THE G-20 – ADDRESSING GLOBAL CHALLENGES

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Introduction

Thank you for the opportunity to be with you today. It's always a pleasure to speak at an ABE luncheon.

In 10 days, Treasurer Peter Costello will host the annual meeting of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors in Melbourne. It will be the most significant economic and financial forum ever held in Australia and the culmination of Australia's year as chair of the G-20.

Under the overarching theme of 'Building and Sustaining Prosperity', the G-20 will discuss key challenges facing the global economy.

Today I will focus on three of these challenges: reform of the IMF and the World Bank, collectively known as the Bretton Woods Institutions (BWI); demographic change; and resource security.

The G-20 is a relatively new grouping yet it is driving a quiet revolution in international policy cooperation. So to set the scene I will briefly outline what the G-20 is, where it fits in, and why it is important for Australia.

OVERVIEW OF THE G-20

The formation of the G-20 in 1999[1] was recognition of the rapid and widespread changes that have been occurring in the balance of global economic activity in recent decades. While industrialised countries remain economically important, emerging market economies (EMEs) have become significant players in the world economy. China and India together, for example, have more than tripled their share of global output in purchasing power parity (PPP) terms over the past 25 years (Chart 1). That is a prodigious feat made even more impressive given the global economy is now almost 5 times larger than it was in 1980 (also in PPP terms).

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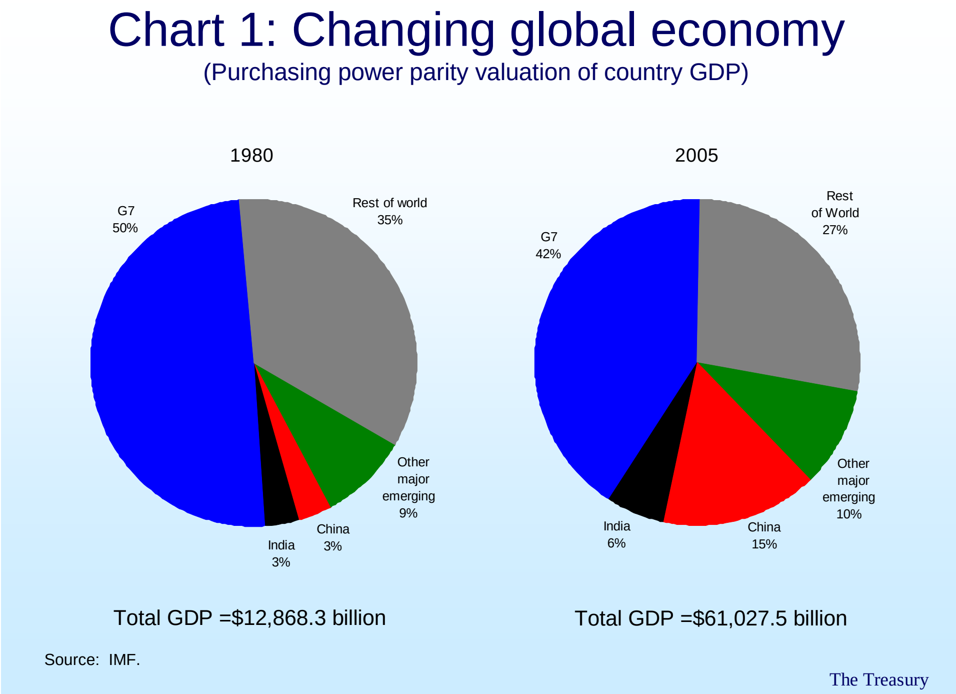
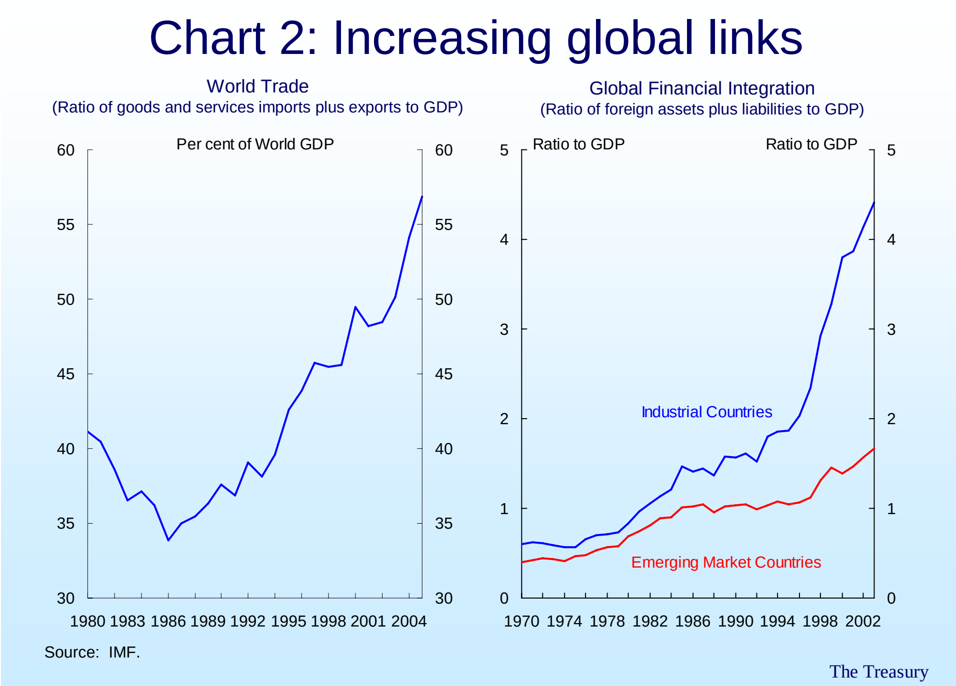
[1] The group was established in 1999 in response to the financial crises of the late 1990s, with a broad mandate to address international, financial and development issues.



