

MAY 2011

# FACING THE CHALLENGES

Three Scenarios for Global Economic Governance in 2020

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## ABOUT THE REPORT

This report was produced within the framework of the Global Governance 2020 program, organized by the Global Public Policy Institute in Berlin in collaboration with partner institutions in the United States (Princeton University and the Brookings Institution), China (Fudan University and Shanghai Academy of Social Sciences), and Germany (Hertie School of Governance).

GG2020 brought together 24 young professionals from the US, China and Germany for three meetings, one each in Berlin (17-21 January 2010), Shanghai (11-15 July 2010) and Washington DC (16-20 January 2011). During these meetings, the GG2020 fellows jointly discussed challenges of global governance in the year 2020 and beyond with a particular focus on three issue areas: climate change, nuclear weapons and the global economy.

This report reflects the work and findings of the GG2020 working group on global economic governance. The diversity of the working group members in terms of nationality, background and expertise represented a crucial asset for devising international strategies and solutions in a multicultural and multidisciplinary way.

The working group made extensive use of the intellectual instruments provided by the field of future research, including trend analysis and scenario planning, in order to jointly explore possible developments in global economic governance. During the three sessions, the working group also met with leading academic experts and policymakers on economic issues from all three countries to gather their input, opinion and advice. For more information please visit [www.gg2020.net](http://www.gg2020.net).

The views expressed in this publication belong solely to the authors and do not necessarily reflect the views of the institutions for whom they work.

# INTRODUCTION TO OUR METHODOLOGY

Drawing from a variety of backgrounds in the public and private sectors, as well as economics and politics, our working group – comprised of young professionals from China, Germany and the US – designed three scenarios that depict global economic interaction in 2020. The scenarios are meant to provide conjecture only and are in no way predictive. The exercise provided a platform to think of ways in which the global economy could develop, be they better or worse. From these three scenarios, we formulated a series of policy questions that will need to be answered in the near future.

In this paper we focus primarily on the key conclusions from the scenario exercise. These conclusions represent the result of a year long working process. Each scenario is briefly presented here.

The first scenario depicts a vibrant global economy with the normalization of balances of payments as well as stronger and more sustainable levels of economic growth across the board. The second scenario depicts economic blocs based on regions that interact in a fragmented global marketplace. The third scenario is a global economy fraught with political hostilities and major impediments in the global market. Each is detailed in this report. By fleshing out the scenarios, in particular the themes and triggers that helped construct them, we drew insights with implications for contemporary policymaking.

A series of stages and triggers form the axis to explore possible futures. The stages represent overarching trends, while the triggers are key transitional moments that provide a catalyst and facilitate momentum. The stages and triggers are not consistently weighted across the scenarios. The differentiation is reflective of the uncertainty of forecasting and scenario building. As noted above, the goal is to formulate potential outcomes in order to stress test global economic interaction and thus generate debate on key challenges that the world faces in global governance. It must be emphasized that these scenarios are illustrative and not predictive.

Through this process, we hope to create a policy dialogue that is directive rather than reactive.

We singled out crucial factors that will influence the path of the global economy in the future. Our analysis honed in on four factors that drive patterns in the global economy across each of the three scenarios:

- **Trade liberalization:** Maintenance of liberal trade routes shapes scenario 1, but protectionism forces the creation of trading blocs in scenarios 2 and 3.
- **European Union consensus and consolidation:** Meanwhile, the success of the EU's effort to deal with its debt crisis proves to be an important consideration for future trends in sovereign debt and credit markets.
- **Chinese domestic consumption:** The speed and ability of the Chinese to implement reform affect the global economy in two ways. If the Chinese implement reform under domestic pressure, the global economy will benefit. But if Chinese reform is pressured from changes in the external economic environment, the subsequent impact on global commerce could be costly. Similarly, regional integration in Asia will depend on Chinese engagement at the international level and the ability of Japan, China and Korea to work together.
- **US domestic economic restructuring:** The global economy's stability will largely depend on whether the US is able to overcome static institutions and develop an economic policy appropriate for the 21st century. US economic resurgence can help facilitate a more peaceful rebalancing of the global economy, but the inability to deal with core issues could create instability and volatility at the international level.

