The 2014 G20 Growth Agenda: Why Business as Usual is not Enough[1]

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In February this year, G20 Finance Ministers and Central Bank Governors committed to boost the G20 economies' collective GDP by at least 2 per cent above the current trajectory by 2018. What was the rationale behind the 2 per cent ambition? How can the ambition be realised?

While accommodative monetary policy remains necessary due to ongoing economic weakness, prolonged low interest rates pose risks for financial stability. That's why a concerted effort to boost output through structural reform and quality infrastructure investment is required.

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[1] An abridged version was delivered.

[2] I am grateful to Stephanie Gorecki, Jyoti Rahman, and Barry Sterland, and thank David Drage, Damien Dunn, Blake Ford, HK Holdaway, Emily Hurley, Jessica Montgomery, Deepika Patwardhan and Thomas Williamson for comments and assistance.

I appreciate the opportunity to be here this morning.

I notice that in the recent past you have hosted the Australian High Commissioner to the United Kingdom, Mr Alexander Downer, and the Australian Minister of Communications, Mr Malcolm Turnbull. The high profile of these speakers reflects the high regard in which Chatham House is held in Australian policy circles.

Unsurprisingly for a Treasury Secretary, my focus today will be on economic policy issues. It's always intellectually gratifying to engage in debates on policy issues, and given its place in the history of economics it's a particular pleasure to be able to discuss economics in London.

I want to talk about the G20's economic policy agenda for 2014 and beyond - specifically its growth agenda. There are many facets to what the G20 is focusing on this year, such as reforming the global financial safety net, reshaping international institutions like the IMF, and strengthening tax systems. But I think the growth challenge is central, and it warrants a more detailed exploration due to the collective efforts needed to make it a success.

London, of course, hosted the G20 Leaders' Summit in April 2009, held in the immediate aftermath of the Global Financial Crisis. The need for an economic summit of leaders from advanced as well as emerging economies, and which was regionally balanced and reflective of the global economy, was self-evident in early 2009. As bad as it was, the Crisis could have been much worse if not for the leadership and actions taken by the G20, which moved quickly to help stabilise financial markets and support the global recovery.

Five years on and I contend that, while the G20 still remains as relevant today, we need a focused and action-oriented agenda to ensure that the Leaders' summit is as effective this year as it was in London.

Let me briefly explain why.

The G20 represents around five-sixths of the world economy, three-quarters of global trade, and two-thirds of foreign direct investment — so it is naturally well-placed to be a key global economic policy-making body. Its representation is designed to be regionally balanced, and its less formal structure allows both flexibility and frankness in discussions. These strengths continue to ensure the relevance of the G20 in the global economic architecture.[3]

However, these strengths notwithstanding, the G20 has in recent times been criticised for a broad and unwieldy agenda. Further, the quality of debate and interaction among ministers has been characterised as less robust than in the past, leading to less effective policy outcomes.

Australia is acutely aware of this and in our presidency year we want to facilitate genuine debate on policy issues – debate that will lead to concerted action.

In short, we want to let Leaders be Leaders.

In designing our agenda, we started with the premise that the G20 needs to move away from a period of intense crisis management during the Great Recession and toward a period of ongoing transition, in which the policy challenges are both significant and in many ways more complex. There are three layers of underlying forces shaping this transition:

- First, the cyclical recovery from a deep recession, which is eventually leading to a recalibration of macroeconomic policies, particularly monetary policy.

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[3] These strengths were apparent back in 2006, when Australia hosted the G20 Finance Ministers and Central Bank Governors. See Parkinson, M, 'The G-20 —Addressing Global Challenges', presentation to the Australian Business Economists luncheon 8 November 2006, available at www.treasury.gov.au.

- Second, the ongoing efforts to address the legacy of vulnerabilities exposed during the Crisis, including responding to financial vulnerabilities, repairing private and public balance sheets, and resolving external and internal imbalances.
- And thirdly, the return to global growth that is increasingly being shaped by countries' underlying structural potential.

Recent poor performances in key economies show that the G20 task now is to decisively shake off the lingering after effects of the Crisis. In addition to the growth agenda, there is a need to complete the financial regulation response to the Crisis to ensure financial stability and certainty in this sector.

