by financial market participants. Policy uncertainty in this realm has arguably had negative effects on the willingness to lend, especially for longer term projects such as infrastructure.

It might also be suggested that, within the regulatory framework, too little effort has gone into measures to strengthen the resilience of the financial system as a whole. Macroprudential instruments might be used more aggressively to resist excessive and imprudent credit expansion. As well, much more attention should have been paid to preventing cascading effects within the financial system. Scaling up systems generally provides greater efficiency but the damage caused when things go wrong can be an order of magnitude greater. At the least, unnecessary complexity should be removed. It is also common in other complex systems (like IT networks) to build in redundancy and to rely more on modular designs.

This might, however, be work for a later period after the current regulatory changes have been fully adopted.

Going beyond the regulatory framework, two other sets of measures that might have contributed to financial stability have been relatively underused, namely self-discipline and market discipline. As to the former, the ever expanding role of the "safety net" raises serious concerns of moral hazard. Bankers also need to regain their former sense of fiduciary responsibility. Legal redress resulting in punishments for individual managers, not shareholders, also needs to be brought back. As to market discipline, how can accounting figures and auditing be made more useful in the pursuit of market discipline? Something is very wrong when even Warren Buffet says the interpretation of current numbers in the financial sector is beyond him.

The greatest analytical challenge has to do with *macroeconomic policy coordination*. At the risk of caricature, there seems to be a wide gap between the hard-line US view (the Washington consensus) and that held by German policymakers (the Ordoliberal consensus) concerning the policies required to achieve desired goals. The former emphasizes shorter term goals (strong growth), the usefulness of discretionary policies, the importance of demand management and the self reliance of individuals. The latter emphasizes longer term goals (sustainable growth), the need for time-consistent rules, the importance of supply-side reforms and a strong social safety net to help individuals cope with market change. Both see the state as playing an important role in establishing a framework for free markets, although that role would be relatively more limited from a US perspective.

Fortunately, both hard-line views have been increasingly under attack, the former in the context of the global crisis and the latter in the context of problems in the euro zone. This opens the way to a retreat from respective ideologies and the recognition that a middle ground might be possible. Indeed, some movement is already clear. Even in the US, it is now being admitted that trade creates losers as well as winners and that the former may need state help to adjust. Even in Germany it is now being recognized that fiscal austerity can, in some circumstances, be counterproductive in the pursuit of longer run debt sustainability. Further research work needs to be done with respect to each aspect of the policy debate, and a new consensus achieved that blends the insights of both Keynes and Hayek. Two particular issues need attention.

First, we need a greater understanding of the role played by credit and debt in the economy and the associated benefits and risks. This also raises the related questions of measuring "fiscal space", the need (or not) for restructuring of both private and public debt, and the adequacy (or not) of our global insolvency procedures.[5] To focus on just one aspect of this problem, the level of contractual sovereign debt, together with the off balance sheet promise made by G7 governments, is simply unsustainable. These promises cannot be honoured. Further, the private-sector debt problem has not yet been resolved, and some of that debt threatens to fall back onto governments that are already overburdened. What is the best way to face up to this reality in order to avoid a disorderly outcome, likely in the form of an eventual market backlash?

Second, we need to revisit the issue of the international monetary system. The current "non-system" has many shortcomings. It has not been able to deal with the problem of growing current account imbalances, implying that the Triffin paradox still threatens the continued use of the dollar as the principal international reserve currency. Moreover, it is increasingly clear that the international spillover effects from domestic monetary policies (especially those of the Federal Reserve) are both significant and harmful to others. Put another way, the "system" has put no constraints on the right of domestic central banks to expand their balance sheets in a way that is historically unprecedented. We need to consider the implications of, not just one large central bank doing this, but all of them. If these implications are thought dangerous, how can we collectively minimize these dangers? And looking forward, how might we devise a better international monetary system that avoids all the shortcomings of the current "non-system"?