We recommend that policymakers consider these key factors and how they might lead to both positive and negative outcomes when making policy decisions. Our year-long exercise with scenario planning has provided a platform from which specific ques-

tions arise, which could in turn drive policy-related insights. To help bridge the transition from imagining possible futures to understanding implications for policy planning, we highlight key questions derived from our exercise at the end of this report.

Scenarios	Stages	Triggers
<b>1. THE INCLUSIVELY GOVERNED WORLD</b>	<ol style="list-style-type: none"> <li>1. Increased regional economic interaction and a better managed global financial system</li> <li>2. Sustained, inclusive global economic growth driven primarily by emerging market growth engines</li> <li>3. Improved and strengthened US-Sino relations</li> </ol>	<ol style="list-style-type: none"> <li>1. G20 consensus, delivery and strengthening</li> <li>2. Improved trust in global financial markets through the strengthening of institutions for financial cooperation and management</li> <li>3. A roadmap for Chinese renminbi appreciation</li> <li>4. Increased trade liberalization (including to emerging markets)</li> <li>5. Global trade imbalances correct as Chinese reserves of US dollars diminish</li> </ol>
<b>2. THE END OF GLOBALIZATION AND THE BEGINNING OF THE ERA OF REGIONALISM</b>	<ol style="list-style-type: none"> <li>1. Domestic pressures lead to rise of protectionism and challenging economic environment</li> <li>2. Economic contraction and anti-market sentiment is not addressed through global governance mechanisms</li> <li>3. Disentanglement of the global economy, creation of regional trading and financial blocs with limited international coordination</li> </ol>	<ol style="list-style-type: none"> <li>1. Bailout of Portugal, Spain and Italy by the EU and failed austerity program in Greece</li> <li>2. Subsequent rounds of quantitative easing instigate currency war</li> <li>3. Property bubble bursts in China</li> <li>4. Fallout of G20 summit in Mexico over currency and trade war with Doha Round declared dead in 2013</li> <li>5. Establishment of an Asian Monetary Fund and European Monetary Fund; nomination of an American managing director to the International Monetary Fund</li> </ol>

Scenarios	Stages	Triggers
<b>3. WELTSCHMERZ, A DIVISIVE GLOBAL ECONOMY</b>	<ol style="list-style-type: none"> <li>1. Continued stagnation in global markets leads to ever-increasing levels of protectionism</li> <li>2. Opposing ideologies are at the core of a US-Sino dispute that affects trade and financial markets globally</li> <li>3. Political discord leads to the rise of a burgeoning informal economy</li> </ol>	<ol style="list-style-type: none"> <li>1. In advanced economies, debt crises extend over multiple years and are exacerbated by a second dip</li> <li>2. An autarkic turn in US domestic politics</li> <li>3. Economic activity is restrained by a security fallout after the second dip</li> <li>4. Formalization of an economic bloc in the East through the issuance of a regional currency</li> <li>5. The emergence of poles and an informal economy</li> </ol>