It is against this backdrop that, at their meeting in Sydney earlier this year, G20 Finance Ministers and Central Bank Governors committed to:

> "… develop ambitious but realistic policies with the aim to lift our collective GDP by more than 2 per cent above the trajectory implied by current policies over the coming 5 years."[4]

In what follows, I will elaborate on the rationale for the Sydney ambition and how we can achieve this, first by juxtaposing the current global economic circumstances and policy debates against what we observed in the mid-2000s, then by discussing what we can do, before finishing with some broad reflections.

Then and now

It is all too easy to look back at how the Global Financial Crisis unfolded and, with the benefit of hindsight, see where the vulnerabilities in the global economy were that resulted in the Crisis and the subsequent Great Recession.

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[4] Communiqué — Meeting of G20 Finance Ministers and Central Bank Governors Sydney 22-23 February 2014, available at www.g20.org

That being said, it's hardly the case that we were completely unaware of the pressure points in the lead up to the Crisis. There was certainly commentary on global imbalances—reflecting factors such as the inevitabilities of global demographic changes and a 're-emerging' Asia resuming its place as an economic powerhouse—as well as discussion about the macroeconomic and structural policy choices facing key economies. Some of these issues were very much in the G20 agenda in the early-to-mid 2000s – for example demography, which was a key issue when Australia last hosted the G20 in 2006, back prior to the participation of Leaders in the G20 process.

While there was awareness of pressure points and vulnerabilities, even the emergence of key systemic risks, the so-called Great Moderation largely lulled investors — and many policymakers alike — into thinking that volatility would remain low, spurring a search for yield and higher leverage. This is a pattern we've seen in periods preceding other financial crises, and indeed some of these risk characteristics are evident now (albeit not involving leverage).

While the risks and vulnerabilities were perhaps clearer at the macro level, what remained obscured was how the search for yield was being intermediated. There were clear cases of mispricing of risks, with the US housing boom the prime example.

But it was not merely the existence of asset-price bubbles in the lead up to the Crisis that was the sole source of the problem. Accurate assessment of the real risks from these bubbles was made vastly more complicated by the increasingly complex and often opaque inter-linkages between the macroeconomy and the financial sector. The complexity of financial instruments also contributed, as a situation evolved where investors did not fully understand the nature of the instruments they were buying and selling, despite devouring them whole.[5] As

[5] For more detail see Gruen, D, 'Reflections on the Global Financial Crisis', address to the Sydney Institute, 16 June 2009, available at www.treasury.gov.au

some of these instruments had direct ties to the real economy, there was a fundamental misunderstanding of the risks that had built up between the real economy and the financial sector.

The increasingly obscure linkages between the real and financial world made the nature and sustainability of growth somewhat ambiguous.

The fruits of this complacency can be seen in a number of structural weaknesses in the fiscal and structural policy settings of some of the world's major economies during the 2000s. For example, with a few notable exceptions such as Germany, countries within the euro area were content to simply discuss structural reform during the good times, and do little to safeguard fiscal sustainability. Similarly in the United States, despite the jobless recovery of the 2000-01 recession, the wider economy performed comparatively well, breeding a degree of lassitude in policymakers' willingness to tackle fiscal sustainability issues – something that to various extents is also true of other Anglophone economies.

Arguably, many emerging economies were in better shape in the lead up to the Global Financial Crisis, not least because their own crisis experiences during the 1990s induced difficult reforms. But even in many of these economies, reforms necessary for rebalancing growth were avoided.

Collectively, this risk taking by private agents — fuelled by complacency about the fallout from growth prospects and volatility — combined with government complacency over prudent policy settings, morphed into higher public debt in many countries as private losses were absorbed by the state. This manifested in a sovereign debt crisis in countries that could not borrow in their own currency.

The Crisis was unprecedented, at least in terms of living memory, as was the policy response.[6] The depth and severity of the downturn required extraordinary effort from monetary and fiscal policy.

But the circumstances in the lead up to the Crisis also mattered for monetary policy. Even though there were secular influences — imported disinflation from emerging economies — that were fundamentally changing the relationship between aggregate prices and output in the US, the Great Moderation precipitated policy rates in the US that left the Federal Reserve less room to move in response to an exceptional crisis.

While policies of least regret were implemented at great speed in response to the Crisis, it was inevitable that this unprecedented response would cast a long shadow into the future. And the legacy is still with us through extremely accommodative monetary policy that is depressing yields on risky assets, and high levels of public indebtedness. As this legacy shapes the challenges ahead, I would like to unpack both of these a bit more.