What could be done?

Knowing what should be done is only the first step in successfully implementing cooperative policies. Often, governments are constrained by domestic legal or regulatory provisions from doing what they might other-

[5] It is simply a fact that we still are not capable of winding down, large internationally active banks in an orderly way. Ten years after the onset of the financial crisis, we still have banks that are "too big to fail". Worse, some are "too big to save".

wise want to do. The Federal Reserve presides over the world's principal reserve currency, yet must legally pursue only the domestic objectives of full employment and price stability. While the Federal Reserve has entered into currency swap arrangements with a number of central banks, they could unilaterally refuse to honour them. Congressional intervention in a crisis might lead to the same outcome. Similarly, domestic regulatory agencies are often forbidden to share confidential information with other such agencies, even in a crisis. Finally, by way of example, the German Constitutional Court has repeatedly been asked to rule on the legality of measures taken by the European Central Bank to support either the euro zone economy or the integrity of the euro zone ("whatever it takes").

A useful role for the G7 would be to draw attention to laws and regulations that seem to impede the scope for desired international cooperation without serving any legitimate domestic objective. Evidently, there will be a wide range of views as to what constitutes a "legitimate domestic objective". Nevertheless, it would be a useful function just to point out the areas where a trade-off exists between domestic and international objectives. Without appreciation of these tradeoffs, achieving domestic objectives seems likely to be the default position.[6]

What would be done?

Even if what should be done is clear, and the power to act is available, the absence of a political will to act is a further impediment to international action in pursuit of the common good. The brand of "populism" now ascendant in many countries favours strictly national pursuits. Perceived problems faced by the average citizen are blamed on those deemed to be "others": foreigners (via unfair trade), immigrants (taking jobs and welfare payments) and traditional scapegoats like the Jews and other minorities.

[6] The basis of the current world order rests in the Treaty of Westphalia that ended the Thirty Years War in 1648. It was there that the concept of state sovereignty was established. Some might argue that the interlinkages between sovereign states have now reached such a point that state powers might be ceded to some higher authority. In a sense, this is the process underway in the European Union. Evidently, the political climate in today's world is not supportive of such a position. As suggested above, just preserving yesterday's gains from globalization will be a significant achievement.

The root of the problem seems to be widening inequality in many countries, with the benefits of growth over the last few decades going to only a small proportion of the population. This is widely perceived to be "unfair", a perception which erodes trust in domestic government and also in the benefits of international cooperation. Also contributing to this erosion, and almost certainly a trigger for the recent shift in political sentiment, has been the financial crisis which began in 2007. There is now an impressive literature documenting similar political effects arising from financial crises in many countries over the last century or so. In the current crisis, the general trend to "bail out the banks", at the expense of the taxpayers, has further contributed to the sense of unfairness. In the euro zone, such policies have not only driven a wedge between citizens and their national governments but also between the citizens of creditor and debtor countries.[7]

What might the G7 suggest in the face of this deep-seated problem? Actions might be suggested both to address the underlying economic realities and also to address the problem of misguided popular perceptions.

As for the reality of widening domestic inequality, various "worker friendly" policies should be investigated. Could wages be allowed to rise without sparking an inflationary spiral? Record-high profit spreads seem to point in this direction. Could more aggressive competition laws and enforcement levels bring prices and profits down, to the benefit of ordinary people? Could less stringent employment protection and better "safety net" provisions for the unemployed (what the Danes call "flexicurity") help in promoting inclusiveness (especially for the young) and a greater sense of well being? Could more active labour market policies (to reverse the growing problem of skills mismatch) and more attention to skills development (both vocational education and adult training) be more vigorously pursued? Pushing these issues higher up on the G7 agenda, accompanied by concrete follow up, would help restore a sense of fairness and the trust in government that arises naturally from it.