# SCENARIOS

## Scenario 1: The Inclusively Governed World

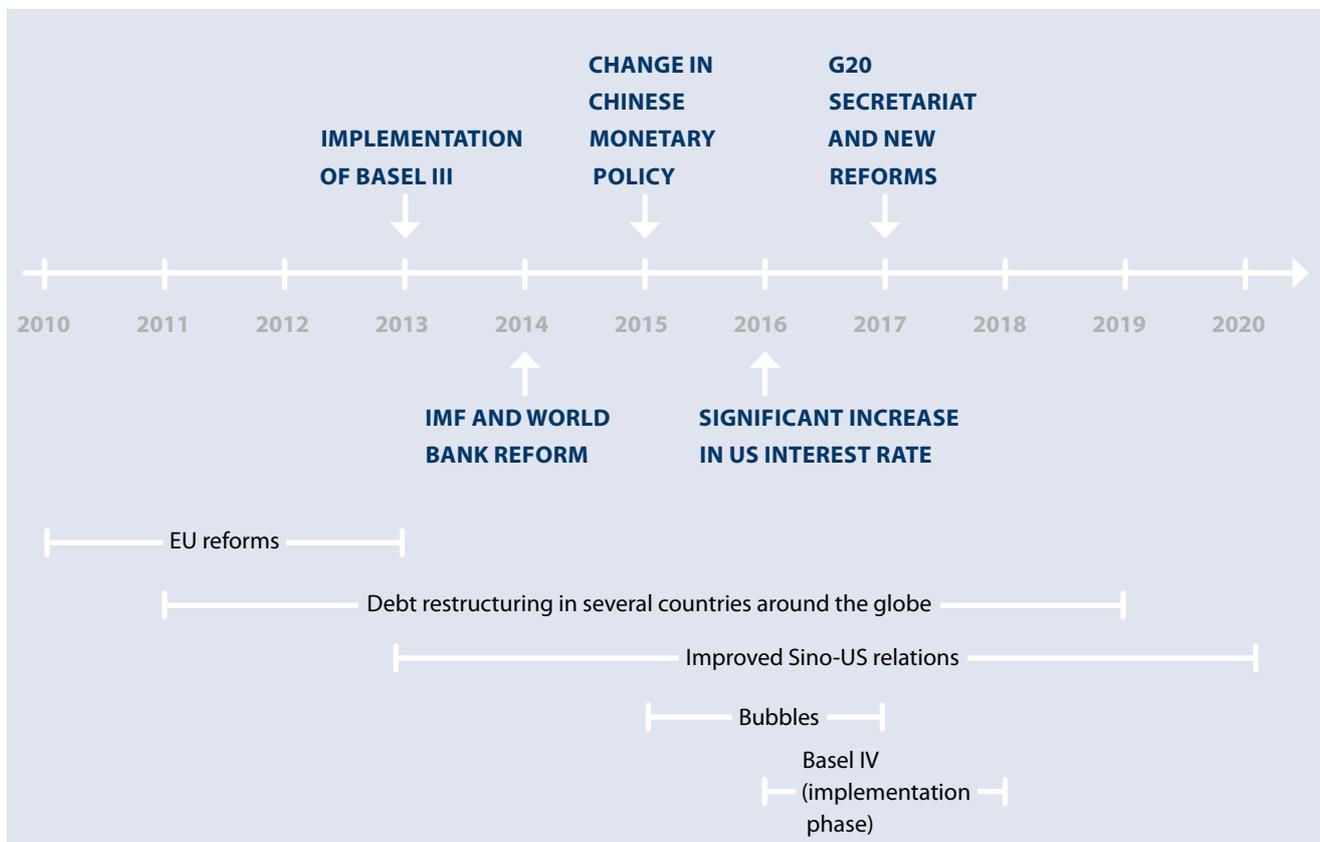
### The Situation in 2020

In scenario 1, The Inclusively Governed World, a period of open trade has been accompanied by increasing regional integration and a better managed global financial system. The world is better integrated and more inclusively governed. Regional integration is on the rise and protectionist measures are giving way to greater liberalization. A new class of emerging markets has entered the global economic stage. In addition, trade imbalances have begun to narrow, fuelled by a rising renminbi against the dollar and the euro. Imbalances within the Eurozone have also evened out. Relations be-

tween the US and China, as well as with other world trading partners, have improved considerably.

Worldwide economic growth has kept above 5% in the last decade, making the last global recession little more than an unpleasant memory. Global economic growth has increasingly been driven by emerging markets such as Brazil, India and China, among others. The traditional advanced economies have also achieved a relatively stable and constant growth pattern. The global growth outlook past 2020 is positive.

