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THE MEXICO SUMMIT OF THE G20: WHAT IS AT STAKE FOR ASIA AND THE PACIFIC?

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I. Introduction

The Group of Twenty (G20) is a group of 19 countries and the European Union.[1] The Group came first into existence as the G7 finance ministers invited counterparts from a number of systemically important countries from regions around the world, as well as representative of the EU, IMF and World Bank to a first ministerial meeting in Berlin in December 1999 to respond to the 1997-99 financial crisis that affected developing countries in Asia and other regions. While initially, the G20 was a forum of its members' finance ministers and central bank governors, the G20 *Summit* in which heads of state or government meet, was created as a response to the global financial crisis in 2008 and in recognition that key emerging countries were not adequately included in the core of global economic discussion and governance. The first summit was held in Washington DC on November 2008 with the aim of responding to the global financial crisis that initiated in the United States. Since, additional Summits have been held in London (April 2009), Pittsburgh (September 2009), Toronto (June 2010), Seoul (November 2010) and Cannes (November 2011). The next G20 Summit is will be held in Los Cobos, Mexico, in June 2012.

At the London summit, a consensus was reached about the urgency to stop the downward spiral that the global economy found itself trapped in. While there was no actual coordination of policies, all members of the G20 countries implemented similar expansionary fiscal and monetary policies to accelerate the recovery from the crisis (Ahluwalia, 2011). With the recovery underway, concerns about fiscal sustainability became increasingly important, to the extent that at the Toronto summit in 2010, the developed countries of the group committed to "at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016" (G20, 2010a), a commitment that they reaffirmed at the Seoul summit. However, at the onset of the Cannes Summit, the macroeconomic environment had changed significantly: having been through a turbulent period, with volatile food and commodity prices, the world economy was in fact teetering once again on the brink of another major downturn at the end of 2011. This turnaround in economic outlook was largely triggered by premature fiscal austerity in advanced economies which pulled the rug from under the nascent economic recovery. Thus, the worsening sovereign debt crisis in Europe dominated the agenda of the Cannes Summit.

In an increasingly interdependent world, the risks emanating from the global economy – be they booms and busts of commodity prices, financial crises, or recessionary conditions in the advanced countries – affect every single country in the world. Keeping in mind that the growth outlook of the Asia-Pacific region is so critically affected by the global economic environment, there is clearly a lot at stake for Asia and the Pacific in the upcoming Mexico summit. This note overviews recent developments in the international economy and examines the various challenges faced by the region in the current context. It places the key items of the Mexico agenda within current context and discusses how Asia-Pacific countries could benefit from the G20 process and what advantageous positions could be considered.

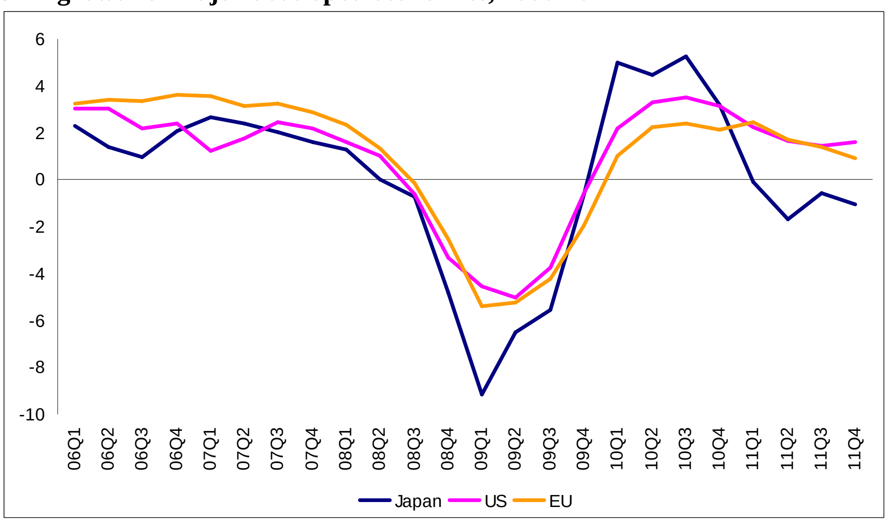
[1] Members of the G20 are Argentina, Australia, Brazil, Canada, China, European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States.

