A NEW ECONOMIC MULTILATERALISM

Christine Lagarde

THE GLOBAL economy is changing. The good news is that the recovery continues; we have growth; we are not in a crisis. The not-so-good news is that the recovery remains too slow and too fragile; risks to its durability are increasing.

Certainly, we have made much progress since the onset of the great financial crisis. But because growth has been too low for too long, too many people are simply not feeling it.

This persistent low growth can be self-reinforcing through negative effects on potential output. These can be hard to reverse. The risk of becoming trapped in what I have called a "new mediocre" has increased. This has consequences for the social and political fabric of many countries—even in those where the economy has been strong.

We must be on alert, but not alarmed. While there has been a loss of growth momentum, the positive effects on global confidence—and the global economy—will be substantial if policymakers can confront challenges and act together. We can get back on track—but only if we embrace the multilateral imperatives of the twenty-first century.

A Time of Uncertainty

Overall, the global outlook has weakened in the past months—exacerbated by China's relative slowdown, lower commodity prices, and the prospect of financial tightening for many countries. Emerging markets largely drove the recovery, and the expectation was that the advanced economies would pick up the "growth baton." This has not happened.

Indeed, for many advanced economies, the recovery is proving to be more moderate than anticipated. In the United States, for instance, growth remains relatively flat; in the Euro Area, low investment, high unemployment, and weak balance sheets weigh on growth; in Japan, both growth and inflation are weaker than expected.

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Christine Lagarde giving keynote remarks at the 2016 China Development Forum

While emerging markets are a very diverse group, the story is broadly similar. China's transition to a more sustainable economic model—which is good both for China and the world—means that its growth rate, while still strong, is now lower. Downturns in Brazil and Russia are larger than expected. The same is true for the Middle East, a region which has been hit hard by the oil price decline. Many African and low-income nations also face diminished prospects.

India, by contrast, remains a bright spot due to strong growth and rising real incomes. The ASEAN-5 economies—Indonesia, Malaysia, Philippines, Thailand, and Vietnam—are also performing well, while countries such as Mexico continue to grow.

Indeed, following turbulence at the beginning of 2016, economic sentiment has improved—driven by further quantitative easing from the European Central Bank (ECB), an apparent shift to a slower pace of rate increases by the U.S. Federal Reserve, a relative firming of oil prices, and lower capital outflows from China. We should welcome this, but we should not be complacent: in the absence of decisive action in addressing lingering problems, downside risks remain and have probably increased.

There are two broad categories of risks. For advanced economies, they relate to longstanding crisis legacies: high debt, low inflation, low investment, low productivity, and, for some, high unemployment. In some countries, the balance sheets of banks—and increasingly for non-bank financial institutions—are strained by non-performing assets and low operating profit margins.

For emerging and developing economies, risks relate to rising vulnerabilities: lower commodity prices, higher corporate debt, volatile capital flows and, for some countries, de-risking and reduced bank lending.

These risks should not be looked at in isolation—they have a macrofinancial dimension. This could, in adverse circumstances, create feedback loops to sovereign balance sheets—for example, through implicit guarantees of large and inefficient state-owned enterprises that take a hit from falling commodity revenues.

Moreover, each of these risks can be the cause of spillovers that cross borders with greater frequency and force than ever before. Indeed, IMF research indicates that spillovers from emerging economies have increased in recent years, including from trade, commodities, and financial markets.

The reason is simple: emerging markets have reached a size where such effects are big enough to be noticed everywhere. As a group, emerging and developing economies now account for almost 60 percent of global GDP—up from just under half only a decade ago. They have contributed to more than 80 percent of global growth since the 2008 crisis, and have been the main driver behind the significant reduction in global poverty.

After years of success, however, emerging markets are—as a group—now facing a harsh new reality. Growth rates are down, capital flows have reversed, and medium term prospects have deteriorated sharply. Last year, for example, emerging markets saw an estimated $531 billion in net capital *outflows*, compared with $48 billion in net *inflows* in 2014.

In the short term, the softening of growth and the scale of capital outflows are cause for concern. Furthermore, on current IMF forecasts, emerging and developing economies will converge

to advanced economy income levels at less than two-thirds the pace we had predicted just a decade ago.