### Scenario 1 Timeline



## Stages and Triggers

### **Stage 1: Increased Regional Economic Integration and a Better Managed Global Financial System**

#### **Trigger 1: G20 Consensus, Delivery and Strengthening**

An improved relationship among key global players led to progress in G20 deliberations. In the earlier part of the decade, despite high levels of public debt and slow economic growth in a period of recovery, states were able to resist autarkic pressures. After a few major economies displayed protectionist tendencies, the economic interdependence between markets became increasingly apparent and most governments reversed course to ensure that world trade remained liberalized. Global reforms successfully addressed key underlying issues, such as mechanisms to monitor financial systems, made possible through a series of agreements that included a financial stability board with significant global powers, harmonization of international accounting standards and agreement on how to finance transitions to greener economies.

#### **Trigger 2: Improved Trust in Global Financial Markets Through the Strengthening of Institutions for Financial Cooperation and Management**

The consequences of the financial crisis that started in 2008 remained visible for many years. Many economies were deeply mired in debt to the edge of default. Towards the end of the decade, however, states were able to better control deficits and debts through domestic reforms, which had positive implications for the global marketplace. Greater consensus in global economic governance and the implementation of institutional reforms helped strengthen the image of cooperation among governments to ensure market stability. States were able to achieve consensus on supervisory standards, including the implementation of a new round of Basel regulations. An increasingly resilient network of financial safety nets with institutions like the International Monetary Fund (IMF), regional development banks and stabilization mechanisms also provided credible mechanisms to protect against future

crises. While investors remained cautious, trust in the markets had recovered by 2020.

Regional cooperation was not abandoned. The EU continued to outpace other regions in its integration, and the changes within the Eurozone had global ramifications. The euro area established an effective mechanism to govern economic policy through the creation of a fiscal policy apparatus. European countries most affected by the debt crisis (Portugal, Ireland, Greece and Spain) were finally able to stabilize debt levels and introduce successful structural policies that improved their competitiveness. In most international organizations, the EU consolidated its representation (eg, the IMF, World Bank and UN Security Council) and in most cases has held a single seat.

Effective regional integration is still missing in Africa and in some parts of Latin America, where growing income inequalities and political strife have made reforms challenging. As a result, while these regions made progress in increasing their voice on the global stage, they still face developmental challenges. One major consequence of the slower growth rates and the political instability of Africa and Latin America is continued immigration struggles, as a significant portion of their population continues to seek opportunities elsewhere.

## **Stage 2: Sustained, Inclusive Global Economic Growth Driven Primarily by Emerging Market Growth Engines**

### **Trigger 3: A Roadmap for Chinese Renminbi Appreciation**

China gained its position as one of the two leading world economies. The Chinese market experienced a fairly tough restructuring and slump after the government revalued the renminbi at a faster pace. The key turning point came in 2015 when the Chinese government implemented a roadmap towards a floating Chinese currency after having trouble containing inflation.

Gradually, domestic consumption began to compensate for losses in export-oriented businesses. Chinese firms slowly moved up the value chain, providing new employment opportunities. While unemployment remained relatively high, the government was able to provide basic welfare benefits and employment transition packages. China continued to struggle with demographic challenges, including a surplus of unskilled labor, an aging population and an immature pension system. Nevertheless, reform was executed in the face of political stability.

In 2020, China is primarily focused on domestic affairs, but its economic policy has helped smooth over foreign policy conflicts and has stimulated greater international cooperation. The Asian region, for example, increased the use of the IMF's Special Drawing Rights as a reserve currency. By 2020 China has established itself as an active and reliable partner in the IMF.

While China has continued to lead the pack of emerging markets, other economies like India and Brazil have sustained strong growth records. Across the world, the most successful developing countries have finally been able to close the earnings gap with the advanced world, as per capita gross domestic product converged worldwide.