II. The G20 Mexico Summit amid a weak global economic environment

World output growth slowed considerably in 2011. Following the rebound of growth in 2010 from the depth of the global financial crisis in 2009, the downward trend is expected to persist in 2012 as weaknesses continue to particularly plague the major developed economies: high unemployment is hampering domestic demand and is negatively affecting the demand for credit, financial turbulence is affecting the willingness of banks to supply credit and market concerns about the sustainability of public finances is fuelling the drive towards greater austerity, dampening economic activity further. Accommodative monetary policy in advanced economies is becoming ineffective to boost economic activity in developed economies, yet its contribution to increasing global liquidity is negatively affecting developing regions by contributing to volatile capital flows and by fuelling rises in commodity prices.

The major developed economies and key markets for the Asia-Pacific region experienced a slowdown in growth in 2011 (see Figure 1). While the economy of Japan suffered severely and contracted as a result of the devastating earthquake and tsunami in March 2011, which caused a record $210 billion in total damages, and the ensuing nuclear crisis, the decline in growth in the euro zone was caused largely by the inability to deal decisively with the sovereign debt crisis. In the United States, the inability to tackle persistent unemployment and political gridlock over fiscal policy damaged the confidence of consumers, businesses and financial markets, thereby dragging down growth prospects.

Figure 1 - Real GDP growth of major developed economies, 2006-2011



Source: ESCAP, based on data from CEIC Data Company Limited

Fiscal problems in developed economies have acted both as a cause and as an effect of the rapidly cooling global economy. The problems stalking the global economy are multiple and interconnected, however the shift to fiscal austerity in 2010 that was triggered by concerns with public debt and large fiscal imbalances, extinguished the nascent global recovery. At the same time efforts to tighten fiscal deficits did not always result in reductions in public debt. To the contrary, in most developed economies, levels of public debt, measured relative to GDP, continued to increase. In the United States, it reached 102.9% in 2011, compared to 76.1% in

2008; the average level of euro zone debt reached 88.1% in 2011, significantly above the 70.2% of 2008. The concerted contraction in public demand has aggravated the economic situation in most economies and threatens to lead to a downward spiral of growth coupled with increasing levels of public indebtedness.

The worsening of the sovereign debt crises contributed to turbulence in financial market. In particular, the debt crisis aggravated weaknesses in the balance sheets of banks sitting on related assets as concerns of debt default increased. As spreads on interest rates on public borrowing increased for several European economies, concerns about debt sustainability intensified further. However, rather than deal conclusively with the debt crisis by taking a committed stance, coordinating policies between countries and providing a sufficiently endowed firewall, indecisive policy action coupled with conflicting policy statements by members of the Euro zone did little to quell anxiety. This contributed to the downward spiral of economic sentiment.

Europe is not out of the woods yet. Although spreads on sovereign bonds have declined from heights seen in 2011 as financial markets digested the first *selective default* of a euro-zone member, Greece, 13 years after the single European currency was adopted, sovereign stress remains high in many countries. Stringent austerity and significant rollover funding pressures in Spain and Italy are contributing to a worsening economic outlook, such that it is increasingly likely that Spain may have some form of a bailout despite continued pressure to slash its deficit from 8.5% to 5.3% in 2012, in what will be one of Europe's most stringent austerity programmes. There is thus an urgent need for greater policy coordination among developed economies so that those with fiscal space and those with current account surpluses do more to foster domestic demand, thereby providing positive spillovers to weaker neighboring countries.