At the same time, the world has become more integrated. There has been a rapid expansion in cross-border economic activity in the last several decades – reflecting growing trade and investment, broad liberalisation and deregulation of domestic markets and institutions, growth of multinational enterprises and increasing mobility of people. The growth in international flows of goods and services and financial integration can be seen in Chart 2.



In an increasingly interdependent world, the distinction between domestic and international economic challenges is blurring, reinforcing the importance of international economic cooperation, especially between emerging and established economic players. Indeed, it is hard to think of a global economic issue that can be successfully addressed with national policies alone, or without the involvement of both industrialised and emerging market economies – think climate change as an example.

This is important.

History reveals that a multilateral rules-based system reduces the ability of major powers to pursue their interests without regard to the interests of others in the broader international community. A rules-based multilateral system provides greater certainty about the terms of engagement between nations.

It also facilitates the integration of emerging economies into the global system – helping embed rules-based systems domestically and providing certainty to emerging powers about how the incumbents will respond to their growth and development.

For mid-sized countries like Australia this is of critical importance. It makes predictable the behaviour of existing major powers and provides a role model for emerging ones.

Experience highlights the importance of basing rules – whether domestic or international – on market principles. The effective operation of price signals for goods, services, capital and labour is the surest mechanism to achieve an efficient use of scarce resources, and to deliver rising prosperity and sustained economic and social development.

Sustained economic growth built on open, global markets has paid dividends – raising living standards and delivering permanent reductions in poverty. While the fight against poverty is far from over, globalisation has helped halve the proportion of people in the world living on less than US$1 a day[2].

To make further progress on poverty we need to provide more economic opportunities for the world's poor. As Kofi Annan has said, in referring to the poor, "Personally, I do not