### **Trigger 4: Increased Trade Liberalization (Including for Emerging Markets)**

Consensus on historically divisive trade topics, such as agricultural subsidies, textile products and intel-

lectual property, provided a major boost for trade liberalization. As the renminbi appreciated, manufacturing began to spread more evenly across emerging markets and to developing countries. Meanwhile, the swelling Chinese and Indian middle classes created new economic opportunities by boosting global demand for South-based manufacturing. The catalyst for greater trade liberalization began in 2014, when the Doha round was finally concluded. Agreements were achieved not only on a range of tariff-related issues but also on mechanisms to avoid rash protectionist reactions arising from domestic pressures. The latter was dealt with by explicitly detailing rules on non-tariff barriers. Market access and significant technical assistance to help meet global trade standards improved the situation of many developing countries. A new class of emerging markets began to attract capital, led by a handful of Eastern European, African and South American states.

The rapid changes in the global economic landscape induced pressure to give greater voice to developing and transition countries in global decisions. Countries like Brazil, India and China asserted themselves in key international institutions, like the G20, the IMF and the World Bank. The newly emerging countries have since become important donor countries, contributing significant capital to international development funds. However, with regard to the least developed countries, there is still progress to be made in increasing their participation in the international financial institutions and other international forums.

### **Stage 3: Improved and Strengthened Sino-US Relations**

#### **Trigger 5: Global Trade Imbalances Correct as Chinese Reserves of US Dollars Diminish**

In the years just preceding 2020, the relationship between the US and China improved significantly. It started when the two economic powers aligned themselves over common trade and economic growth objectives, particularly global reforms that helped American and Chinese business-interests succeed abroad. Since the renminbi began to float roughly five years ago, China's US dollar reserve holdings declined significantly. As a result, worldwide trade imbalances improved. Chinese exports (over 15% of world total exports in 2015) began to decline, and consequently US imports from China decreased, leading to an overall decrease in the US current account deficit. China released some of its dollar reserves in the process of revaluation, leading to a lower value of the US dollar, a rise in US exports and some benefit to the US current account balance. Some of the imports previously coming from China are now coming from other developing and transition countries.

Domestically, the unemployment rate in the US recovered to pre-2008 levels. The economy shifted towards skill-intensive jobs or highly specialized sectors (eg, green economy), while traditional manufacturing declined at home. China, on the other hand, had to deal with increasing unemployment as the domestic market found itself having to reorient to meet domestic demands. The transition, however, was controlled and a new entrepreneurial spirit brought a positive view on the Chinese economic outlook. The US recovery resulted in reduced hostility in domestic opinion towards China. Within China, the controlled economic transition ensured a relatively stable political climate. Both positive domestic atmospheres fostered a renewed political accord between the two powers.

## **Scenario Summary**

The outcomes in this scenario offer substantial benefit to most global players. The clear winners in

this scenario are international institutions (particularly the G20), regional economic bodies, international businesses (particularly those that invest in high value-added manufacturing) and emerging market countries. By managing the renminbi appreciation carefully, with the necessary domestic structural reforms, China is better positioned for ascendance as a global citizen rather than an economic threat. The US is able to manage and reverse some of its industrial decline by investing in high-growth IT businesses, high value-added manufacturing and the high-skilled workforce required for both. There are, however, some losers in this scenario. A number of Chinese citizens are left displaced and struggling during the country's economic transition following the renminbi appreciation. The least developed countries, particularly in sub-Saharan Africa, gain some representation in international institutions but are still left on the fringes of global wealth creation and distribution. The specter of an international financial crisis – this time motivated by overheating emerging economies – remains present.