Accommodative monetary policy in developed economies was not effective in 2011. Responding to the weak economic environment and the withdrawal of fiscal stimulus measures, with interest rates close to zero, 'unconventional measures' continued to be applied in many developed economies. As banks remain cautious to extend credit and with anemic demand for credit in most developed economies, these measures were not though effective in fostering domestic demand. The United States Federal Reserve (Fed) introduced a second round of quantitative easing (QE2) in November 2010, purchasing $600 billion of Treasury securities by the end of the second quarter of 2011. This continued to exert downward pressure on interest rates of long-term securities. In September 2011, the Fed further announced that by the end of June 2012 it would swap $400 billion worth of Treasury securities maturing within 3 years or less into Treasury securities maturing within 6 to 30 years to push long-term bond yield down further ("Operation Twist"). Across the Atlantic, the European Central Bank surprised markets by raising interest rates in early and mid-2011, having left its main policy rate unchanged for more than a year and a half following the recession. This policy was though reversed in November and December of 2011 in an attempt to revive the ailing European economy and ease credit conditions for troubled euro zone banks. Moreover, despite the temporary rate increases, unconventional policy measures remained active throughout 2011 as the ECB supported banks and the sovereign debt of crisis-affected countries, primarily by supplying liquidity though refinancing operations at various term lengths, by purchasing covered bonds and by providing US dollar liquidity. So far, the ECB has however resisted pressure to make large-scale purchases of government bonds in secondary markets, as it did in 2011, to help prevent the spread of debt contagion in the euro area. However, it widened in December its policy toolset to include the provision of unlimited 36-month credit for banks in the euro zone, a reduction of the rating threshold for certain asset-backed securities (ABS) to increase the collateral availability of ECB loans, and a decrease in the reserve requirement for commercial banks from 2% to 1% to free up collateral and support money market activity.

Weak labour markets are damaging the prospects for recovery and may lead to increased trade protectionism from developed economies. Persistent unemployment in developed economies is hampering the global recovery: in the US, unemployment reached 8.2% in March 2012; in the euro zone unemployment increased to 10.9%, its highest level in almost 15 years. Unemployment remains high particularly among the young in many economies, exceeding 50% in Spain and Greece. An increasing concern is the imposition of various trade restrictive measures by developed countries to protect their economies in a climate of slow growth. It is important to resist such protectionist tendencies and to conclude a successful Doha development round at the World Trade Organization and thereby encourage freer flows of trade.

Challenges to the Asia-Pacific region

As highlighted by the *Economic and Social Survey of Asia and the Pacific 2012* (ESCAP, 2012a), the Asia-Pacific region continues to face the challenge of having to cope with a fragile global environment. As the V-shaped recovery from the depths of the 2008-09 global financial crisis in 2010 proved to be short-lived and the world economy entered the second stage of crisis in 2011, with a sharp deterioration in the global environment with the accentuation of euro zone debt crisis and continued uncertain economic outlook of the US economy, growth of the Asia-Pacific region declined in 2011. It is forecast to decline further in 2012 with a slackening demand for the region's exports in advanced economies and because of higher costs of capital. However, the region will continue to remain the fastest growing globally and an anchor of stability in the world economy as the region's growth engines continue to grow at robust rates.[2]

The most critical risk to the region is a disorderly sovereign debt default in Europe, or the break-up of the euro common currency area. This would lead to a renewed global financial crisis and could, in a worst case scenario, lead to a total export loss of $390 billion over 2012-13. Least Developed Countries and Landlocked Developing Countries in the region would suffer the most (ESCAP, 2012a). The loss of exports could lead to up to a 1.3 percentage point reduction in growth in 2012 and would hamper poverty reduction such that by 2013 an additional 14 million people could be trapped below the $1.25-a-day poverty line in the region.

At the same time, measures likely to be adopted by developed economies to kick-start their growth may also be damaging to the Asia-Pacific region. For instance, the further injection of liquidity to the financial system, as well as the interest rate differentials with the region would result in the continuing attraction of asset markets and currencies in the region for foreign investors. This would heighten the risk of asset market bubbles, exchange rate appreciation and inflationary pressures. The imposition of various trade restrictive measures by developed countries to protect their economies in a climate of slow growth would further damage the outlook of Asia-Pacific countries.

[2] More details on the most recent economic performance of the Asia-Pacific region and on the challenges that it faces can be found in ESCAP (2012a).