As for misguided popular perceptions, again a great deal could be done. The G7 should make the positive case for globalization, not least

[7] With banks having been exempted from bearing the costs of the bad loans they initiated, the ultimate borrowers (citizens of peripheral countries) and ultimate lenders (citizens of core euro zone countries) must bear the costs. Both now feel unjustly aggrieved.

lower consumer prices for the poor. Focussing solely on the negative effects of withdrawing from global processes is unlikely to be adequately persuasive; think of the Brexit campaign. As well, it should be much more widely publicized that the real threat to jobs has not been globalization (and global supply chains) but technology. Moreover, there are grounds for belief (e.g., artificial intelligence) that the threat to jobs from technology could become even more menacing in the not so distant future. The G7 should indicate clearly that they not only recognize this common problem, but also are collectively working on how to deal with it in a "socially just" way. Again, a government commitment to ensure that technological advances benefit the many, and not just a few, would enhance both a sense of fairness and of trust in government.

A new set of powers for the G7?

A new agenda which focussed on identifying long term problems and proposing longer term solutions would seem to require new powers to make it happen. In particular, a longer term institutional memory and the support provided by a permanent secretariat would seem required. The current approach to supporting the G7 agenda, where a rotating Presidency provides secretarial support and proposes new issues each year, is a recipe for overload and an inability to follow through.

A permanent secretariat need not be large, or even tasked with doing its own research. The main task would be to identify the longer term issues that the G7 thought needed attention but that have not yet been picked up by the G20. It would then provide surveys of existing research and the possible policy implications for international cooperation. Further research might then be carried out by some combination of requests to existing institutions (like the BIS, IMF or OECD), working groups assembled for the specific purpose or commissioned research from universities and think tanks. Physically, it might be best to house the new secretariat in one of the existing institutions. This would provide the cost savings associated with the use of existing corporate services and also provide daily interface with other professional staff (economists, statisticians, lawyers, etc.).

A new form of G7 accountability?

How can it be assured that the G7 actually pursues its new agenda of identifying longer term problems and initiating a process for dealing with them? One way of assuring this is for the G7 to be fully transparent about what it proposes to suggest to the G20. As well, it should be clear about what issues it intends to address at the G7 level – how it intends to lead by example. Then the full weight of public opinion could be mobilized to support G7 initiatives (or not).

A complementary role for the G7 might then be to keep track of the implementation record. The sad truth is that many of the promises made in previous Communiqués (both G7 and G20) have subsequently been ignored by many of the countries signing them. This brings the whole process of international cooperation into disrepute by feeding the current of popular distrust, and cynicism concerning government promises that is already too well established. The G7 should keep a record of all its suggestions to the G20, and also a record of those that the G20 accepted to pursue. Further, the G7 should then keep a record of whether or not those G7 suggestions, reproduced in G20 Communiqués, were adequately followed up or not. This would help induce action where action had been promised. In this way, the reputation of both the G7 and the G20 might be enhanced, and the longer term welfare of their citizens improved.

PART III

KEYNOTE SPEECHES

1.

Financial Market Volatility and Global Policy Uncertainty: a Conundrum

Ignazio Visco

After the turnaround that has been observed since the second half of 2016, there are encouraging signs that the global economy is continuing to gain positive growth momentum. Overall, financial market developments have been and continue to be favourable. The positive tone associated with widespread gains in stock markets, including in bank equities, and with higher long-term interest rates, also following the increase in market-based inflation expectations, has been accompanied by persistently low levels of financial market volatility.

In the same period, however, there has been a sharp rise in global policy uncertainty. This is a cause for concern: there is ample empirical support for the claim that economic policy uncertainty – if persistent – dampens economic activity and trade as well. Although the positive tone and low financial market volatility provide some comfort, we should be aware of the fact that economic policy uncertainty measures – with all the caveats that apply to news-based approaches – may capture longer-term concerns only partly correlated with perceptions of the short-term macroeconomic outlook on which financial markets tend to focus.