The current global economic conjuncture is one where monetary policy in the major advanced economies continues to remain extremely accommodative. Although the US Fed is 'taking its foot off the accelerator' so to speak, monetary conditions remain very accommodative, while the European Central Bank and the Bank of Japan continue to be on an easing trajectory.

[6] In its early stages, after July/August 2007, there was always the possibility that the Financial Crisis would intensify, but the extent of the intensification after the mid-September 2008 collapse of Lehman Brothers caught almost everyone by surprise. The following quote by Alan Blinder (Interview on US Public Broadcasting Service, 9 January 2009) illustrates this vividly:

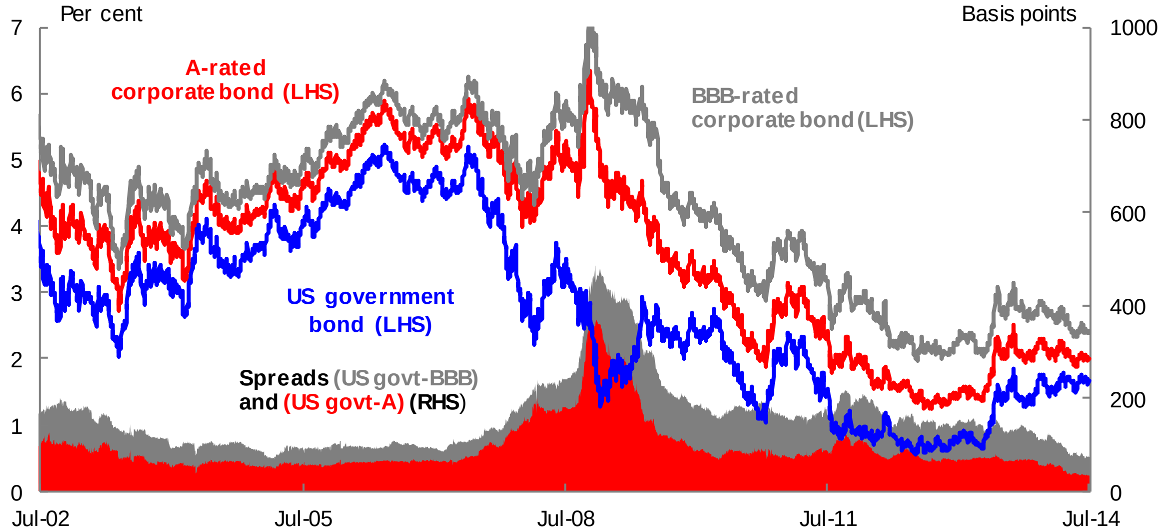
> "Nobody thought this might happen. Things can go wrong. But the number of things that have gone wrong, and the ferocity with which they have gone wrong I think was beyond the imagination of almost everyone."

We must acknowledge though that the policies pursued by the world's major central banks no doubt prevented a worse crisis, despite the risks we find ourselves discussing now.

The overarching objective of expansionary monetary policy has been to stimulate greater risk-taking among consumers and businesses. Indeed, it was expected that while such policies might encourage undesirable risk taking behaviour — such as excessive speculation in financial markets — they would also encourage good risk taking, such as business investment in the productive capacity of the economy.

In this regard, and without knowing the counterfactual, monetary easing does indeed appear to have triggered risk-taking behaviour as intended. Nowhere is this more evident than in high-yield debt markets for corporate paper (Chart 1).