A further risk to the region would be a sharp surge in commodity prices. Many economies in the region continue to grapple with the challenge of inflation which, while moderating somewhat in recent months, still remains elevated in many economies. As global food prices remain close to record levels, oil prices have been very volatile in recent months, mainly due to political tensions in some of the major oil-producing economies. A deterioration of oil prices would put significant upward pressure on prices in the region: for instance, an increase of $25 per barrel, due to geopolitical tensions, for example, would add an estimated 1.3 percentage points to inflation in developing Asia-Pacific economies. At the same time, current account balances and fiscal balances would deteriorate, as most economies in the region are net importers of fuel, many of which also grant extensive fuel price subsidies. For instance, ESCAP (2012a) estimates that a 25% increase in diesel and gasoline price subsidies would increase the fuel price subsidy bill in the region up by an estimated $17 billion.

Fortunately, the Asia-Pacific region has policy space to mitigate a potential worsening of the global economic environment. With relatively sound macroeconomic fundamentals and low public debt to GDP ratios, Asia-Pacific developing economies could mount fiscal stimulus programmes to cushion the blow of lower exports to developed countries. In fact, some economies in the region already announced fiscal stimulus programmes in the second half of 2011, including Malaysia and the Philippines. The growing importance of intraregional trade would cushion the impact further, as would resilience in some of the region’s increasingly promising markets, including India, Indonesia and China where domestic demand remains strong. At the same time, several countries also have the space to lower policy rates to relax monetary policy to stimulate the economies; some economies such as India, Indonesia and Thailand have already lowered interest rates to mitigate the impact of declining developed economies.

III. Key issues to be discussed in Los Cabos

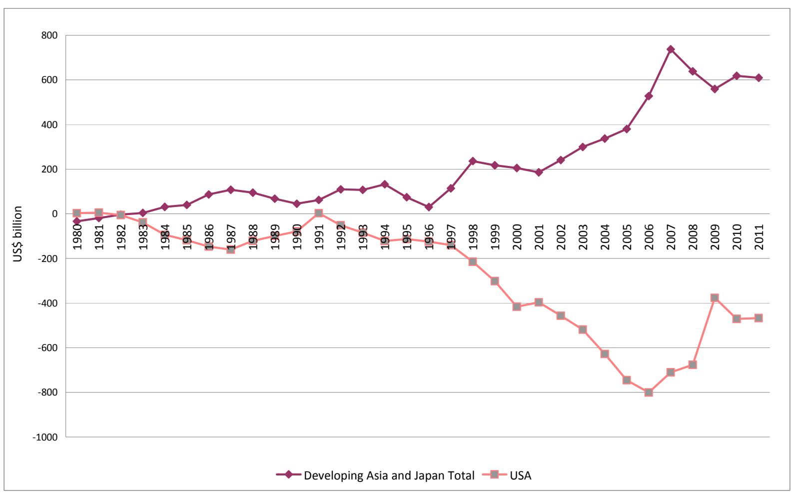
By rallying economies to stimulate their economies through fiscal stimulus packages, the G20 proved effective when tackling urgent short-term issues at the nadir of the global financial crisis. Since 2009, it has also developed an ambitious agenda to address important longer-term issues affecting the global economy. However, although the G20 countries established a framework of achieving strong, sustainable and balanced economic growth, the continued emphasis of developed countries on the need to rebalance of global economy while ignoring robustness and sustainability contributed to a worsening of the global environment. Nevertheless, as the G20 has not reverted to “crisis-mode” despite the deterioration of the debt crisis in Europe and the worsening global economic outlook, it is useful to review its longer-term agenda to understand what is at stake for the Asia-Pacific region.

Economic stabilization and structural reforms as foundations for growth and employment

In recent years, imbalances in trade have increased dramatically. For instance, the US current account, which has been running a deficit since 1992, reached a record $801 billion in 2006, equivalent to 6% of its GDP, while the combined current account of Developing Asia and Japan, which has been in surplus since 1983, widened to a record high of $737 billion in 2008.[3] While the dramatic contraction in economic activity during the global financial crisis led to a decline in these imbalances, they have since widened, with the deficit exceeding $470 billion in the US in 2011, and the surplus reaching $618 billion in Asia (see Figure 2). Through its current account deficits, the US transferred $7.8 trillion to the rest of the world between 1992 and 2011. Such liquidity, along with the low interest rates prevailing particularly during this latter part of this period, boosted economic activity around the world. It also had major financial implications by encouraging risk-taking and leverage in search of higher yields. This contributed to bubbles in commodity and asset prices in many countries, notably in real estate.

