Renewing multilaterlism: A german perspective

Good morning. Thank you for the introduction. I appreciate the invitation to speak here today, especially because this conference is tackling issues that have a great bearing on the stability of the world economy.

Having just passed the 10th anniversary of the start of the Global Financial Crisis, and now looking forward, I'd like to address what I see as key topics: a possible next financial crisis and a renewed multilateralism.

History suggests that an economic downturn lurks somewhere over the horizon. Many are already speculating as to exactly when, where, and why it might arise. While we can't know all that, we ought to be focusing right now on how to forestall its arrival and how to avoid creating another systemic crisis.

Over the past two years, for example the IMF has called on governments to put in place policies aimed at just that goal— "fix the roof while the sun shines" is a famous german saying. But like many of you, I see storm clouds building, and fear the work on crisis prevention is incomplete.

Before asking what should be done, let's analyze whether the international community has the tools to respond to the next crisis, should it occur. And here I mean both individual countries, and the international organizations tasked to act as first responders. Should we be confident that the resources, policy instruments, and regulatory frameworks at our disposal will prove potent enough to counter and contain the next recession? Let`s have a look on the main policy options:

Policy Options for the Next Recession

On monetary policy, much has been said about whether central banks will be able to respond to a deep or prolonged downturn. For example, past U.S. recessions have been met with 500 basis points or more of easing by the Fed. With policy rates so low at present in so many places, that response will not be available. Central banks would likely end up exploring ever more unconventional measures. But with their effectiveness uncertain, we ought to be concerned about the potency of monetary policy.

We read every day that for fiscal policy, the room for maneuver has been narrowing in many countries. Public debt has risen and, in many countries, deficits remain too high to stabilize or reduce debt. Now to be fair, we can presume that if the next slowdown creates unemployment and slack, multipliers will grow larger, likely restoring some potency to fiscal policy, even at high debt levels. But we should not expect governments to end up with the ample space to respond to a downturn that they had ten years ago. Moreover, with high sovereign debt levels, decisions to adopt stimulus may be a hard sell politically.

Given the enduring public resentments borne by the Global Financial Crisis, a recession deep enough to endanger the finances of homeowners or small businesses would likely lead to a strong political call to help relieve debt burdens. That could further stress already stretched public finances.

And if recession once again impairs banks, the recourse to bailouts is now limited in law, following financial regulatory reforms that call for bail-ins of owners and lenders. Those new systems for bail-ins remain underfunded and untested.

The point is that national policy options and public financial resources may be much more constrained than in the past. The right lesson to take from that possibility is for each country to be much more careful to sustain growth, to limit vulnerabilities, and to prepare for whatever may come.

But the reality is that many countries are not pursuing policies that will bolster their growth in a sustainable fashion. The expansion actually has become less balanced across regions over the past year, and we are witnessing a buildup of vulnerabilities: higher sovereign and corporate debt, tighter financial conditions, incomplete reform efforts, and rising geopolitical tensions.

Five Key Policy Challenges

So, let me turn to five key challenges that could affect the next downturn—areas where governments face a choice to take proactive steps now, or not, and where inaction would probably make matters worse.

The first challenge is the simple and familiar admonition: “First, do no harm.” This is worthy advice for doctors and economic policymakers. Let me mention some examples.

In the case of U.S. fiscal policy over the past year, the combination of spending increases and tax cuts was intended to provide a shot of adrenalin to the U.S. economy and improve investment incentives. However, coming at a time when advanced recovery meant little need for stimulus, this choice runs the three risks of increasing the potential need for Fed tightening; raising deficits and public debt; and spending resources that might better be put aside to combat the next downturn.

Another example is the recent escalation of tariffs and trade tensions. Fortunately, the U.S. and China agreed recently to call a ceasefire. That was a positive development. There certainly are shortcomings in the global trading system, and countries experiencing disruption from trade have some legitimate concerns about a number of trade practices. But the only safe way to address these issues is through dialogue and cooperation.

The KAS has been advocating de-escalation and dialogue for some time. That is because the alternative is hard to contemplate. We estimate that if all of the tariffs that have been threatened are put in place, as much as three-quarters of a percent of global GDP would be lost by 2020. That would be a self-inflicted wound.

So it is vital that this ceasefire leads to a durable agreement that avoids an intensification or spread of tensions.

Now to the second challenge, which is closely tied to the trade issue: China’s emergence as an economic powerhouse. In many ways, this is one of the success stories of our era, showing that global integration can lead to rapid growth, poverty elimination, and new global supply chains lifting up other countries.

