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T7 Task Force Sustainable Economic Recovery

POLICY BRIEF

KEEPING THE WORLD ECONOMY ON TRACK: DEALING WITH THE SHORT-TERM EMERGENCY AND PURSUING LONGER-TERM OBJECTIVES

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Abstract

As the global economy emerges from the COVID-19 pandemic in 2022, the road to sustainable economic recovery has been interrupted by the Russian invasion of Ukraine. In the *short term*, the G7 needs to address the crisis in Ukraine and deal with the impact of the war on lives and livelihood. At the same time, it needs to keep track of *long-term* objectives. A new *global bargain* is needed to support long-term economic growth, accelerate energy transition and the decarbonisation of the world economy, and tackle inequalities. *Improved governance* of this new global bargain will be essential, to preserve stability and ensure cooperative policies, to mitigate polarization, and to avoid the fragmentation of the international economic order.

Challenges

At the G7 summit in Cornwall in June 2022, G7 leaders signed off on the “Cornwall consensus”¹ and launched an agenda to re-establish “strong, sustainable, balanced and inclusive growth”.² This remains the overriding purpose of both the G7 and the G20.

But we now face what Tharman Shanmugaratnam has called a “Perfect Long Storm”.³ His list is a long one: stagflation; the climate crisis; insecurity caused by the continuing global pandemic; the effects of war between Russia and the Ukraine; higher prices for energy, food and fertilizer, the potential of a global food crisis; and a growing fragility from income inequality.

This policy brief provides an assessment of the main economic policy challenges ahead, outlines a set of proposals, and presents a series of concrete actionable policy measures both for dealing with shorter-term emergencies and for pursuing longer-term objectives.

At the start of 2022, the macro-economic policy task challenges for the G7 were to support the recovery from the COVID-19 pandemic while, at the same time, to:

- contain inflationary pressures and debt burdens;
- meet growing fiscal demands due to the need to decarbonise the world economy;
- deal with inequality both within and among nations;
- manage global demographic change.

While these challenges remain fundamentally important, the outlook for the world economy has greatly worsened since late February when Russia invaded Ukraine. Although Russian GDP (in PPP terms) is only 3% of the world economy, warfare and sanctions have pushed up the prices of energy and of commodities including fertilisers. Food costs have also increased, especially wheat, for which Ukraine and Russia account for 30% of global exports⁴. As many as 25 African countries, including many least developed countries, import more than one third of their wheat from the two countries at war. For 15 of them, the share is over half⁵. Inflationary pressures were already present because of the post-Covid 19 supply-chain shortages and accommodative monetary policy; these have greatly increased. Financial sanctions, and the write-downs of foreign investments in Russia, are creating significant difficulties for many international companies. Overall, the most significant global risks include the following:

- Higher energy prices, resulting from the reduction of Russian gas and oil supplies (even if it is not yet a complete cut-off). This will disproportionately affect the EU, with its greater dependence on Russian imports than the US. As a result, inflation could become much more entrenched.
- A steep increase in global food prices. This is creating an increase in food insecurity and the risk of unrest in many parts of Latin America and sub-Saharan Africa.

- Significant fiscal challenges. Many countries were already facing such problems in the wake of the covid pandemic. In addition, a rapid increase in defence spending in G7 countries will further shrink the available fiscal space. Higher prices of energy and food are exacerbating these difficulties.
- Rising global interest rates will test the resilience of bank and non-bank financial institutions during this period of record debt. Russian sanctions will further complicate the financial stability risks, especially for European banks.

Inevitably, given different exposure to the area of conflict, some economies with closer economic links to Ukraine and Russia will be more affected than others. Europe, for instance, is not only at risk of energy scarcity and supply disruptions but is also most affected by the increasing inflows of refugees – approximately 4.3 million to date⁶. Divergent economic outlooks and even the possibility of recession in Europe mean that post-pandemic recovery policies will be very different in different parts of the world.

The OECD estimates that global economic growth could be more than 1 percentage point lower this year than was projected before the conflict⁷, while inflation, already high at the start of the year, could rise by at least a further 2.5 percentage points on aggregate across countries – and perhaps by much more in the short term.

Against the background of these challenges, global policymakers must ensure that the impact of war is managed as well as possible and that economic recovery after the pandemic really does happen.

Proposals

Re-establishing strong, sustainable, balanced, and inclusive growth in the face of these challenges will require an internationally cooperative framework⁸ in which there is:

- (a) a growing level of global aggregate demand and a restoration of well-functioning, efficient global supply chains;
- (b) a workable international adjustment mechanism for global imbalances;
- (c) a sustainable system of worldwide lending between countries;
- (d) an open international trading system.

Achieving such a framework will require supportive economic policymaking in six key areas, which we now describe. In the next section we present a set of concrete actionable policy measures that are necessary in these areas.