Budget deficits and public debt widened significantly during the financial crisis, particularly in developed economies. Fiscal deficits increased from 1.7% of GDP in 2008 to 9.6% in 2009 in advanced G20 economies as expenditure accelerated, triggered for instance by higher social expenditure such as unemployment benefits, and tax revenues declined. Deficits have since declined to 7.2% in 2011. In emerging G20 economies the surplus of 0.3% turned to a deficit equivalent to 4.8% of GDP in 2009, a notably weaker decline, and reached 2.2% in 2011. During the same period, average levels of public debt increased in the advanced G20 economies from 60.6 % of GDP in 2007 to an estimated 110.3% in 2011. In emerging G20 economies, levels increased by less than 1 percentage point to 37.0% in 2011 (IMF, 2012).

Figure 2 - Current account imbalances



Source: World Bank Development Indicators

Premature fiscal austerity derailed the nascent recovery. Triggered by concerns about the sustainability of fiscal imbalances at the onset of the global recovery in 2010, developed economies embarked upon fiscal austerity. This turned out to be premature as it derailed the nascent recovery. It has also not alleviated the pressures on debt in advanced G20 economies. Moreover, the inability of the European Union to deal with the debt crisis in several of its member states, notably in Greece, worsened the sovereign debt crisis in a number of European

[3] Asian countries are not the only ones that experienced large current account surpluses in the second half of the 2000s. In particular, a number of developed economies including Switzerland, Luxembourg, the Netherlands, Sweden and Germany ran current account surpluses exceeding 5% of their GDP in the mid-2000s. In Germany the surplus reached $248 billion in 2007, before declining somewhat to $195 billion in 2011.

countries in the second half of 2011 by aggravating weaknesses in the balance sheets of banks sitting on these assets, making the fiscal adjustment and efforts to repair financial sector balance sheets even more challenging. It also exacerbated the volatility of capital flows to developing regions, particularly the Asia-Pacific region, and contributed to further exchange rate volatility as investors fled to safe havens.

There is agreement among the G20 countries that global imbalances, particularly in trade, contributed to the crisis. Clearly, something should be done about them (Angeloni, 2011). At the Pittsburgh summit, the G20 launched the ‘Framework for Strong, Sustainable and Balanced Growth’, the backbone of which is the ‘Mutual Assessment Process’ (MAP), a process to coordinate macroeconomic policies among the major countries and through which G20 members aim to improve coordination critical for sustaining global growth and reassuring markets by collectively evaluating how their policies fit together and work together to achieve their common growth objectives over the medium run.

The G20 endorsed at the Seoul Summit an ‘enhanced MAP’ to gauge progress toward framework goals. Following a first stage of the MAP during which the G20 shared information ahead of the Toronto Summit on policy and macroeconomic frameworks, the G20 finance ministers and central bank governors agreed during two meetings in 2011, upon indicative guidelines to assess persistently large imbalances using a set of indicator, including public debt, fiscal deficits, and the external balance composed of the trade balance and net investment income flows and transfers. In the second stage of the MAP, the IMF presented at the Cannes Summit an in-depth ‘sustainability’ analysis of the nature of the imbalances, their root causes and impediments to adjustment of seven systemically important G-20 countries that had ‘moderate’ or ‘large’ imbalances. These countries comprised China (for having high private savings and a large external surplus), France (with a high external deficit and large public debt); Germany (with high public debt and a significant external surplus); India (with high private savings and a large fiscal deficit); Japan (with high public debt and private savings); the United States (with large fiscal and external deficits) and the United Kingdom (with low private savings and high public debt).[4]

Institutional development of the MAP has been slow. Neither the “Framework for Strong, Sustainable and Balanced Growth”, agreed to at the Pittsburgh in 2009, nor the MAP were mentioned in the outcome document of the Cannes summit. Rather, the potential of a deteriorating debt crisis dominated the original Summit agenda and altered leaders’ priorities. Nevertheless, tackling trade imbalances will be on the agenda at the Mexico summit. Already, the