This means that millions of poor people are finding it more difficult to get ahead; and members of the newly created middle classes are finding their expectations unfulfilled.

This is bad not only for emerging markets themselves, but also for the advanced world that has come to rely on said emerging markets—both as destinations for investment and customers for its products.

The answer to the reality of our interconnected world is not fragmentation. It is cooperation. We need to come up with proposals that are fit for the future: a strengthened framework for international cooperation.

This situation also carries with it the risk of rising inequality, protectionism, and populism.

Such risks are also exacerbated by others that transcend borders—and which feed uncertainty and fear.

Here, I am referring to terrorism and the repeated, appalling attacks on innocent lives; the silent threat of global epidemics; and conflict and persecution that force people to flee their homes. Many people wonder whether their way of life will have to change and whether their lives are still secure. This extends all the way to states that have received large numbers of refugees, like Jordan, Lebanon, and Turkey, as well as to some European nations—both transit and destination countries.

These and other frustrations are leading people to question established institutions and international norms. To some, the answer is to look inward, to somehow unwind these linkages, close borders, and retreat into protectionism.

As history has taught us—time and again—this would be a tragic course. The answer to the reality of our interconnected world is not fragmentation. It is cooperation. We need to come up with proposals that are fit for the future: a strengthened framework for international cooperation. In short, a new multilateralism for the twenty-first century.

A Three-pronged Approach

From a macroeconomic perspective, the first priority must be to secure the recovery and lay the foundation for stronger and more equitable medium term growth. Overcoming the voices of despair and exclusion requires an alternative path—one that leads to prospects for more employment, higher incomes, and more secure lives.

Solidarity is an imperative, the policies of individual countries must go further, and the policy mix must be more potent.

We need different actions in different countries guided by a three-pronged approach spanning structural, fiscal, and monetary measures. This may seem as "old-hat" to some, but if countries agree to take decisive action that goes beyond the status quo, I believe there is tremendous scope for making these policies mutually reinforcing. If each country plays its part, these policies can add up to a significant global package that could truly produce a whole that is greater than the sum of its parts.

The first of these is structural reform. There have been commitments on this front by the G20 members to raise global GDP by an additional 2 percentage points by 2018. Rather than being implemented over several years, I have called to advance these commitments into 2016.

What kind of structural measures are needed? We know the usual suspects: deregulating product and services markets and reforming labor markets. But now is the time to get specific. For instance, the United States could boost its labor supply by expanding the earned income tax credit, increasing the federal minimum wage, and strengthening family-friendly benefits. The Euro Area countries could implement better training and employment-matching policies to help more people find jobs—especially young people. And commodity exporting states, along with many low-income developing countries, could increase diversification.

I believe such supply-side measures should be taken now. To maximize their benefits, however, and to offset any dampening effect on demand in the short term, they must be complemented by supportive fiscal and monetary policies.

For most countries, the issue is how to make fiscal policies more growth-friendly. This can be done by shifting the composition of revenue and expenditure. India, for example, has reduced spending on costly energy subsidies so it can invest more in growth-enhancing social infrastructure. Japan is investing in childcare to help more women work, which will boost growth over the medium term. And Germany is implementing plans to expand public investment by €17 billion between now and 2018, among other measures.

Increasing the efficiency of public spending is also key. Research by IMF staff shows that the most efficient public investors get twice the growth "bang" for their investment "buck" than the least efficient. Investing in badly-needed—but well-designed—infrastructure is an obvious area of great potential.

Investing in innovation is another. Again, a recent report by IMF staff has found that GDP in advanced economies could increase by 5 percent over the next two decades if private R&D investment was raised by 40 percent. This would entail a relatively small fiscal cost of around 0.4 percent of GDP per year—partly achieved through improved public spending, and partly through better-targeted tax incentives.

In low-income and developing countries, strengthening domestic resource mobilization—including by reducing energy subsidies—can create room for social spending even while rebuilding fiscal buffers.

Of course, countries with high and increasing debt, as well as those with elevated sovereign spreads, need to pursue further fiscal consolidation. But others may have room for fiscal expansion—and even more so if they commit to credible, medium term consolidation plans.