But as Winston Churchill once said of the U.S. during World War II, “the price of greatness is responsibility.”

China's Global Role

Chinese policies that may have been globally inconsequential and thus acceptable when China joined the WTO and had a $1 trillion economy are now important to much of the world. That's because China now is a globally integrated $13 trillion economy whose actions have global significance. If China is to continue to benefit from globalization and support the aspirations of developing countries, it will need to focus on how to limit adverse spillovers from its own policies and invest in ensuring that globalization can be sustainable.

Moreover, China would likely gain at home by addressing many of the policy issues that are controversial.

For example, through

- stronger protections for intellectual property, which will benefit China as it becomes a world leader in technologies;
- reduced trade barriers, especially related to investment rules and government procurement procedures, which will produce cost-reducing and productivity enhancing competition that will benefit the Chinese people in the long run.
- and an acceleration of market-oriented economic reforms that will help China make more efficient use of scarce resources.

Of course, this notion of global responsibility also applies to Europe and Germany as well, and this is the third challenge. Forecasts show growth in the euro area falling short of previous projections, and only modest potential growth going forward.

The future of the European economy will be shaped by the way the EU addresses its architectural and macroeconomic challenges and by Brexit. The recent EMU agreement on reforms is welcome. Going forward, the Euro area would gain by pushing further to shore up its institutional foundations.

The absence of a common fiscal policy limits Europe's ability to share risks and respond to shocks that can radiate through its financial system. And crisis response will be constrained because too much power remains vested in national regulators at the expense of an integrated approach across the continent.

All of this prevents Europe from playing a global role appropriate with the size and importance of the euro area economy.

The Task for Emerging Markets

The fourth challenge is in the emerging markets. For all of their extraordinary dynamism, we have seen a divergence among emerging markets over the past year: between those who have not shored up their defenses against shocks, including preparation for the normalization of interest rates in the advanced economies; and those that have taken advantage of the global recovery to address their underlying vulnerabilities.

Capital outflows over the past several months have shown how markets are judging the perceived weaknesses in individual countries. If global conditions become more complicated, these outflows could increase and become more volatile.

The fifth and final challenge is the role of multilateral institutions.

We know that these institutions have played a crucial role in keeping the global economy on track. In the nearly 75 years since the UN, World bank or IMF were set up, our world has undergone multiple transformations—from post-war reconstruction and the Bretton Woods system of fixed exchange rates to the era of flexible rates; the rise of emerging economies; the collapse of the Soviet Union and transition to market economies; as well as a series of financial crises: the Mexican debt crisis, the Asian Crisis, and the Global Financial Crisis.

At each stage, experts already called upon to evolve and even remake the system.

Now, we see a rising tide of doubt about globalization and discontent with multilateralism in some advanced economies. Of course, it is fair for the international community to ask for modernization in its institutions and organizations, to seek reforms to ensure that institutions serve effectively their core purposes.

This applies to groupings such as the G20, as well as international organizations. So, it was heartening to see the G20 Leaders to call for reform of the WTO when they came together in Osaka. This reform initiative, which has the potential to modernize the global trading system and restore support for cooperative approaches, should now go forward.

The policy challenges we face are clear. As I have suggested, governments have their work cut out for them and may have to contend with less potent policy tools.

Now, it is essential that they do what they can to address vulnerabilities and avoid actions that worsen the next downturn.

The Multilateral Response

But we should prepare for the possibility that weaker national tools may mean limited effectiveness, and therefore may result in greater reliance on multilateral responses and on the global financial safety net.

Former IMF Managing Director Christine Lagarde has recently called for a "new multilateralism," one that is dedicated to improving the lives of all this world's citizens. That ensures that the economic benefits of globalization are shared much more broadly. That focuses on governments and institutions that are both accountable and working together for the common good. And that can take on the many transnational challenges that no one government alone, not even a few governments working together, can handle: climate change, cyber-crime, massive refugee flows, failures of governance, and corruption.

Working together, we will be better able to prevent a damaging downturn in the coming years and a dystopian future in the coming decades. With ingenuity and international cooperation, we can make the most of new technologies and new challenges, and create a shared and sustained prosperity. The principles "ingenuity and international cooperation" are also fundamental when it comes to the belt and road initiative. Hopefully this project can proof that short sighted nationalist approaches are not best ways to shape a common future.

Thank you for your attention!