Chart 1: Corporate bond yield spreads

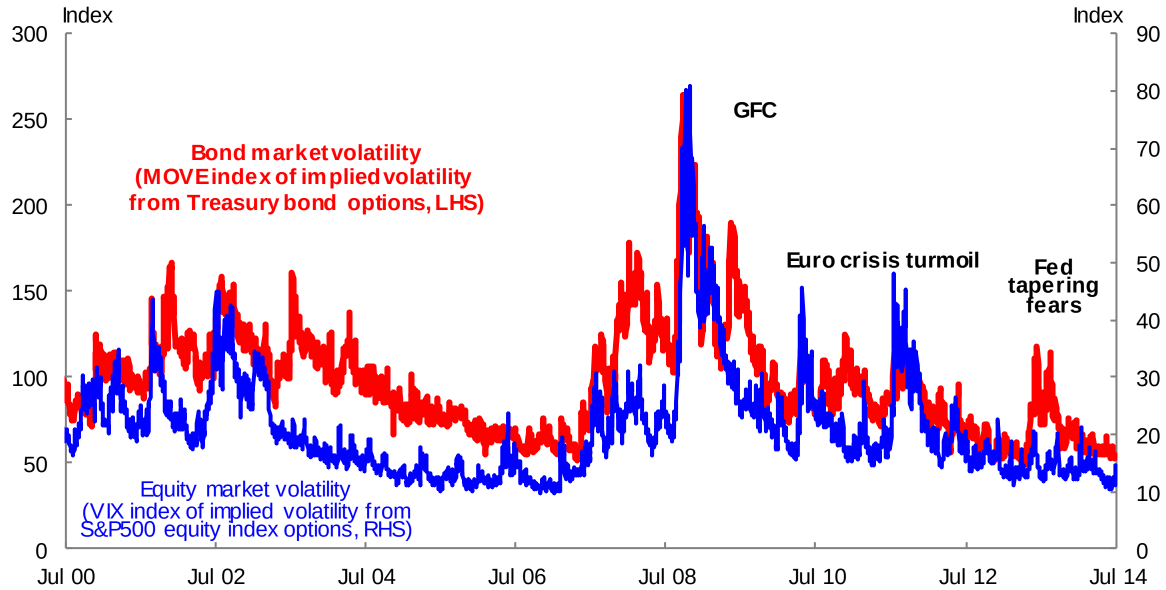


Source: Bloomberg

Note: Data as at 22 July 2014

Moreover, investors seem to have a favourable perception of risks in the future. The low level of implied volatility being observed today suggests there's a low demand for protection from sharp market corrections; rather, markets seem to be more concerned about 'missing out' on gains. Further evidence of this appetite for risk can be seen in the limited enduring reaction to recent geopolitical events, such as the crisis in Ukraine and events in Iraq, or the recent worries over the Portuguese banking system (Chart 2).

Chart 2: VIX and MOVE index



Source: Bloomberg

Note: Data as at 22 July 2014

The problem, however, is that the yield-seeking behaviour is raising the potential costs associated with extremely easy monetary policy. On the one hand, ongoing accommodative monetary settings are likely to continue to stoke risk-taking behaviour; while on the other hand, premature withdrawal of stimulus may undermine the recovery and increase corporate default rates with obvious flow-on impacts to asset markets and the real economy. As several

Central Bank Governors have pointed out, prudential responses will need to play a key role.

In addition to monetary stimulus, the Financial Crisis generated regulatory responses in an effort to prevent this sort of crisis from occurring again. Of course, on the matter of regulatory response we must ask the question: has the horse already bolted before we could close the gate? Further, the follow-up measures to prevent a future crisis have naturally proceeded at a slower pace, due to a lack of urgency in solving a problem that will inevitably occur sometime in the future.

And it is natural that these questions arise, for it's a tricky balancing act. A lack of thoroughness will do nothing to avert a similar crisis in the future, which — let us be clear — is inevitable in an increasingly complex and integrated world. But similarly, we cannot be too heavy-handed as such a severe approach may reduce risk taking too much or may breed the very complacency that contributed to the Crisis.

For this reason, Australia has sought to focus the G20 financial regulation agenda on substantially completing reforms that directly address the flaws that were exposed by the crisis.[7] By focussing the agenda, we hope to reduce the ever present risk of regulatory over-reach that stems from the tendency of policymakers to try to pin down *every* risk, rather than the most critical ones. This is the point at which stability and growth trade-offs can be harmful – where the cost of regulation can outweigh the benefits.

But it is my view that the most effective salve to these concerns is for the global economy to return to sustained growth. This is necessary to generate sufficient

[7] We are focusing the G20's efforts this year on finalising key elements of four core reforms – those being:

1. building resilient financial institutions;
2. addressing 'too big to fail';
3. making derivatives markets safer; and
4. addressing risks in the shadow banking sector.

corporate earnings and maintain low default rates that justify the increasingly elevated valuations across a range of equity and credit markets.

Finally, moving from the monetary and financial issues to public finances, the aftermath of the Financial Crisis has led to a rapid accumulation of government debt in many economies around the world. This reflects both the operation of automatic stabilisers from the sharp deterioration in economic growth, as well as the sizeable fiscal stimuli and government needed in some countries to support the banking sector.

As I have already mentioned, the Crisis had no modern precedent in its intensity, forcing authorities to take extraordinary measures to stabilise their economies. The issue with fiscal stimulus is that authorities need to strike a precarious balance between optimising the benefits of expenditure against the risks associated with growing public-debt levels potentially undermining investor confidence – particularly as future interest rate rises will increase the fiscal burden of debt servicing costs.