Countries should also prepare fiscally smart contingency measures that can be implemented promptly—should downside risks materialize.

In sum, if each country plays its part, the global economy will be better for all.

Monetary policy is the third "prong" to help deliver more durable growth. Accommodative measures have played an invaluable role in supporting the global recovery. Across several major economies, this has been achieved through successive rounds of quantitative easing, combined with the successive lowering of interest rates. To be commended are the efforts of ECB President Mario Draghi for the steps that have been taken to improve confidence and financial conditions in the Euro Area, which will further support the recovery.

In this context, we see the recent introduction of negative interest rates by the ECB and the Bank of Japan—though not without side effects that warrant vigilance—as net positives in current circumstances.

While accommodation should continue in most advanced economies, it is clear that monetary policy can no longer be the alpha and omega to recovery. Indeed, it will be much more effective with support from structural and fiscal elements, along the lines mentioned above.

It also needs to be supported by efficient transmission channels. High levels of non-performing loans impede the positive effects of lower interest rates. That is why it is important to strengthen bank balance sheets by enhancing prudential oversight, debt enforcement regimes, and insolvency frameworks.

These measures are also vital for strengthening the financial sector as a whole—crucial in supporting a growing economy.

In emerging and developing economies—many grappling with the impact of weaker currencies on inflation and private sector balance sheets—monetary policy should continue to adapt to circumstances. This includes exchange rate flexibility where feasible, especially to help cushion against trade shocks.

Implementing such a three-pronged approach will involve going beyond the status quo. Frankly, in some instances, it could necessitate crossing political red lines. Hence, it may be seen as a step too far for some. But such reticence would be precisely the wrong move: the growth momentum is weak, risks are probably on the rise, and confidence is sorely lacking. Now is the time for leadership and increased cooperation.

Time for Greater Cooperation

Indeed, greater multilateral cooperation is essential for addressing shared priorities that countries cannot tackle by themselves. These include shoring up global trade, pressing ahead with financial regulatory reform, and tackling a range of "global public goods" challenges. It is also essential for maintaining a strong global financial safety net that protects countries from sudden liquidity shortages or external shocks.

During the crisis, the global community came together to address weaknesses in the international monetary system: creating the Financial Stability Board and European Stability Mechanism, strengthening central bank swap lines, and carving out a more prominent role for the G20.

The IMF was a central part of this effort: overhauling our surveillance and lending toolkits, and boosting our resources. One of the measures we embraced—the doubling of quotas—recently came into effect, with the long-awaited passage of the 2010 Governance Reforms. This not only put our financial resources on a stronger footing; it also greatly enhanced the representation of dynamic emerging markets in the IMF.

While these measures were welcome, there is a need for the international community to re-visit the global safety net for at least three reasons.

First, to reflect on its size, given the rapid acceleration in financial globalization, and to take account of the scale and speed of spillovers. Second, to consider ways to improve access, given that most emerging and developing countries are unable to use key elements of the current safety net—advanced-economy swap lines, for example. And third, to increase its responsiveness to new challenges facing the international monetary system—from digital currencies, to blockchain technology, to cyber-hacking.

Various options are being discussed by the IMF's membership. A well-resourced IMF is fundamental, and we, in turn, will be looking at how we can strengthen our approach to helping members manage risk, volatility, and uncertainty—including a financial backstop, as needed.

We will also be working to help countries identify policy space, craft measures, and build capacity. For example, we are deepening our work on issues such as structural reforms, capital flows, and de-risking.

In addition, we are striving to be more agile in responding to other emerging issues. Four in particular should be addressed: demographic shifts, environmental degradation, income inequality, and gender disparities.

Demographic Shifts

First is demographic change. In 40 years, the world's population is projected to grow from about 7.5 billion to an estimated 10 billion. In some parts of the world—especially in South Asia and sub-Saharan Africa—populations will continue to grow rapidly. In others—including most advanced and emerging economies—a momentous transition towards aging and shrinking populations will have to be faced.

By the end of the century, about two-third of all countries are expected to have declining populations. This will have profound implications for economics, financial markets, social stability, and geopolitics.