1. Monetary policies

Monetary policy should focus on stabilising inflation. Of course, in the medium-term monetary authorities should be aiming to wind down the record size of central bank balance sheets to normalise policy interest rates and avoid distorting longer-term interest rates. But in the short-term monetary policy must concentrate on stabilising inflation expectations and avoiding second-round effects on prices transmitting from higher energy and food prices as well as wage-price spirals. It must be the task of higher interest rates to bring this about. Central banks, however, need to calibrate the tightening based on both national and global data developments while monitoring the pass-through of rising international prices to domestic prices. Against the differentiated effects of the current crisis the G7 will need to consider different policy stances. Policy tightening may have to be more gradual in the euro area than in the US.

Timing is critical but so also is the pace and the distribution of burdens. Withdrawing too quickly could prompt a significant global recession, but too slow a move could result in a failure to stem inflationary pressure. There will be exchange rate effects and the dollar is likely to strengthen. Spillover effects on emerging markets will likely re-create the international pressures seen at the time of the taper tantrum.

2. Fiscal policies

Many countries are facing increased costs of imports of energy and other commodities, and this is causing a reduction in their terms of trade and in potential real national income. This, in turn, is leading to very sharp falls in living standards. Fiscal policies will be key to provide income support to vulnerable households, enabling them to continue purchasing necessities. Indeed, macroeconomic stabilisation may require an overall fiscal loosening to support incomes in countries that are most adversely affected by the current crisis.

Fiscal policies also need to address short-term food and energy security needs as well as underpinning long-term energy transition in the move towards achieve the zero-net-emissions target by 2050.

The G7 needs to coordinate these efforts to ensure there is no freeriding while also devising the necessary backstops for countries, both developed and developing, with limited fiscal space. Calls on fiscal resources needed to finance the energy transition cannot be addressed without adding significant pressures on the fiscal position in many countries, narrowing a fiscal space that was already curtailed by the pandemic⁹.

3. Managing short-term capital flows and ensuring long-term capital for energy transition

The provision of long-term capital to emerging market economies is critical for the expansion of public infrastructure in these countries, and also to enable the provisions of public infrastructure and allow firms in these economies to invest and grow.

There is complementarity between the finance provided by the private sector and that provided by multilateral development banks (including the World Bank). Increased lending by these multilateral institutions will be essential, in current circumstances, to ensure adequate supply of longer-term funds for emerging market economies and for the world's poorest economies. A very large flow of funds to these countries is needed to assist both with economic recovery, and with emissions-reduction investment.

Furthermore, the management of capital flows, including possibly capital controls and foreign-exchange market intervention, is back on the agenda for emerging market economies. Policies of this kind may well be essential for these countries to defend themselves from the effects of risk-on/risk-off fluctuations in shorter-term international movements of capital and from the tightening of monetary policy in the US and Europe¹⁰.

4. Ensuring aid and relief to low-income countries

The Covid-19 crisis has created a need for fiscal expansion in developing countries and emerging market economies both to pay for necessary health expenditures and to cushion the effects of a worsened terms of trade¹¹, an expansion which many countries are currently unable to finance.

The global system currently lacks an extensive, and hence satisfactory, safety net for countries in difficulty during times when external adjustments are being carried out. Some countries might well need more financial support. Low-income countries face even larger challenges and will need aid and further debt relief, along the lines recently agreed by the G20¹².

5. An open trade system and resilient global supply chains

It is essential that the world does not retreat to protectionism. As acknowledged in the Cornwall consensus, G7 leaders now see globalisation and free-market competition as creating vulnerabilities as well as efficiencies. But protectionism is not an answer.

6. Regulatory policies and better government-private sector collaboration

In the wake of the current war, the collaboration between state and market has become much more critical. Supply chains need to be properly managed. Repairing global supply chains while simultaneously laying the foundation for more resilient supply networks is critical for managing inflation and for the wider global recovery. The G7 countries should encourage an expansion of critical supplies such as food production by addressing distorting regulations and by enhancing incentives to beef up strategic stockpiles, so as to keep goods flowing.

Implementation

The above discussion has described six areas in which actions which will be needed. In what follows we first describe specific policy measures that are needed in the short-term.

Monetary policies should be targeted on a country-by-country basis to restrain inflation and should reflect the differentiated effects of the current crisis

- The G7 should pay attention to monetary policy spillovers from different policy stances, should encourage coordination, and should take into account the needs of emerging market economies.

- G7 monetary authorities should continue to support liquidity and mitigate the risk of financial fragmentation within the world economy.