Rising policy uncertainty is clearly linked to the substantial changes that have occurred in the international political landscape in recent months. The unexpected outcome of the referendum on the United Kingdom's exit from the European Union has thrown a spotlight on the risk of a regression in the process of European integration. Much has been said about the difficulties and uncertainties of the Brexit negotiations. At the same time, nationalist and populist movements are on the rise in many countries within the Union, while political instability and tensions in nearby regions are high.

This year the number of refugees seeking political asylum could rise to new record highs: there is no need to stress the urgency of the migration problem, which concerns virtually all European countries, and some – like Italy – more than others. Indeed, in recent years it seems that a divide has emerged within the European Union on crucial issues such as the approach to migration inflows and the prospects for a unified defence policy. Last Saturday, the Declaration of European leaders on the occasion of the 60th anniversary of the Treaties of Rome pointed to a renovated sense of unity. But we cannot underestimate the risk of costly political paralysis in a year with a number of critical upcoming elections at a time when the challenges we face could not be more difficult.

Even if the recovery seems to be gaining momentum, the legacies of the crisis – most notably in the labour market and in the banking sector – are still weighing on the economy. All this looms over a European construction that is largely incomplete. We still need to take decisive steps to complete the banking union. The functioning of the Economic and Monetary Union is hampered by the lack of a common fiscal policy. Needed progress in these areas is complicated by a decline in mutual trust between countries and by the growing general dissatisfaction of the people with European institutions.

On the other side of the Atlantic, the new US administration is sending conflicting signals on a number of key issues. The details of the next fiscal package are yet to be defined. While the prospect of fiscal expansion may be boosting the business climate, this could have pro-cyclical effects at a time when the economy is almost at full employment. The new administration's stance on financial regulation is also not yet clear, but there is good reason to believe that a wave of regulatory easing, coupled with an expansionary budgetary policy, could lead the Federal Reserve to undertake a less gradual normalization of the monetary stance so as to avoid fostering imbalances such as those observed in the years immediately prior to the financial crisis.

If this proves to be the case, there could be negative international financial spillovers. But the most widespread concern is probably related to the US administration's stated intention of slowing down or even reversing the process of trade liberalization, which could trigger retaliation by other countries, with negative repercussions on productivity and growth worldwide.

Thus, as a result of these global developments, we are now seeing a very sharp increase in economic policy uncertainty in all the main advanced countries. During the first two months of 2017, the most often cited policy uncertainty index (the one developed by Scott Baker, Nicholas Bloom, and Steven Davis) reached its highest points since January 1997, the start of its time series, for both the global economy and the euro area. For the euro area, the index has been on the rise since mid-2014; its most recent movements largely reflect the upcoming elections in France and Germany. The index for the United States has reached its highest level in five years due to the key contribution of two categories: fiscal policy uncertainty and, especially, trade policy uncertainty.

It is well-known that economic uncertainty is a strongly countercyclical variable: it usually increases during recessions and decreases during economic expansions. Many studies, however, have shown that uncertainty is not just the consequence of the business cycle but is also one of its key drivers. Elevated uncertainty affects economic activity through two main channels. First, it weakens aggregate demand, as households postpone consumption decisions and increase precautionary savings, while businesses delay investment and hiring plans. Second, it hampers aggregate supply: by delaying investment and hiring, in fact, the quality and quantity of physical capital diminishes, while the process of reallocation of workers from less to more efficient firms – which is responsible for the highest share of productivity growth – freezes, causing a slowdown in productivity. Indeed, in Italy uncertainty has been a sizeable drag on investment growth, not only during the global financial crisis but also in its aftermath, thus being one of the main factors behind the lagging recovery of the Italian economy.