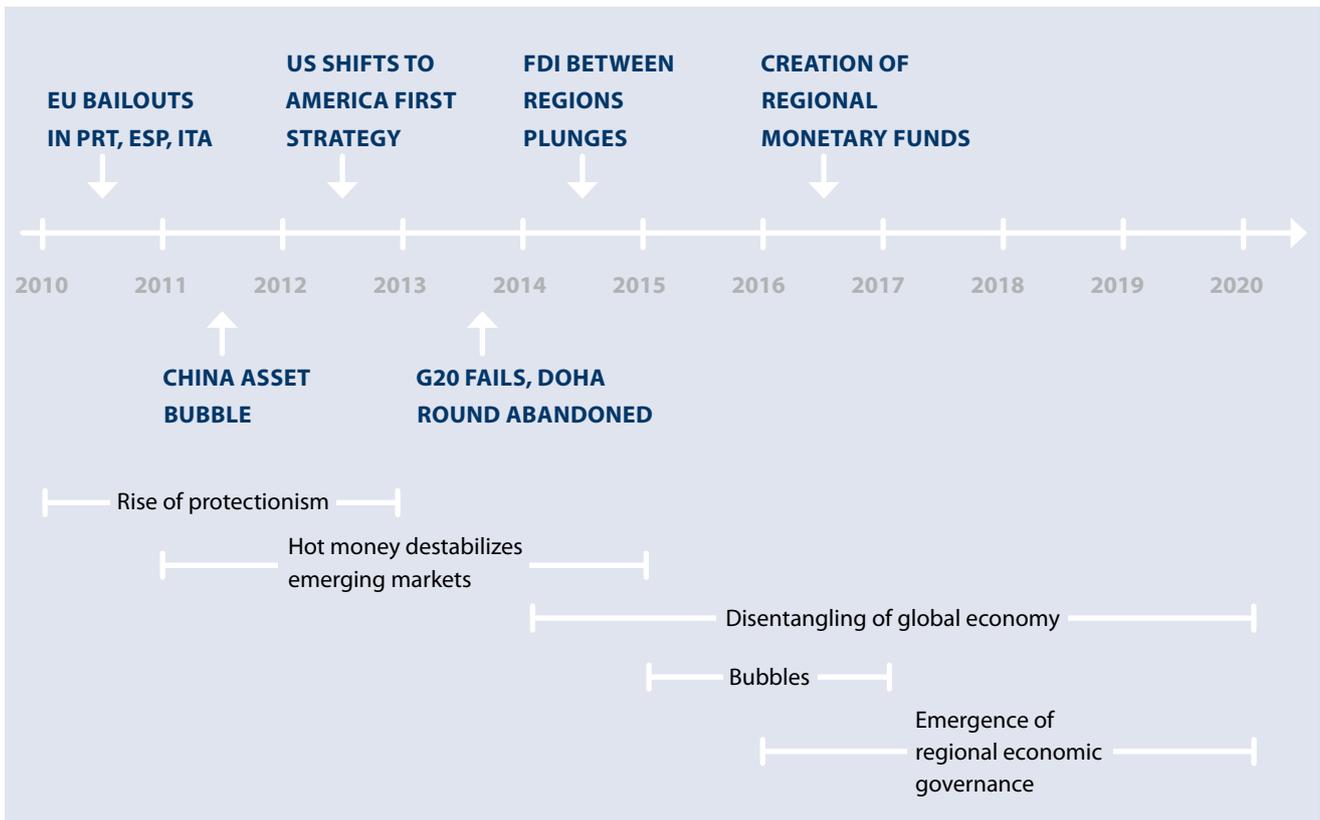
# Scenario 2: The End of Globalization and the Beginning of the Era of Regionalism

## The Situation in 2020

In scenario 2, The End of Globalization and the Beginning of the Era of Regionalism, the world – now multipolar – is less promising and encompassing than had been hoped for at the beginning of the decade. Instead, the second great era of globalization has come to an end. Increasing economic tensions between the US, China and the EU led to political

conflict and the emergence of three distinct regional blocs. The establishment of three distinct monetary funds epitomizes the new power structures, with the IMF representing US interests, the Asian Monetary Fund representing Chinese interests and the European Monetary Fund representing the interests of the EU.

## Scenario 2 Timeline



## Stages and Triggers

### Stage 1: Domestic Pressures Lead to Rise of Protectionism and Negative Economic Spiral

#### Trigger 1: Bailout of Portugal, Spain and Italy by the EU and Failed Austerity Program in Greece

Efforts by Eurozone countries to impose prudent fiscal policies proved too socially and politically costly. Implementation of austerity programs slowed dramatically in these countries and led to a further deterioration of public finances. Portugal, Spain and Italy, following the lead of Greece and Ireland, moved to request external financial support from both the EU and the IMF. Bond markets began to turn on all Eurozone countries because of uncertainty surrounding the survival of the euro itself. Investor confidence in the European market and its ability to solve internal problems continued to drop sharply. The euro continued to depreciate to almost 1:1 with the US dollar. Anti-market sentiments led to a wave of protectionist measures and an increasingly inward-looking economic policy throughout the union.