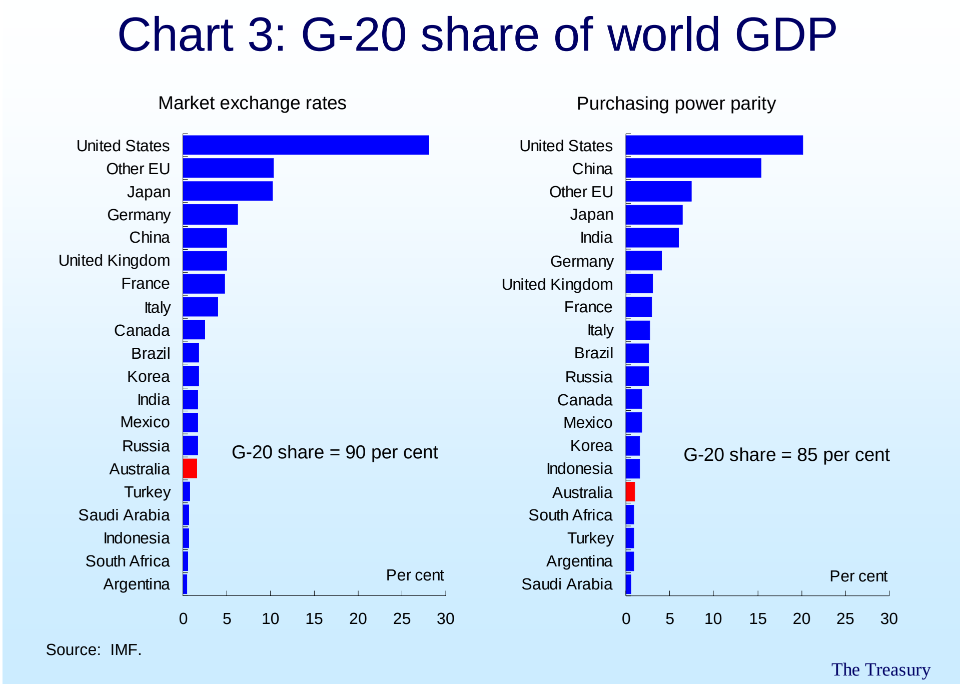
[2] The share of the world's population living on less than US$1 a day fell from 40.4% in 1981 to 19.4% in 2002 (Source: *World Development Indicators 2006*, World Bank).

believe that those people are victims of globalisation. Their problem is not that they are included in the global market but, in most cases, that they are excluded from it." [3]

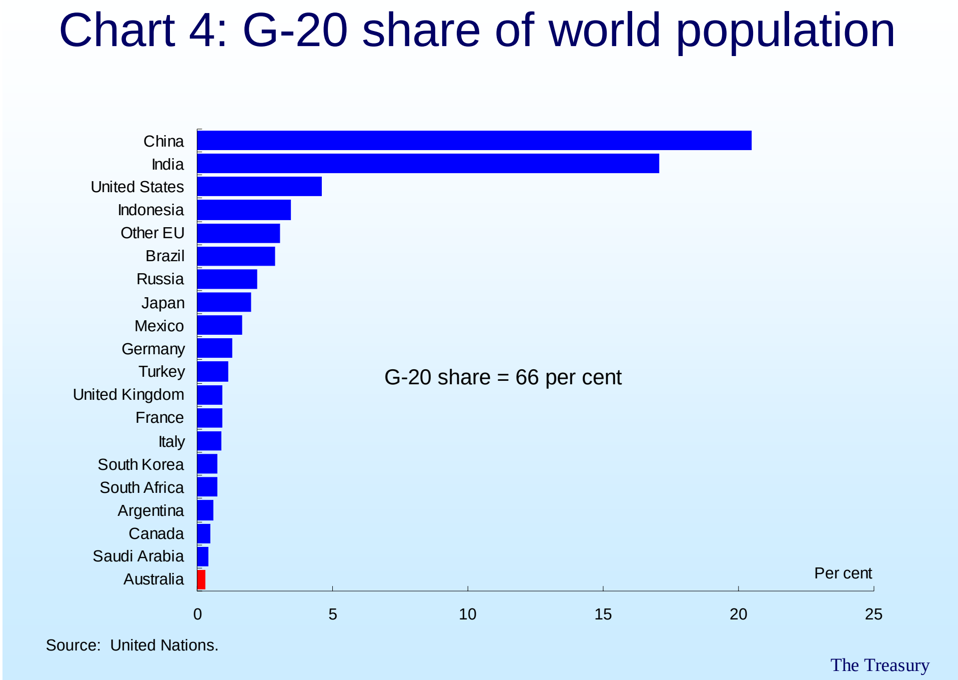
One of the challenges for the G-20 is to find ways to help more of the world benefit from globalisation.

In contrast to many of the longer established international fora, the G-20 is highly representative, bringing together the key global economic players of the 21st century. It comprises the world's 19 'systemically significant' industrial and emerging market economies plus the European Union (EU). It includes the G7 countries (US, Canada, UK, France, Germany, Japan and Italy) and key emerging economies such as China, India, Brazil, Russia, Mexico, South Africa and Indonesia.

The G-20 – which represents around 85 per cent of global GDP (in PPP terms) and around two-thirds of the global population (see Charts 3 and 4) – is structured to encourage open and effective policy dialogue. Its key institutional features are membership diversity, open and informal interaction, breadth of experience and national perspectives, and discussions framed with a robust economic perspective.