Life expectancy is up across the globe, although it still varies greatly across regions. And, at the risk of greatly oversimplifying the issue, this leads over time to lower fertility rates, which are historically related to changes in economic circumstances that increase the financial returns to education. To put it simply, it has became rational for families all over the world to raise fewer but better-educated children.

Increased investment in human capital has played a significant role in reducing income inequality *between* countries, as well as poverty rates over the past decades—with global income per capita nearly quadrupling since the end of World War II. The bottom line is that emerging and developing countries have been catching up with advanced economies in facilitating longer and more prosperous lives for their citizens.

There is a darker side to this demographic change, however. We know that in some advanced economies, declining fertility rates resulted in stagnant or even negative population growth, while sharply increased life expectancy has led to aging populations. The same effect will likely become true for emerging and developing countries.

These trends will have several important implications. One is a slowdown in potential growth: a country with an aging and shrinking population is likely to see lower economic growth over the medium term. Fewer workers also means less need to equip them with capital. Likewise, countries may become reluctant to upgrade their capital stock: why build more infrastructure for fewer people?

Another implication is reduced financial stability. Many see population aging as a significant drag on asset prices. Some even hypothesize that retiring baby boomers may trigger stock market disruptions because they may liquidate their equity holdings to finance their retirement. This may or may not be true, but what we definitely know is that governments, pension funds, and individuals seriously underestimate the prospect of people living much longer than anticipated. IMF analysis suggests that if everyone lived three years longer than expected, pension-related costs could increase by 50 percent in both advanced and emerging economies. This would heavily affect both private and public sector balance sheets, and could also undermine financial stability.

Moreover, there are potentially serious fiscal implications. Research indicates that in advanced economies alone, age-related spending is projected to jump from around 16 percent of GDP to 25 percent by the end of this century—unless policy action is taken. Meeting this challenge successfully will require creative policymaking. Neither increased borrowing, higher taxes, nor drastic entitlement reform—as conventionally understood—seem politically attractive options. Technological innovation, greater R&D investment, and tailored immigration policies—to name but a few measures—will also need to be considered.

Environmental degradation

Another long term challenge is environmental degradation. Indeed, it represents one of the greatest challenges of our era. We all know what is at stake here. More people with more prosperity will stretch our natural environment to the limit.

We can expect growing pressure points around water, food, and energy scarcity as the century progresses. For instance, by 2030, almost half of the world's population will live in regions of high water stress or shortage.

Looming in the background of all of this is the merciless march of climate change. Because of humanity's hubris, the natural environment, which we need to sustain us, is instead turning against us.

The world's most vulnerable people will be the ones to suffer the most from the convulsions of climate. For example, some estimates suggest that 40 percent of the land now used to grow maize in sub-Saharan Africa will no longer be able to support that crop two decades from now. This will have hugely disruptive implications for many African livelihoods and lives.

Overcoming climate change is obviously a gigantic project with a multitude of moving parts, and the Paris Climate Agreement goes a long way to providing the framework for action. The essential point is to make sure that people pay for the damage they cause. Why is this aspect—getting the prices right—so important? Because it will help reduce the harm today and spur investment in the low-carbon technologies of tomorrow.

Phasing out energy subsidies must also be part of the solution. It is paradoxical that we continue to subsidize, at an enormous scale, the very behavior that is destroying our planet. According to IMF estimates, global energy subsidies amounted to \$5.3 trillion last year, or 6.5 percent of global GDP. This staggering number, which includes the damaging effects of energy consumption on air quality and health, needs to come down. These subsidies are also deeply unfair because they mostly benefit the relatively affluent, not the poor. Reducing subsidies and properly taxing energy use can be a win-win prospect for both people and planet.

Domestic income disparity

Changing demographics and environmental degradation are two major long term trends. Rising income inequality *within* countries is a third. In too many cases and in too many countries, poor and middle-class households have come to realize that hard work and determination alone may not be enough to keep them economically afloat.

In fact, over the past two decades, inequality of income has risen substantively in most advanced economies and major emerging market economies, especially in Asia and Eastern Europe.

In the past, economists have underestimated the importance of inequality. They have focused on economic growth—on the size of the pie rather than its distribution. Today, we are more keenly aware of the damage done by income disparity within states. Put simply, a severely skewed income distribution harms the pace and sustainability of growth over the longer term. It leads to an economy of exclusion—a wasteland of discarded potential.