Notwithstanding a sharp increase in economic policy uncertainty, growth in the euro area has recently improved. This is to some extent surprising. While some analysts have argued that what really matters is financial uncertainty, which is currently low, as I have pointed out, evidence for the United States shows that economic policy uncertainty negatively affects employment and industrial production even when financial uncertainty is taken into account. My personal view on why high policy uncertainty seems to have had only a limited effect in the euro area in recent months is that its negative impact was successfully countered by the strongly expansionary monetary measures implemented by the ECB.

Indeed over the last few years the euro area has faced a very challenging environment. Downward risks to price stability increased sharply after mid-2014: as inflation fell, economic activity lost traction and monetary and credit dynamics remained weak. There was a material risk of expectations de-anchoring from levels consistent with price stability, as long-term expectations reached historical lows. In an environment of high levels of public and private debt, activating "debt-deflation mechanisms" would have had very serious effects on the economy.

To combat these risks, the ECB Governing Council adopted a bold set of conventional and unconventional monetary policy measures. Official interest rates were progressively cut to zero on our main refinancing operations and to negative values (currently -0.40 percent) on the deposit facility for banks, representing the truly "non-conventional" element of our monetary policy. A very substantial asset purchase programme was then put into place, following the example of other central banks. (I would like to point out that – although this is a new approach for the euro area and is very broad and comprehensive, involving purchases of asset-back securities, covered and corporate bonds, and public sector securities in particular – this measure is not revolutionary for monetary policy: it certainly would have been regarded as "conventional" in the 1960s and 1970s given the emphasis on changes in the composition of private sector balance sheets that prevailed at that time both in policy-making and in academic works on the transmission mechanism of monetary policy). Finally, we launched two series of "targeted" long-term refinancing operations with conditions that rewarded banks for providing more credit to the economy.

The impact of the overall package has been considerable. Our purchases have significantly reduced yields in the market segments where we have intervened and, through the portfolio rebalancing channel, they have also bolstered the prices of a wider range of financial assets, with a positive impact on household consumption through the wealth effect and on business investment through the fall in the cost of capital. Credit supply conditions have gradually eased. The cost of loans to the economy has fallen to historical lows and financial fragmentation in the euro area has lessened. The combination of the decline in returns on fixed-income securities associated with our purchases and the reward system attached to our targeted refinancing operations has spurred the supply of credit to firms and households.

The significant improvement in financial conditions has gradually affected the economic outlook. Deflation risks have disappeared: according to the distribution of inflation expectations based on option prices, the probability of deflation, after reaching a peak of around 30 percent in early 2015, has returned to levels very close to zero. Market and survey-based expectations on inflation in the short- and the long-term are recovering from the very low levels observed in the last two years; economic expansion is firming and broadening, mainly reflecting the recovery in investment and consumption and rising employment. Headline inflation has also increased, although largely on account of its most volatile components, like energy and unprocessed food prices.

Since underlying inflationary pressures continue to remain subdued and are expected to rise only gradually over the medium term, the Governing Council of the ECB is maintaining the very favourable financing conditions that are necessary to secure a durable, self-sustained and broadly-based convergence of inflation rates towards our price stability objective.

Notwithstanding the overall positive assessment of the effects of our actions, we are aware that prolonged recourse to a bold set of measures might have unintended consequences and that the potential repercussions for specific sectors of the financial system certainly should not be ignored. As far as the impact of low interest rates on bank profitability is concerned, low short-term interest rates can depress bank margins because, for many types of deposits, banks are reluctant to lower deposit rates, especially below zero. Moreover, since banks transform short-term liabilities into longer-term assets, a flattening of the yield curve depresses the net interest margin. This implies that banks with a higher share of retail deposits, floating rate loans and a large maturity mismatch may suffer more from low interest rates. In the current environment, this effect could be particularly problematic for those banks that are not in a sound financial position and have to manage large amounts of non-performing loans.

Our evidence suggests that the impact of monetary policy measures on bank profitability has been in general contained: they have led to higher asset valuations and, more importantly, have supported economic activity and enhanced lending. To achieve a long-lasting return to higher profitability and contribute efficiently to financing the economy, banks also need to make further progress in containing costs, upgrading technologies, and streamlining their organization and branch networks.