Fiscal policies should be focused on helping vulnerable households manage price increases in energy and food

- G7 governments should focus on income support programs to offset the negative impact of higher food and energy prices on low income consumers.
- G7 governments should avoid cutting fuel duty to offset high energy prices
- G7 governments should encourage their fiscal authorities to coordinate with their central banks to ensure that policy instruments are effective in addressing the crisis: as monetary policy is tightened to control inflation, fiscal policies should be targeted to where possible to support output growth. Care should be taken to avoid repeating the mistake of premature austerity that followed the global financial crisis.

The G7 should promote international macroeconomic policy cooperation, by fostering the coordination of fiscal and monetary policies, nationally and internationally

- The G7 should design and implement a macroeconomic policy that manages and minimises the risk of a global recession and of a crisis in the global financial system, in the global climate system and in the global health system.¹³ This is very different from a framework merely focussed on the use of monetary policy to fine-tune the macro-economy through inflation targeting, with fiscal policy devoted only to ensuring public-sector solvency by means of austerity.
- This will require enhanced data sharing, more frequent international dialog amongst leaders, and more focus on cooperative adoption of best policy practices.

In ensuring aid and relief to low-income countries the G7 should assess the different needs of countries more exposed to the war because of geographical proximity and trade and financial interdependencies

- The G7 should work with the IFIs to set up a new contingent facility to finance emergency spending in countries on the Black Sea rim and in north Africa
- G7 governments should also encourage the World Bank to set up an export credit programmes for developing countries whose terms of trade have deteriorated because of the war and sanctions.
- G7 central banks should consider extending the group of countries with currency swap agreements to include many small-open advanced economies, emerging market economies and key developing countries, notably Turkey and Egypt

We now describe specific policy measures which are needed in the longer term

In order to achieve its longer-term objectives, the G7 countries should spearhead a new ‘global bargain’

- This bargain should be not unlike what happened at Bretton Woods in 1944 when the international financial system was reformed, and at San Francisco in 1945 when an international conference agreed on the Charter of the United Nations and on the statute of the new international Court of Justice.

- International policy cooperation and this ‘new global bargain’ should underpin strong, sustainable, balanced, and inclusive growth with the following additional objectives:
 - to tackle the energy transition and the decarbonification of the world economy; and
 - to strengthen the governance of the international financial architecture.

To tackle the energy transition and the decarbonisation of the world economy, G7 countries need to implement the following measures:

- investment subsidies necessary to support moves towards zero emissions;
- a credible longer-term plan for a high-enough carbon tax to ensure fiscal sustainability;
- taxation policies which direct windfall profits in the energy sector towards subsidies for the provision of renewable energy. One example of this might be incentives for investment in renewables in North Africa.
- long-term capital for energy transition should be available and affordable, especially for developing countries with limited fiscal space and access to capital markets.
- Governments that cannot afford the scale of investment must be able to join initiatives like GFANZ and the Climate Finance Leadership Initiative and others to
 - develop voluntary carbon markets;
 - set up a more reliable system of ESG data and taxonomies;
 - strengthen global disclosure standards with the new International Sustainability Standards Board; and
 - develop carbon markets based on reliable, high-quality data.

To strengthen the governance of the international financial architecture and avoid fragmentation the G7 should:

- reinvigorate a broad policy discussion on the above proposals in collaboration with a broader group of countries including the G20 member countries;¹⁴
- focus on
 - a multilateral framework for international debt restructuring
 - the governance of international sanctions
- establish international commissions directed towards both of these last two objectives with the aim of gathering existing evidence, consulting relevant stakeholders, and making policy recommendations.

Conclusion

A new grand bargain seems again necessary, not unlike that which led to the rise of multilateral institutions after World War II. The speech made by John Maynard Keynes to the House of Lords on 18 December 1945, seems directly relevant to our current position.¹⁵ This was the time when the UK was in danger of rejecting the Bretton Woods settlement and attempting to “go it alone”. Keynes spoke of a need to act boldly, with imagination, in implementing an ambitious new global plan. His words echo across the years. For working together again is what we now need to do.

Endnotes

¹ See G7 (2021).

² It was more than a dozen years ago, in the aftermath of the Global Financial Crisis of 2008/2009, that G20 leaders embraced such a goal. See OECD (2022a).

³ T. Shanmugaratnam (2022).

⁴ See J. Azour et al. (2022).

⁵ See UNCTAD (2022).

⁶ UNHCR data as of 8 April 2022.

⁷ See OECD (2022b).

⁸ See C. Adam et al. (2012) and P. Temin and D. Vines (2014).

⁹ W. McKibbin and D. Vines (2020), Adrian, *et. el.*, (2022)

¹⁰ M. Chamon *et. al.* (2010) and O. Blanchard (2016).

¹¹ McKibbin and Vines (2020).

¹² See J. Lipsky and W. Rhodes (2022).

¹³ M. Sandbu (2021) and S. Wren-Lewis (2021).

¹⁴ See Tett (2022)

¹⁵ J.M. Keynes (1971-89, Vol 24, pp. 605 – 624)

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