No wonder that politicians, business leaders, top-notch economists, and even central bankers are talking about reducing excessive inequality of wealth and income. This has become one of the defining issues of our time.

Producing more *durable* growth requires generating more *equitable* growth. Research conducted by colleagues at the IMF shows that excessive income inequality actually drags down the economic growth rate and makes growth *less* sustainable over time.

This IMF study demonstrates that if one lifts the income share of the poor and middle class by 1 percentage point, it leads to a GDP growth *increase* of as much as 0.38 percentage points in a country over five years. By contrast, if one lifts the income share of the rich by 1 percentage point, then GDP growth *decreases* by 0.08 percentage points. In other words, our findings suggest that—contrary to conventional wisdom—the benefits of higher income are trickling up, not down. This, of course, shows that the poor and the middle class are the main engines of growth. Unfortunately, these engines have been stalling.

The causes are well known and include technological progress and financial globalization—especially in advanced economies. In emerging and developing economies, extreme income inequality is largely driven by inequality of access to education, healthcare, and financial services, as well as low social mobility. With these kinds of disadvantages, millions of people have little or no chance of earning higher incomes and building up wealth. This is, in the words of Pope Francis, an "economy of exclusion."

Remedies abound. Along with maintaining macroeconomic stability, a key priority should be good governance: endemic corruption can be a strong indicator of profound social and economic inequality.

Another key priority should be prudence. We all know that actions need to be taken to reduce *excessive* inequality. But we also know that having a *certain* level of inequality is healthy and helpful. It provides incentives for people to compete, innovate, invest, and seize opportunities. Standing out from the crowd is an essential driver of prosperity.

Of course, policymakers need to be mindful of the country-specific drivers of inequality, including political, cultural, and institutional settings. No more one-size-fits-all approaches, but smart policies—potential game changers—that could help reverse the trend towards greater inequality within states. Smart structural reforms, with a focus on education and greater labor market flexibility, for instance, are essential to lift potential economic growth and boost both income and living standards over the medium term.

Gender parity

There is at least one additional dimension of inequality that needs to be addressed: if we talk about inclusion in economic life, we need to talk about gender parity.

Around the world, women still struggle to get an education, open bank accounts, own land, and find paid work—just because they were born female. They are held back in virtually every facet of public life, from the school bench as children to the boardroom as adults.

If women participated in the labor market to the same extent as men, GDP could increase by 5 percent in the United States, by 9 percent in Japan, and by 27 percent in India.

This hurts economic growth worldwide. By not letting women contribute on par with men, we end up with lower living standards for everyone, less poverty reduction, and more income inequality. Women's empowerment is not just a fundamentally moral cause, it is also an absolute economic "no-brainer." The IMF estimates that if women participated in the labor market to the same extent as men, GDP could increase by 5 percent in the United States, by 9 percent in Japan, and by 27 percent in India.

In short, we simply cannot afford to throw away these gains. The November 2014 pledge made at the G20 Summit to reduce the gap in women's labor force participation by 25 percent by 2025 was a critical step forward. So was the September 2015 commitment made by world leaders to end discrimination against women as part of the Sustainable Development Goals (SDG).

Delivering on these pledges will require decisive, sustained, and collective action. The IMF is focusing on three policy areas to help countries deliver on their promise to "achieve gender equality and empower all women and girls"—to quote from SDG 5.

The first is education. In fact, girls' education is probably the single best investment a country can make. Beyond investment in education per se, there are other ways to boost schooling of girls. Social programs such as cash transfers to poor families can be made conditional on their daughters' school attendance—as is the case in Bangladesh and Cambodia, for instance. And strengthening infrastructure—such as roads and sanitation—makes it easier for girls to get to school. A comprehensive approach is required.