In evaluating the possible side effects of our unconventional monetary policy measures, we also carefully consider the risks to asset prices. To date, we do not see signs that our purchases are causing generalized imbalances. Financial assets and property prices in the area as a whole do not appear under pressure and credit growth is still weak. Furthermore, when discussing financial imbalances, I believe that it is important to bear in mind that, in the euro area, the primary objective of monetary policy is to maintain price stability and that, should any threat to financial stability materialize, macroprudential measures should be used instead to limit the accumulation of systemic risks and to smooth the financial cycle in particular sectors or geographical areas.

While monetary policy has been successful in warding off a deflation trap and no negative side effects have emerged so far, monetary policy cannot remain "the only game in town". Aggregate demand in the euro area must be supported by fiscal policy, wherever and however possible. At the same time, potential growth must be reinforced through the adoption of appropriate reforms to foster technological progress and strengthen human capital.

This said, the divergence between economic policy uncertainty measures and financial market volatility is something that should not be ignored, in Europe as well as in the United States. The former indicator is high precisely because of doubts associated with factors other than the monetary policy stance, and the latter is low precisely because this stance has delivered the necessary short-term conditions for a cyclical revival of economic activity. But as rising economic policy uncertainty points towards the severe risks that the political and economic environments will face down the road, low financial volatility may suggest that markets are overly optimistic about the medium-term outlook and underestimate the risks, including political ones.

Eventually, either economic policy uncertainty will recede or an increase in financial volatility will produce (possibly very) negative headwinds for the global economy. Obviously, this will hinge on policy decisions and their crucial effects on trade, investment and growth. But we should be aware that the challenges we are facing on the domestic front are not the only ones confronting us. Indeed, as Tommaso Padoa-Schioppa observed at the height of the financial crisis,

> one way in which domestic policy may lose credibility is by continuing to feed the illusion that national governments can address issues – like climate change, energy, security, immigration, finance – that are no longer national, but that increasingly have a global dimension.[1]

But how can countries manage to cooperate? On the one hand, we have cooperation forums like the G7 and the G20. The joint statements of these groups are highly visible and tend to have a strong impact on the media and the markets. Think, for example, of the attention paid to the communiqué of the G20 two weeks ago and, in particular, to the absence of the standard reference to the need to combat trade protectionism.

After the "coordination honeymoon" that led to the Plaza and Louvre Accords in 1985-87, for reasons that would be too long to discuss here, concerted actions by governments and central banks have been rather sporadic. It is obvious that policy coordination implies facing trade-offs and accepting that we must incur some losses in exchange for well-identified and notable gains. Still, behind the losses lay real interests, with all the difficulties entailed in identifying and possibly compensating for them. Indeed I believe that much of the emphasis put on "cooperation" serves to highlight the problems faced in effectively coordinating policy. Policy coordination at the G20 level, for example, temporarily garnered high visibility at the height of the global crisis, but has subsequently produced mixed results at best.

On the other hand, there are forums where cooperation occurs in a more informal setting, usually focusing on more technical matters. One example is the regular meetings of central bank governors in Basel, where

[1] Tommaso Padoa-Schioppa, interview with Massimo Giannini, "Padoa-Schioppa: 'Ora si muova l'Ue. Bisogna difendere il libero mercato'", in *la Repubblica*, 6 October 2008, http://www.repubblica.it/2008/10/sezioni/economia/crisi-mutui-8/giannini-padoaschioppa/giannini-padoaschioppa.html.

a frank exchange of views takes place on issues regarding monetary policies and financial stability. Another example is the peer reviews of individual countries' policies on the basis of comparative evidence, such as those conducted at the OECD and in G20 sub-groups. By sharing their experiences, national authorities can find better ways to deal with policy challenges, including those arising from technological, social and economic transformations.