#### Trigger 2: Subsequent Rounds of Quantitative Easing Instigate Currency War

An acerbic political climate in the US prevented a coherent response to the stagnant economic performance of the US. Domestic pressures pushed for autarkic policies aimed at protecting jobs. The populist pressures pushed the US to enter a vicious circle of economic policies that failed to stimulate growth. With the US turning inwards, other economies began to follow suit. Especially troubling was the active slandering of Chinese economic policy by the US Congress, which led to the official accusation that China was a currency manipulator. The US and other actors tried to use the World Trade Organization as a mechanism to galvanize momentum and put pressure on China. Trade between the two states was severely disrupted. Without low cost Chinese goods to fulfill American demand and to hold down prices, inflation began to creep into the US domestic market. Inflation in the US facilitated the weakening of the dollar and further triggered appreciation pressures in other floating currencies.

For example, markets like Brazil, Chile and South Africa began to overheat as new global capital flows moved away from traditional western markets.

#### Trigger 3: Property Bubble Bursts in China

Hot money from asset investment poured into emerging markets, which in turn fuelled an asset bubble that exacerbated the already high inflation. Even in countries with a relatively closed capital account, the pressure was present. For example, faced with fewer investment options, property and stock markets in the Chinese economy continued to inflate, leading to a bubble. Global market volatility ensued. As a result, the Chinese economy faced a dilemma: keep the undervalued exchange rate through a peg but have increasing inflationary pressures through imported inflation, or float the renminbi, with the possibility of economic contraction as the Chinese economy restructures around domestic demand. With the traditional fear of economic contraction and vested interests in exporting (despite opposition from the Chinese Central Bank), the government decided to stick to the de facto peg. When questions about the sustainability of an export model arose due to sluggish demand in the anemic economies of the West, speculators quickly withdrew their investments, creating a panic much like that of the late 90s in Southeast and East Asia.

The resulting domestic economic turmoil posed not only an economic challenge to the Chinese government. It also created an environment of political instability. Many Chinese began to strongly question the state's ability to deliver economic growth through state-run capitalism.

## **Stage 2: Economic Contraction and Anti-market Sentiment is Not Addressed Through Global Governance Mechanisms**

### **Trigger 4: Fallout of G20 Summit in Mexico Over Currency and Trade War with Doha Round Declared Dead in 2013**

Differences in underlying interests meant that the G20 could not reach consensus on how to handle the new round of crises. Underlying interests included, for example, price stability in Europe, fiscal expansion and exports in the US, and continued trade surplus in China. The IMF ran out of financial (and political) resources to handle the extensive fallout from Europe. Furthermore, no real progress was made in reforming the voting rights of the IMF in 2011. The recession continued to drag along and high unemployment rates introduced populist pressures for higher levels of trade protectionism. China became an easy target for trade sanctions and non-tariff barriers. Green protectionism became prominent as states began to use green technology investments as a front for protectionist policies. For example, the US passed a domestic energy bill in 2012 that imposed tariffs on imports that do not meet domestic environmental and safety standards. The measure was widely perceived as a tool to impose further protectionist measurement on Chinese exports. China retaliated in the same manner. Trade wars became visible among other major economies as well. The WTO was unable to handle the sudden rise in claims and as a result proved to be ineffective as a means for international mediation.

Furthermore, the Doha Round was declared dead by the leaders of major world economies in 2013. Global markets became increasingly nervous about longstanding trade conflicts. Cross-continent foreign direct investment flows and trade levels started to slump even before most protectionist measures went into effect. Global markets braced for the worst. As it became increasingly clear that no dispute in the international financial and trade system would be solved at the global level, the US, China and Europe shifted their focus towards regional solutions to limit the damage to the real economy.