The second policy area is employment. After receiving an education, a common life event for most women is getting a job. And while having a good education certainly helps women enter the workforce, it is by no means a guarantee of employment. A number of countries with highly educated women still have low levels of female labor force participation, such as Japan. In addition to cultural barriers, legal ones will need to be removed too. These include obstacles that prevent women from engaging in everyday activities—such as opening a bank account and having equal property rights. Then there is women's pay. Even with the same level of education, and in the same occupation, women earn just three quarters of what men earn. Infrastructure is yet another barrier. Without access to basic transport or energy sources, women find it very difficult to work outside the home. In rural South Africa, for example, electrification increased female labor force participation by 9 percent. The last barrier is unequal access to finance. In emerging and developing countries, around 70 percent of female-owned small and medium-sized enterprises are either unserved or underserved by financial institutions.

The third policy area to achieve women's economic empowerment is the family. Women play a special role in family life. A number of steps can be taken to acknowledge this evident reality. These include paid parental leave, which helps to maintain a woman's connection to the labor market, as well as providing affordable and high-quality childcare. Reducing the cost of childcare by half could increase the number of young mothers in the labor market by 10 percent. Tax reform can also help: in too many countries, the tax system discourages secondary earners—who are often women—from working. This package of parental leave, childcare, and a fairer tax system can enable women to combine a job with a family. Along with investing in girls' education and easing women's entry into the labor market, it also supports women's economic empowerment.

A MULTILATERALISM FOR A NEW ERA

In one way or another, all of the issues that have been raised in this essay will affect the global economy in the years to come. Virtually none of them can be successfully addressed without a renewed commitment to international cooperation—that is to say, without leaders from all over the world to make the choice to put common interests above their respective self-interests.

As Martin Luther King once said, "We are caught in an inescapable network of mutuality, tied in a single garment of destiny. Whatever affects one directly, affects all indirectly."

This is really an old lesson for a new era of multilateralism. In many ways, we need to rekindle the Bretton Woods spirit of 1944 that has served us so well.

That does not mean, however, that we need to go back to the drawing board.

Thanks to the inheritance of history, we have specific, working forms of cooperation at hand. For a start, think about the United Nations, the World Bank, the World Trade Organization—and of course the IMF. We might call these concrete—or 'hard'—forms of global governance.

The new multilateralism must be made more inclusive.

We also have a number of 'soft' instruments, such as the G20 at one end and networks of non-governmental organizations at the other. These entities have no formal mandates or legal powers of enforcement, but they do have value. They can move quickly and they can wedge open the doors of dialogue.

The beauty of the new multilateralism is that it can build on the old whilst going further, and perhaps deeper. The existing instruments of cooperation have proven extremely successful over the past decades, and they must be preserved and protected. That means that institutions like the IMF must be brought fully up to date, and made fully representative of the changing dynamics of the global economy. The recent approval of the 2010 Quota and Governance Reforms was a very big step in the right direction—and we need to continue working on that.

More broadly, the new multilateralism must be made more inclusive—encompassing not only the emerging powers across the globe, but also the expanding networks and coalitions that are now deeply embedded in the fabric of the global economy. The new multilateralism must have the capacity to listen and respond to those new voices.

The new multilateralism also needs to be agile, making sure that soft and hard forms of collaboration complement, rather than compete, with each other. It needs to promote a long term perspective whilst being decisive in the short term so as to overcome the temptation toward insularity and muddling through.

Fundamentally, it needs to instill a broader sense of social responsibility on the part of all players in the modern global economy.

What might this mean in practice? For a start, it means making a renewed commitment to openness and to the mutual benefits of trade and foreign investment.

It also requires collective responsibility for managing an international monetary system that has traveled light years since the old Bretton Woods system. Such collective responsibility would translate into all monetary institutions cooperating closely—mindful of the potential impact of their policies on others.

In short, we need a financial system for the twenty-first century. We need a financial system that serves the productive economy rather than its own purposes—one in which the greater global good prevails over particular advantage. We need the sort of financial oversight that is effective in clamping down on excess while making sure that credit gets to where it is most needed. And we need a financial structure in which industry takes co-responsibility for the integrity of the system as a whole, where culture is taken as seriously as capital, and finally, where the ethos is to serve, rather than rule, the real economy.

We also need a new twenty-first-century multilateralism that gets a grip on big ticket items such as climate change and inequality. On these, as on so many other issues, no country can stand alone.

When we think about it, a new multilateralism is really an imperative for the twenty-first century in which we live.