I believe that, for the time being, as the new US administration searches for a way to interact and cooperate with other countries, this type of flexible cooperation is the only way to go. However, to cooperate effectively, we must also be wary of a long-held misconception that has appeared again in some recent public statements: that international economic relations and free trade are essentially a zero-sum game, where a country can only gain at the expense of others. The opposite view that free trade, in particular, is mutually beneficial is not a blind act of faith by economists, but is based on logic and overwhelming evidence, and has survived centuries of deep scrutiny. As a matter of fact, trade integration has been a powerful engine of economic growth at the world level over the last twenty five years or so, and I suspect that the slowdown in trade and in the development of global value chains witnessed in more recent years may be one of the causes of the concurrently slow growth in global productivity.

Eventually, all countries benefit from the effects of trade integration. It cannot be denied that freeing up trade has had its casualties, but preaching stronger trade protection would be as wrong as pushing for a retreat from the technology frontier and the spread of new technologies on the grounds that not everyone benefits equally from them. We should all work to make clear how wrong an inward-oriented policy is in response to political discontent.

Protectionism, in fact, usually serves a few interest groups at the expense of everybody else. A strong signal should instead be sent that it is in the interest of all countries to preserve the overall benefits of open markets. At the same time, managing globalization (and technology) requires that we pay much closer attention to those who are slower to adapt and most likely to be harmed. And we must recognize that this consideration has been to a large extent overlooked so far, both at the national level and in the resolutions of the G7 and the G20.

To conclude, as the global financial crisis has illustrated dramatically, in a world as economically and financially interdependent as ours right now, a failure to set the right financial regulations and economic policies can lead to very bad outcomes, with everyone paying a steep price. Such outcomes can only be prevented through open-minded cooperative confrontation. This is not an oxymoron, but instead is the basis for economic and political progress, the only way, given current conditions, to arrive at decisions that will reduce global economic uncertainty rather than cause a sharp rise in financial market volatility, with its associated sizable instability risks.

2.

Priorities for the Italian Presidency of the G7

Raffaele Trombetta

The common thread of the Italian G7 Presidency, its key concept, is trust. We have identified our mission in "Building the Foundations of Renewed Trust". First of all, trust among countries, especially G7 countries. In fact, the present geopolitical landscape is characterized by high political and policy uncertainties; it is therefore important that like-minded countries, which have been collaborating for a long time, continue to do so. To this end, mutual trust is a necessary condition. It is true that the G7 Summit – which will be held in Taormina on 26–27 May 2017 – will feature many Heads of State and of Government who are participating for the first time. However, we are confident that this will not constitute an obstacle to developing a common approach to the many challenges we are facing.

Secondly, the Italian G7 Presidency aims at rebuilding the trust of citizens towards institutions. Citizens are indeed increasingly sceptical of their governments' ability to deliver on issues that concretely affect their daily lives, ranging from security to economic well-being. Therefore, behind the mission of the Italian Presidency stands the notion that governments should first and foremost adopt policies aimed at meeting their citizens' expectations.

Against this background, the Italian Presidency's programme of work rests on three main pillars. The first one is "Citizen Safety". G7 countries should act together and collaborate to address the worries of citizens caused by different factors, including geopolitical instability and terrorism. In addition, the Italian Presidency aims to devote particular attention to the phenomenon of human mobility, so as to manage the current migrant and refugee flows in an orderly and safe manner. To this end, there will be a special focus on the need to deploy a joint effort to solve the crisis situations in sub-Saharan Africa and the MENA region, as well as to prevent terrorism and violent extremism.