In some countries with lower debt to GDP ratios, fiscal policy has arguably been too tight, holding back their recovery and harming growth elsewhere through spillovers.

This being said, as we look forward, it's more fruitful now to focus on ensuring the composition of fiscal policy is optimised for achieving sustainable growth. There is concern that our responses to the Global Financial Crisis have left us far less equipped to respond to future crises than we were in 2008-09.

The task ahead

And we must not forget there *are* a number of longer-term challenges that will put pressure on public finances in the future.

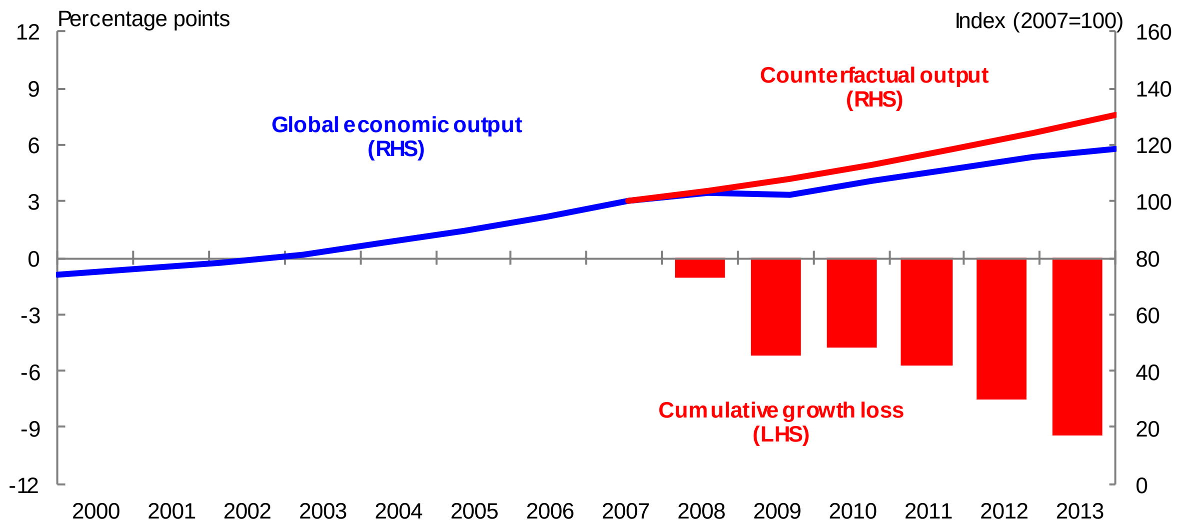
One major challenge I'd like to touch on that is being faced by advanced economies, as well as some emerging ones, is an ageing population — as mentioned already, something we stressed when Australia last hosted the G20 in 2006.

As their population ages, the dependency ratio — that is, the ratio of people requiring support relative to the working-age population — will increase to previously unexperienced levels in most of these countries. This changing demographic structure will also have a dampening effect on future potential growth. The extensive social safety nets in place in most advanced economies are costly to run and costs are projected to increase rapidly over the coming decades. Meanwhile, as living standards rise, citizens of many emerging economies will, rightly, expect greater social safety nets from their states. As a result, in the absence of corrective measures, governments around the world are likely to see growing pressure on public finances.

As the full impact of these challenges will not be felt for another decade or so, responding to them requires a high degree of political maturity and the right incentive structure.

With the output gap that remains compared to where global output might have been if the pre-crisis trend had continued (Chart 3) and the challenges that we face, we have a sizeable hole to fill. And that gap is noticeably larger than the initial decline in GDP in 2009.

Chart 3: Global economic output



Source: IMF World Economic Outlook databases, various and Treasury calculations.

Note: Counterfactual growth is taken to be the entirety of the April 2008 WEO projections.

I know Larry Summers and others have noted, the pre-Crisis growth trajectory was buoyed by successive bubbles in key economies[8] and meanwhile Robert Gordon and others note that the pace of potential growth may be slowing in key economies.[9]

However, notwithstanding these views, let me contend that with better policy settings, the pre-Crisis trajectory might have been sustainable and the counterfactual growth path — or at least something higher than the current trajectory — might have been achievable.

This is the exact motivation for the Sydney growth ambition.