[3] "Companies must take lead to ensure globalisation benefits many", *Financial Times*, 4 February 2002.



The G-20 work program is overseen by a management "troika" of the past, present and future chairs – in 2006, China, Australia and South Africa. The agenda is advanced through workshops (up to three per year), where some of the best thinkers from around the world address important global economic issues, and two deputies' meetings, which refine the policy issues to be discussed by Ministers and Governors. A further institutional strength of the G-20 is its medium-term focus, with issues often discussed over several years and from different angles. This means that Ministers and Governors are able to consider contemporary developments in a broader context, and delve into issues from a variety of perspectives, which better informs their consideration of policy challenges and possible responses.

These features mean that the G-20 is well-suited to the emerging shape of the global economy. In particular, the G-20 has an inherent legitimacy, giving a genuine voice and influence to emerging market countries while maintaining the engagement of the more established global players.

THE ROLE OF THE G-20 IN ADDRESSING GLOBAL POLICY CHALLENGES

The overarching theme of "building and sustaining prosperity" recognises the world's substantial economic progress of recent years at the same time as reminding us that durable economic growth and development requires sound policies and a long-term approach.

To give substance to this, in Melbourne the G-20 will address the three key challenges already mentioned.

The IMF is one of the cornerstones of the international financial architecture. Yet, as Treasurer Costello has argued, the G-20 is focused on **IMF reform** because the failure of Fund governance arrangements to keep pace with the changes in the world economy has eroded its authority and effectiveness.

While people often talk as if the Fund's key role is that of lending, with its associated conditionality (which exists to promote adjustment and safeguard Fund resources), this misses the point. The IMF's key role is to safeguard the integrity of the international monetary system, which it should do through surveillance and policy advising.

It is a shared understanding of the importance of this role that, in September, brought industrial and emerging market economies together with low-income countries to support a package of reforms to IMF governance. This package consists of a first stage of quota increases for the most significantly underrepresented economies, followed by a second stage to deliver, among other things, a new quota formula designed to reflect members' economic weight and an increase in basic votes to strengthen the voice of low-income countries. This new formula will comprise the first major change in the way quotas are calculated since the 1960s.

The fact that there was an agreement at all in Singapore owes much to the G-20's sustained advocacy of IMF reform and, in some key ways, to Australia's leadership within the G-20[4]. Notwithstanding the years of repeated failure of the IMF members to reform the Fund, working within the G-20 we helped build political momentum for reform, articulated the two-stage approach that was adopted by the IMF[5], contributed to the

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[4] A fact recognized by our invitation to discuss IMF reform with G-7 finance ministers and central bank governors at their summit meeting in Washington in April 2006.

[5] A framework for a review of the IMF and World Bank was set out in an Australian Treasury background paper published in October 2005. This is available at www.treasury.gov.au.

refinement of the proposals, and worked hard to build support for reform among other countries both inside and outside the G-20.

But more remains to be done if the IMF is to become better equipped to prevent and resolve future crises.

The already-agreed first-stage reforms – the limited ad-hoc quota increase for China, Korea, Mexico and Turkey – are simply a down-payment, a sign of good faith. If the process stops here the IMF will be consigned to a future of rising irrelevancy for the bulk of the world – it will become an instrument of lending alone (to just a few regions around the globe), and one increasingly focused on poorly performing low-income countries.

The key lies with the second stage of governance reforms – with the development and implementation of a new quota formula that captures countries' changing relative economic importance now and into the future. If we can deliver on this – and our Ministers have given us a deadline of September 2008, but preferably by this time next year – a dynamic will be unleashed that will see a regular finetuning of voting shares and representation that will dramatically alter the Fund over the decades ahead.

But even this needs to be complemented with further work on key mandate issues, including policies and instruments of the Fund and the World Bank, and how the institutions fit together. Attention is also now turning to governance reform at the World Bank.

All these issues will be discussed in Melbourne. The G-20's interest in IMF and World Bank reform – of both governance and their key policies and instruments – reflects the importance it attaches to the institutions' key roles in the context of the multilateral rules-based system I referred to earlier. To carry out these roles effectively, the Fund and Bank must have the necessary legitimacy and authority, and they must ensure their key policies and instruments reflect members' changing needs.

Let me turn now to **demographic change**.

