Upgrading *the* G7

And revamping its agenda.

By William R. White

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?

The global economy is a complex, adaptive system like many others in nature and society. As in all such systems, its agents have evolved over time in response to changes in their environment. They either evolve, showing their fitness to survive, or they die. The G7 group of developed economies seems to be facing such an existential threat in the form of the G20, a broader grouping that includes the important emerging market economies. These fast-growing economies 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 surely improves with time, is that the G7 structure and meetings will seem increasingly irrelevant. The G7, therefore, must evolve, or it will cease to exist.

The end of the G7 would be a pity, since working together these nations 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, and still dominate the financial area. In short, the reflections of the G7 still need to be listened to. Further, their capacity to lead by example 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? To start, 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. The G7 should instead focus on identifying the

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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.

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 that mandate, 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

Implementing agreed policy solutions actually requires rising to at least three challenges to international cooperation. These I refer to as the "should," "could," and "would" challenges.

The first of these is in the realm of economics. Identifying common, longer-term economic problems, along with cooperative policy solutions that might help to alleviate them: this is the question of what should be done.

The second challenge—what could be done—is in the realm of law. It involves identifying national regulatory and legal impediments to achieving the desired degree of international cooperation, and suggesting how these impediments might be removed.

The third challenge is in the realm of politics, and likely the most intractable: What would be done? The challenge is to identify factors impeding the will to act, and offer suggestions for dealing with them.

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 members of the G7 share the ailments identified below, as do increasingly many members of the larger G20.

- Bad demographics.
- 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 domestic inequality.
- Imbalances in financial markets.
- High levels of both private and public debt.
- Highly volatile international capital flows.
- Global trade imbalances.
- Slowing global trade.

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. It must be recognized also 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 trying to find cooperative solutions. We are all in the same boat together.

Before turning to the three specific issues that, I believe, should demand immediate attention, it is important to highlighting a popular fallacy; namely, that a clear distinction can be made between shorter-run and longer-term policy issues. The assumption that macroeconomic policies do not affect longer-term growth, and 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 literature indicates that busts can sometimes permanently reduce the level of output and even its future growth rate. This insight implies that the items on the above list are not independent, but 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 labor market legislation on wage-price dynamics.

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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 played by the World Trade Organization. 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

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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 occur and lead to still further rounds of retaliation, the events following the introduction of the Smoot-Hawley Act in the early 1930s might well be repeated. The underlying fragility of the world economy is arguably greater now than it was then. As noted, 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 after the current regulatory changes have been fully adopted.

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 investor Warren Buffet says the interpretation of current numbers in the financial sector is beyond him.

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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 U.S. view (the neo-Keynesian 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 U.S. 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 eurozone. 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 United States, 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. 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.

To focus on just one aspect of this problem, the level of contractual sovereign debt, together with the off-balance-sheet promises made by G7 governments, are simply unsustainable. These promises cannot be honored. Further, the private sector debt problem has not yet been resolved, and some of that debt threatens to fall back on to 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? Looking forward, how might we devise a better international monetary system that avoids 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 otherwise 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 Fed has entered into currency swap arrangements with a number of central banks, it could unilaterally refuse to honor 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 agencies, even in a crisis. In another 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 eurozone economy or the integrity of the eurozone ("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. 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 tradeoff exists between domestic and international objectives. Without appreciation of these tradeoffs, achieving domestic objectives seems likely to be the default position.

Aside from some elements of the Trump administration, there seems to be almost universal support for maintenance of an open trading system.

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 impedes international action in pursuit of the common good. The brand of "populism" now ascendant in many countries favors strictly national pursuits. The problems perceived by the average citizen are blamed on those deemed "others": foreigners (via unfair trade), immigrants (taking jobs and welfare payments), and traditional scapegoats like religious and other minorities.

The root of the problem seems to be widening inequality in many countries, with the benefits of growth in recent 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 a trigger for the recent shift in political sentiment, has been the financial crisis which began in 2007. Similar political effects arising from financial crises in many countries over the last century or so have been well documented by an impressive literature. The general trend during the crisis to "bail out the banks" at the expense of the taxpayers has further contributed to the sense of unfairness. In the eurozone, such policies have not only driven a wedge between citizens and their national governments, but also between the citizens of creditor and debtor countries. 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 eurozone countries) must bear the costs. Both now feel aggrieved and rightly so.

In the face of this deep-seated problem, what might the G7 suggest in order to address both the underlying economic realities and also the problem of misguided popular perceptions?

Regarding 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 and a greater sense of well-being? Could active labor market policies (to reverse the growing problem of skills mismatch) and added 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 lower consumer prices for the poor. Focusing solely on the negative effects of withdrawing from global processes is unlikely to be adequately persuasive; think of the Brexit campaign. It should be much more widely publicized that the real threat to jobs has not been globalization (and global supply chains), but technology. Moreover, the threat to jobs from technology—such as artificial intelligence—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 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 focused 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 charged with doing its own research. The main task would be to identify the longer-term issues that the G7 thought needed attention but had 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, working groups assembled for the specific purpose, or research commissioned 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 such as economists, statisticians, and lawyers.

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A NEW FORM OF G7 ACCOUNTABILITY?

How we assure that the G7 actually pursues its new agenda of identifying longer-term problems and initiating a process for dealing with them? One way 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.

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 begin by keeping a record of its own promises to "lead by example", and whether indeed it had done so. As well, the G7 should keep a record of all its suggestions to the G20, with a particular focus on those that the G20 had agreed 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. All of this would help encourage 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 through the process of international cooperation. ◆