Ultimately, sustainable global growth will be determined by productive capacity. This is why it's important we make up lost ground not only by

[8] Summers, L. H., 'US Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound', National Association of Business Economics, 24 February 2014.

[9] Gordon, R, (2012), 'Is US economic growth over? Faltering innovation confronts the six headwinds', CEPR Policy Insight No. 63.

expediting the recovery but also by trying to lift the productive capacity of our economies. The Sydney growth ambition set by G20 Finance Ministers and Central Bank Governors in February this year aims to do just this.

So, how do we get there?

Monetary policy needs to continue to play a supportive role. Of course, there is a certain point at which the build-up of undesirable risks becomes a concern. In such instances, there is a need to consider what other tools are available. As monetary policy is a blunt instrument, prudential tools can be employed where necessary and appropriate.[10]

Rather than thinking about the limits of monetary policy, the key here is that monetary policy must be supportive of the real economy — but it can only do so much. Monetary policy easing, generally speaking, is designed firstly to stabilise the economy and then help cement a recovery by encouraging businesses to invest and employ. Instead, we continue to see business investment — critical for strong and sustainable growth — remaining anaemic. And, as already discussed, we are now in a situation where we need to take the pressure off monetary policy.

Without giving away the punchline, I would like to refer to ECB President Mario Draghi's recent observation:

> "I would even say that structural reforms are fundamental to reap the benefits of our recent monetary policy decisions. Our recent monetary policy decisions expand bank credit, but for firms or companies to access this credit they must be in the condition to work. If it takes nine months to

[10] Indeed, the UK recently implemented macroprudential controls on higher risk mortgage lending by limiting 15 per cent of all new mortgage lending (per bank) to 4.5 times income. Bank of England*, Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending*, Consultation Paper, June 2014.

> open a business – and then once it is open, it is overwhelmed by taxation – it makes it very hard for this business to ask for credit."[11]

There is no shortage of analysis available on the types of structural reforms countries should undertake, ranging from blue-sky 'if we could start from scratch' recommendations to those that tinker on the margins.

The types of reforms in mind when the Sydney growth ambition was agreed are certainly ambitious, but they are also realistic and achievable reforms.

For example, the OECD estimates that moving towards more appropriate regulatory and competition policy could lead to sizeable impacts on productivity and investment. Estimates suggest that a 10 per cent reduction in the level of product market regulations (as measured by the OECD's PMR index) could boost GDP by 1 to 1.5 per cent.[12] This 10 per cent reduction in PMR, incidentally, corresponds to the intensity of reforms made by those OECD countries that have undertaken significant product market liberalisation over the past decade. This highlights that ambitious but achievable reforms can get us a long way to the 2 per cent ambition.

Going forward, while specific national needs will differ, substantial common challenges exist, including challenges to open markets, to increase competition through less restrictive regulation, and to develop support for more efficient long-term investment. That is why, in Sydney, Ministers and Governors agreed that in addition to macroeconomic policies, there should be a focus on reforms that increase investment, lift employment and participation, enhance trade and promote competition.

[11] Reported comments made by Mario Draghi at his address to the inaugural Tommaso Padoa-Schioppa Memorial Lecture, 9 July 2014.

[12] *How can competition contribute to the G-20 commitment to raise GDP by at least 2%*, OECD (available at www.g20.org).

For European G20 members, I note that the European Commission has emphasised stepping up structural reforms that make economies more competitive. Indeed, their assessment is that too little progress has been made over the past year on reforms that promote competition in the services sector. In the 2014 European Semester, the European Commission recommended reforms to the regulation of services and network sectors for 14 out of 28 members – and these include stronger performers such as Germany, as well as those with slower growth such as France and Italy.

Let me also note that opening up product markets is a necessary complement to labour market liberalisation. In the context of a depressed economy, wage cuts further hurt demand. But a lack of investment and loss of skills damage the supply side potential of the economy. Arguably, in some European countries, competitiveness is taken to mean labour market reform when *product market* reforms might be more important for productivity gains.