Like many other industrialised countries, Australia will experience major demographic change in the coming decades. Significant analytical and policy work has already been done on the *domestically-driven* implications of demographic change, including through the Intergenerational Report[6]. As a result, Australia has been able to contribute substantially to the G-20's consideration of these issues.

Interestingly, it has been suggested that demography is not a priority issue for a group with ambitions to be among the pre-eminent international economic fora, because this is a "domestic", rather than "international", issue.

I don't agree with this assessment.

Surely a key part of international policy cooperation is to share experience in order to develop better domestic policies in all member countries? Why else was the Treasurer invited to participate in the G-8 summit in St Petersburg, and to discuss Australia's experience with fiscal reform and governance?

Moreover, as the G-20 discussed last year, a large part of the impact on any individual country of demographic change will come about as a result of developments, and policy responses, in other countries. That is, spillovers will be important[7]. Recognition of this has shaped the G-20's work, with a focus on the likely impact on global and domestic growth, and on the extent to which labour mobility might be able to be part of a suite of policy responses.

Our focus this year is on the implications of demographic change for financial markets, institutions and systems. This recognises the potential for changes in the population structure to affect saving behaviour, capital accumulation, asset returns, international capital flows and the relative demand for different types of financial instruments.

At a Lowy Institute/Monash University seminar a few weeks ago I suggested that the G-20's on-going consideration of demographic change reflects the international dimensions of the issue and the diversity of demographic experience across the group. And I noted that, contrary to popular perception, demographic change is not solely about

[6] IGR2 is currently in preparation.

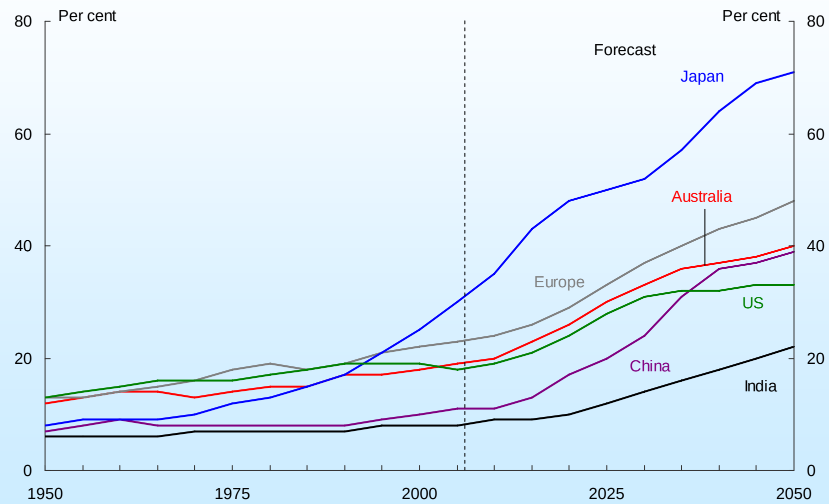
[7] This issue is explored in further detail in a paper presented to the G-20 Workshop on Demographic Challenges and Migration in Sydney in August 2005: W.J. McKibbin, The global macroeconomic consequences of a demographic transition.

the fiscal or growth pressures associated with population ageing in industrialised countries.

The fact is that different countries are experiencing very different types of demographic transitions. The clearest expression of this difference is the expected sharp rise in the old-age dependency ratio – the ratio of retirement age people to those of working age – in industrialised countries. In many advanced economies, working-age populations are barely growing and in some they are already declining. But, in many developing and emerging market countries working-age populations are likely to continue to grow for some time, in some cases quite rapidly. (Chart 5)

Chart 5: Old-age dependency ratios

(Ratio of 65+ year olds to 15-64 year olds)



Source: United Nations 2004 Population Revision Database, medium variant projections.

The Treasury

These differences in the pace of demographic transition present a complex set of challenges and opportunities for both industrial and emerging market countries.

Countries with relatively young populations may be able to benefit from their increasing working-age populations. However, the ability of these countries to harness this demographic dividend depends heavily on the domestic macroeconomic and policy environment. Australia's own experience shows that repeated macroeconomic instability and restrictive labour market arrangements curtail the creation of the employment opportunities required to absorb a rapidly growing labour force.

The G-20, through the *Accord for Sustained Growth*, can help these countries determine appropriate policies and warn them of the consequences of the policies that industrialised economies are now attempting to unwind, for example, the fiscal and workforce participation consequences of different pension and welfare systems.

