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The G7's Task for Restoring Growth and Stability

by Stephen Pickford and Paola Subacchi

ABSTRACT

Most G7 countries are facing political and economic uncertainties, and long-standing structural problems.The short-term outlook is reasonably positive, but longer term prospects are more challenging. These challenges have underlying economic causes stretching back many years, fostered by low productivity growth, stagnating real incomes and living standards, rising inequality and technological change. G7 countries should address short-term weaknesses, reduce political and policy uncertainties, and tackle these longer-term problems as well. Acting together to address these challenges will be more effective: (1) short-term and medium-term measures to boost growth should focus on fiscal actions (including infrastructure spending), normalizing monetary policy, completing financial regulatory reforms, and structural policies; (2) tackling policy uncertainties requires international consensus on consistent policies, starting with greater certainty over the direction of trade policy and over the Brexit negotiations. Sending positive signals on trade cooperation will be difficult, but the G7 could make progress on some specific issues such as a code of practice against competitive exchange rate devaluations; (3) an agenda to emphasize fairness could include: fair trading arrangements, implications of financial regulation for fairness and agreement on international corporate taxation to ensure companies pay their fair share of taxes.

G7 | USA | UK | Economy | Finance | Foreign trade | Economic governance

keywords

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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

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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

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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.

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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

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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.

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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.

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