Greater scope for public investment is also a common recommendation for G20 members. For many advanced economies, declining public investment has been a long term trend – something that is not necessarily unexpected given the stage of development and the high level of infrastructure investment in earlier post-war decades. There is also a cyclical element to recent falls in public investment in some countries, as fiscal adjustments undertaken by advanced economies have involved reductions in public infrastructure investment, exacerbating the trend decline in public capital stocks.[13]

These factors notwithstanding, the fact that investment remains well below pre-Crisis trends — by as much as 18 per cent according to some estimates — is a policy challenge.[14] Take Germany for example, where public investment in

[13] *Macroeconomic and reform priorities*, prepared by IMF Staff with inputs from the OECD and the World Bank (available at www.g20.org).
[14] Ibid.

construction and equipment is actually *negative* by some estimates once depreciation is factored in. This means that Germany may well have been running down its public capital stock for a decade.[15]

It is for this reason that I was very interested to read the Wall Street Journal piece by Minister Schäuble and Minister Padoan that not only made a very convincing case for reform agendas, but was also unequivocal about the need to boost both public and private investment.[16]

The greater scope for public investment feeds in to the global infrastructure gap – a broader issue which also must involve the private sector. We know there is demand, and we also know that private capital is awaiting the right investment opportunity. The challenge lies in matching the two. More often than not, the barriers to greater investment are within countries, and it is not the lack of funds *per se* that inhibits infrastructure investment. Rather, key inhibitors include unfavourable regulatory conditions, financial regulations, a lack of depth in long-term financing markets, constrained public investment, and a lack of capacity to plan and deliver projects.

Long term investors require a degree of certainty to invest over a 20 or 30 year period. They get this through policy and regulatory frameworks within countries that are sound and well accepted. Governments can assist by providing the investment community accessible information and transparency of processes, so that investors can effectively assess the inherent risks around infrastructure projects.

There is a clear link here to the G20's focus on reforms in competition and objective to remove unnecessary obstacles where competition is viable and desirable.

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[15] Odendahl, C, 'More investment, for Germany's sake', Centre for European Reform, 13 June 2014.
[16] 'A Pro-Business, pro-growth agenda for Europe', *Wall Street Journal*, 26 June 2014.

We must also ensure that regulatory settings are not impeding the flow of capital to productive infrastructure projects. There is further scope to examine how capital markets can be better developed and accessed, and what investment vehicles need to be encouraged. For example, more work on standardising documentation, enhancing due diligence processes, and providing clarity around dispute resolution has the potential to encourage a greater flow of capital across borders.

Of course, most G20 members will be embarking on a course of structural reform in the context of ongoing fiscal consolidation and restraint. So now is the time to consider how the composition and long-term structure of government expenditure contributes to sustainable public finances and potential economic growth.

A number of advanced economies, including Australia, have undertaken reforms to reduce the long-term profile of age-related expenditure, typically through reform of public pension systems, including better aligning the retirement age with increased life expectancy. Many emerging economies have also made progress in expanding social safety nets, for example through improving government support for formal workers and enhancing accessibility to health and education services that will support consumption and lift growth.

But, more broadly, there remains significant potential in both emerging and advanced economies to increase the efficiency of recurrent spending on key expenditure items — such as health and education service delivery — that has the potential to deliver both lasting structural savings as well as significant productivity gains.

Will we get there?

From what I have outlined so far, I hope that two factors are evident.

First, that adopting a business-as-usual approach to policy will not put growth back on a strong and sustainable path. The Sydney growth ambition presents policymakers and Leaders with an unprecedented opportunity to pursue genuine reform. Making the case for reform is a vital first step in bringing the community with you — and I believe that, arguably, we have taken this first step.

Second, the Crisis showed us that complacency can be disastrous, so we cannot waste this opportunity.

By being more explicit in their commitments and through their intention to review the growth strategies in the September meeting, G20 members have raised further the cost of failure and given themselves an even greater incentive to put forward concrete initiatives.

At the recent G20 Officials' meeting in Melbourne, members reflected on progress toward achieving the growth objective. Whilst they are still draft, the preliminary growth strategies include around 700 measures, 200-300 are new measures, with many representing a substantive response to reform gaps within member countries. The estimates suggested that we were around half way there. This is a good start, but of course this means there is still more to do.

The Australian Treasurer, the Hon Joe Hockey, is committed to delivering on the 2 per cent GDP ambition. The Finance Ministers and Central Bank Governors meeting in Cairns will provide us an opportunity to assess progress. Ultimately, though, come November, we need to have provided G20 Leaders with solid growth strategies that will make a material impact on growth.

And moving beyond November, the focus will be on implementation. Simply announcing ambitious plans to boost global growth will not deliver the desired outcomes unless these plans are put into action. Ultimately, it is only actions that deliver, not ambitions – no matter how compelling their accompanying rhetoric.

Thank you.