The *Accord* has, surprisingly, received little attention since it was released in 2004. Yet it is a striking document, epitomising the agreed view of the G-20 members about the critical policy foundations required to deliver growth. It reflects the experience of emerging global powers such as China, Brazil, Korea and South Africa as well as that of the current industrialised economies – all of whom emphasise the importance of robust domestic institutions, good governance, sound structural policies and stable macroeconomic frameworks.

For all countries, the policy response to population ageing has international dimensions. With countries ageing at different speeds, cross-border capital flows have the potential to moderate the impact of ageing by allowing funds to flow to countries with relatively younger populations.

This is because emerging economies with young and rapidly growing populations are typically expected to have more investment opportunities than domestic saving, while mature developed economies with older, aging populations might be expected to have the reverse. As a result, in the long run, capital would be expected to flow from the ageing developed economies to the young developing ones—the opposite of what has been seen in recent years.

There is, as yet, no consensus on how to best manage the global economy in order to facilitate the sorts of shifts required. But it is clear that part of the response will need to address both the significant barriers to cross-border capital and labour flows apparent in many countries, and encourage financial market development in many developing economies. Since the G-20 brings all the major financial markets and population centres to the table, it can play a crucial role in highlighting how to improve the policy environment and in ensuring that policies are in place to facilitate, at least cost, the economic adjustment required by demographic change.

The Melbourne meeting will also address the issue of energy and mineral market developments and **resource security,** a topic ideally suited to the G-20, comprising as it does the key global producers such as Australia, Brazil, Canada, Saudi Arabia, South Africa and Russia, and key consumers, including the growth consumers, such as the US, EU, China, Japan and India.

The G-20's focus on resource security is intertwined with the economic changes highlighted earlier. Rapid industrialisation and urbanization in China, India and other emerging market economies, combined with strong growth in industrial economies, has boosted demand for a range of energy and mineral commodities, squeezing spare production capacity and raising prices.

It is no secret that developments to date have been important for Australia, particularly given our significant role in satisfying the growing global demand for energy and minerals.

Looking forward, in work commissioned for Melbourne, the International Energy Agency has suggested around $US 8 trillion of new investment will be needed in the oil and gas sectors alone over the next 30 years – or around $US 320 billion a year. It is worth considering carefully whether such investment will be forthcoming on current policies.

Similarly, in a comprehensive long-term analysis of global minerals markets prepared for the G-20 meeting, the World Bank sees 'a huge potential for continued growth in developing country metal demand', given the low level of use per capita today, large and growing populations, and the prospect of continued economic growth[8].

These developments have some clear macroeconomic implications, including on inflation and activity, notwithstanding the current and prospective expansions in global supply.

At a deeper level, though, these developments have also generated concerns about resource security, concerns which have, at times, been expressed or perceived as threats to national interests. This explains why this issue can sometimes be viewed through a

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[8] Both the IEA and World Bank reports will be released publicly during the G-20 meeting.

narrow strategic prism, which results in policy prescriptions that focus on rushing to lock-up and monopolise available energy and mineral resources.

History suggests that such a strategy is neither new, nor likely to be effective. As Keynes noted[9] in the aftermath of World War 1:

> *If the distribution of the European coal supplies is to be a scramble in which France is satisfied first, Italy next, and everyone else takes their chance, the industrial future of Europe is black and the prospects of revolution very good.*

Moreover, these narrow strategic policies are influenced by considerations outside the criteria economics tends to regard as essential, such as efficiency. One consequence is that commercially-suspect projects can be pursued at the expense of other more sensible alternatives.

But more important, still, is the recognition that the solution to securing a stable and predictable supply of energy and minerals need not be a zero-sum strategic game. Open and well-functioning global markets can deliver resource security and avoid these problems. This is all the more important when you consider the geographic concentration of energy and mineral endowments and the need for imports to satisfy countries' demand. This will inevitably result in rising trade dependency in the decades ahead.

Trade dependence is expected to be particularly acute for energy. For example, as can be seen in Chart 6, the International Energy Agency projects oil trade volumes among net importing nations will rise sharply by 2030. In the G-20, around one-third of members are wholly dependent on imports of oil; and around half rely wholly on imports of some of the main traded minerals[10].