Our second pillar is centred on "Economic, Environmental and Social Sustainability". Following on the positive outcomes of the COP21 and the adoption of the UN Paris Agreement on climate change, G7 countries should now work together to implement the agreement. Food security and gender equality also constitute – according to the Italian Presidency – two fundamental objectives to be pursued when it comes to sustainability. Furthermore, particular attention will be devoted to the issue of increasing inequality – inequality in income, in wealth, and in terms of differences in access to health systems and to education. In fact, inequality represents a serious threat to social cohesion that G7 countries have to face boldly and promptly: inclusive economic growth, a well-functioning international trading system and financial stability – the three subjects at the centre of the conference organized by IAI – are fundamental to reduce inequality.

Our third pillar, identified as "Innovation, Skills and Labour in the Age of the Next Production Revolution", looks at innovation as the catalyst of sustainable and inclusive economic growth. Our existing production systems and societies are being profoundly reshaped by innovation and digitalization. It is therefore important to adopt a broad set of pragmatic and long-sighted policies aimed at enabling firms to increase productivity and competitiveness through Industry 4.0 and new production models; at reviewing education systems so as to provide our labour forces with the necessary skills to use the new technologies; and at adjusting social and labour market policies to support workers throughout these major changes. If properly managed, the digital revolution can offer a tremendous opportunity to reach higher standards of living and of well-being, rather than representing a threat to jobs and employment.

We are aware that the 2017 G7 Summit in Taormina will not be without its challenges. Nonetheless, we remain confident that the desire to cooperate will prevail. Changes in governments, as well as in their policies and views, are part of a democratic process. Even where our views differ considerably, we not only hope, but are also convinced that we will find common ground. This holds true for international trade as well, which has recently become a rather controversial issue. The importance of international trade for economic growth and development remains clear; at the same time, it is also evident that globalization needs to be better managed, ensuring its benefits are more widely distributed and ultimately fostering more inclusive growth.

ANNEX

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Conference Programme

Major Challenges for Global Macroeconomic Stability
The Role of the G7
Rome 27-28 March 2017

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27 March
International Conference Hall, Ministry of Foreign Affairs and International Cooperation

Welcome address and conference introduction

Massimo Gaiani, Director General for Global Affairs, Italian Ministry of Foreign Affairs and International Cooperation
Ettore Greco, Director, Istituto Affari Internazionali (IAI)

First Session: Macroeconomic Policy Coordination

Chair Fabrizio Saccomanni, Vicepresident, Istituto Affari Internazionali (IAI)

Presentation of the country papers by the participating Think Tanks
Anne-Laure Delatte, CEPII (France); Paola Subacchi, Chatham House (United Kingdom); Malcolm D. Knight, CIGI (Canada); Simone Romano, IAI (Italy); Yoichi Otabe, JIIA (Japan); Wolfgang Lechthaler, IfW (Germany); Jeromin Zettelmeyer, PIIE (US)

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Giancarlo Corsetti, Professor, University of Cambridge
Douglas Laxton, Division Chief of the Economic Modeling Division, IMF, Washington
Marcello Messori, Professor, LUISS University, Rome

Second Session: International Trade

Chair Fabrizio Saccomanni, Vicepresident, Istituto Affari Internazionali (IAI)

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Dinner Keynote speech

Ignazio Visco, Governor, Bank of Italy

28 March
Sala Loyola, Roma Eventi Fontana di Trevi

Third Session: Financial Stability

Chair Fabrizio Saccomanni, Vicepresident, Istituto Affari Internazionali (IAI)

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Luigi Guiso, Professor, Einaudi Institute for Economics and Finance (EIEF), Rome
Stefano Micossi, General Director, Assonime, Rome
Richard Portes, Professor, London Business School

Fourth Session: The Role of the G7 in the Global Governance

Chair Fabrizio Saccomanni, Vicepresident, Istituto Affari Internazionali (IAI)

Discussants Iain Begg, Professor, London School of Economics and Political Science
Giancarlo Corsetti, Professor, University of Cambridge
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Concluding Remarks
Raffaele Trombetta, Ambassador, G7/G20 Sherpa to the Italian Prime Minister

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