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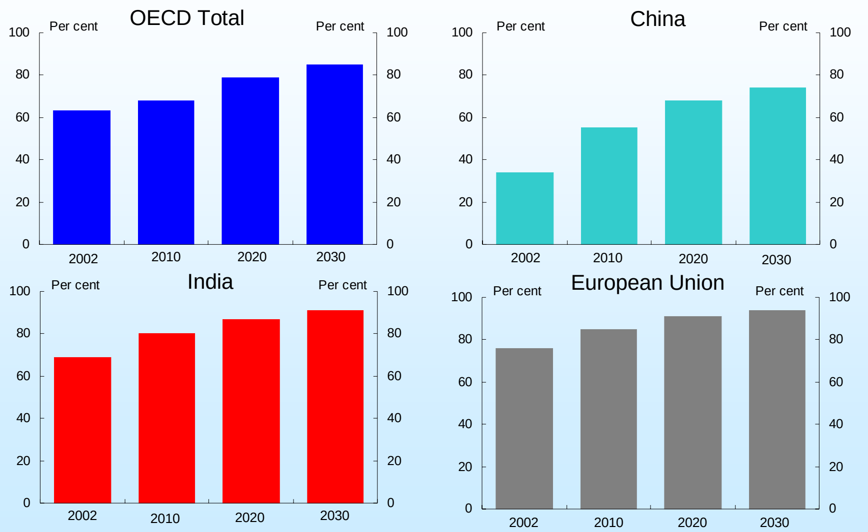
[9] J. M Keynes, *The Economic Consequences of the Peace* (1919), p. 60.

[10] Iron ore, copper, nickel, zinc, lead and bauxite.

Chart 6: Oil import dependency ratios

(net importing regions/countries)



Sources: IEA World Energy Outlook 2004.

The Treasury

One of the key objectives Treasurer Costello is working to achieve in Melbourne is to secure agreement that market-based approaches are critical to delivering greater resource security. Open and well-functioning global markets allow smooth and timely adjustments to changing economic conditions, complement macroeconomic policies, and support cross-border trade and investment.

As chair, the Treasurer will be focusing the G-20 on ensuring that the necessary standards of market transparency and governance are in place to allow capital and expertise to flow to resource-rich areas, wherever they may be. He also wants to encourage his colleagues to address some of the clear impediments to the operation of global markets, including distortions from various taxes, subsidies and investment restrictions. The Treasurer will encourage his colleagues to consider how to identify and implement the policy principles that support effective global energy and minerals markets, a discussion I expect that South African Finance Minister Trevor Manuel will want to build upon in 2007.

Apart from the three key agenda items already discussed, the G-20 will also review current developments and risks in the world economy. Without pre-empting that discussion, I would not be surprised to see active engagement on the risks associated with macroeconomic policy adjustment in the current global environment. In contrast to Australia, many G-20 and non-G-20 countries have made only limited progress on fiscal consolidation in a period where global growth has exceeded its long-term average for almost four years, and in which global spare capacity has been dramatically eroded. As such, the risk of macroeconomic policy mistakes is likely to have increased.

Finally, at the Treasurer's suggestion, the meeting will also discuss the political challenges of implementing reform. The unique feature of this discussion will be its focus on the "how" of economic reform rather than the "why", a distinction which reminds us that reform is much more than just a technocratic exercise.

CONCLUSION

To sum up, I believe that Australia's leadership of the G-20 in 2006 provides an opportunity to make real progress on a range of challenges facing the global economy.

These challenges have significant international dimensions, principally because the world economy has changed substantially over the past quarter century. These changes have seen the emergence of new economic players and increased the links between countries. In this new economic landscape, the distinction between national and international has blurred.

While the "new kid on the block", the G-20 brings together the key global economic players of the 21st century and is structured to encourage open and effective policy dialogue and to deliver practical solutions to global challenges.

It has already been a successful year. Australia and the G-20 have made a substantial contribution to IMF quota and governance reform through the historic decision taken in September. In Melbourne we will aim to make further progress toward comprehensive and effective international solutions to the challenges of demographic change and resource security.

In 2007, we will welcome South Africa as the G-20 chair. South Africa, like our fellow troika member China, has been a great ally during Australia's year as G-20 chair. We look forward to working with them over the next 12 months as they bring key issues to the table and we continue our collective efforts to strengthen the role of the G-20.

Thank you.