## **Stage 3: Disentanglement of the Global Economy, Creation of Regional Trading and Financial Blocs with Limited International Coordination**

### **Trigger 5: Establishment of an Asian Monetary Fund and European Monetary Fund; Nomination of an American Managing Director of the IMF**

Global markets became increasingly volatile and foreign direct investment flows across continents plunged due to a lack of global economic coordination and the combative nature of dialogue at the international level. Anticipating further economic tensions, businesses reduced the complexity of supply chains and vertically reintegrated their businesses. Stock markets stagnated as profit margins were expected to narrow in the increasingly segmented global marketplace.

Politically, the US and China began to signal further isolation from international processes. The Chinese political succession originally planned for 2012 became a year-long process because of slowing economic growth and international engagement. The US, focusing on domestic policy and rhetoric regarding protectionism and jobs, sent mixed signals to international actors. Suspicion and distrust between the two countries led to their confrontation on the international stage. Most importantly, China phased out its purchase of US securities and began a concerted effort to tilt its reserves away from the dollar, thus undermining US creditworthiness and exacerbating the already strained relations.

Trade and currency disputes between the US and China had global repercussions. In order to contain the damage to a broken global economic governance system, and to stabilize regional economic growth, Asian countries deepened their regionalization process by establishing the Asian Monetary Fund. Efforts led by China and the ASEAN states, which had little choice but to align, sought to provide regional stability amid global turmoil and to limit the influence of US and European monetary policy on Asian markets. Faced with global insecurity and financial volatility, regional states increasingly demanded leadership from China. Major Asian economies agreed on a basket of Asian currencies as the starting point for the Asian Monetary

Fund reserves. As Asia became Japan's prime export market, Japan felt compelled to participate. The fund provided an outlet to protect the value of the Japanese yen, which had been driven by a global shift away from the US dollar.

In the midst of the global trade regime's deterioration, a 2014 free trade negotiation known as the Con Dao Round (named after an island in South China Sea) marked the beginning of a renewed effort to reach a regional free trade zone in Asia. Unsurprisingly, China and Japan had to bear the greatest cost in establishing Asia's monetary fund, but both accepted their respective roles given the rapidly changing global economic landscape.

With enormous structural and economic challenges, Europe retreated from the global stage to focus on regional issues specific to the EU. As Germany could no longer bear the majority of bailout costs, once the threat had somewhat stabilized, the European Monetary Fund was finally established in 2015. The fund's mandate included regulation of European financial markets, Eurozone bond issuances and financing packages for European economies under stress.

The establishment of the Asian Monetary Fund and the European Monetary Fund diluted the resources, priorities and commitments of European and Asian member countries to the IMF. The once prominent international financial institution became an American-led regional financial organization with dollar-denominated assets that primarily served North and South American markets. To underscore this shift, the managing directorship of the IMF is held by an American and deputy chiefs are chosen from within the Americas.

## Scenario Summary

With the restructuring of the global economic system into three major economic blocks, increased intra-regional openness took the place of globalization and emerged as the key driver of growth. As strong regional leaders, the US, the EU and China offer stability and economic prosperity under their respective umbrella. The WTO no longer serves as

an international arbiter of trade as all negotiations are conducted between the three regional blocks. In 2020, intra-regional trade accounts for over 70% of global trade, with the balance primarily driven by raw material acquisitions. In the last few years, global markets have become increasingly worried about the lack of global economic governance and the combative tone at the international level. Foreign direct investment levels between regions have plunged. Multinational enterprises have begun to untangle their web of international involvements and refocus on their home regions. With the expectation of further economic tensions, businesses have reduced the complexity of production lines and vertically reintegrated themselves. Stock markets around the world have begun to lose value as margins become tighter in the face of less efficient production models. The new multi-polar global economy is one characterized by suspicion and mistrust, key ingredients of volatile markets.

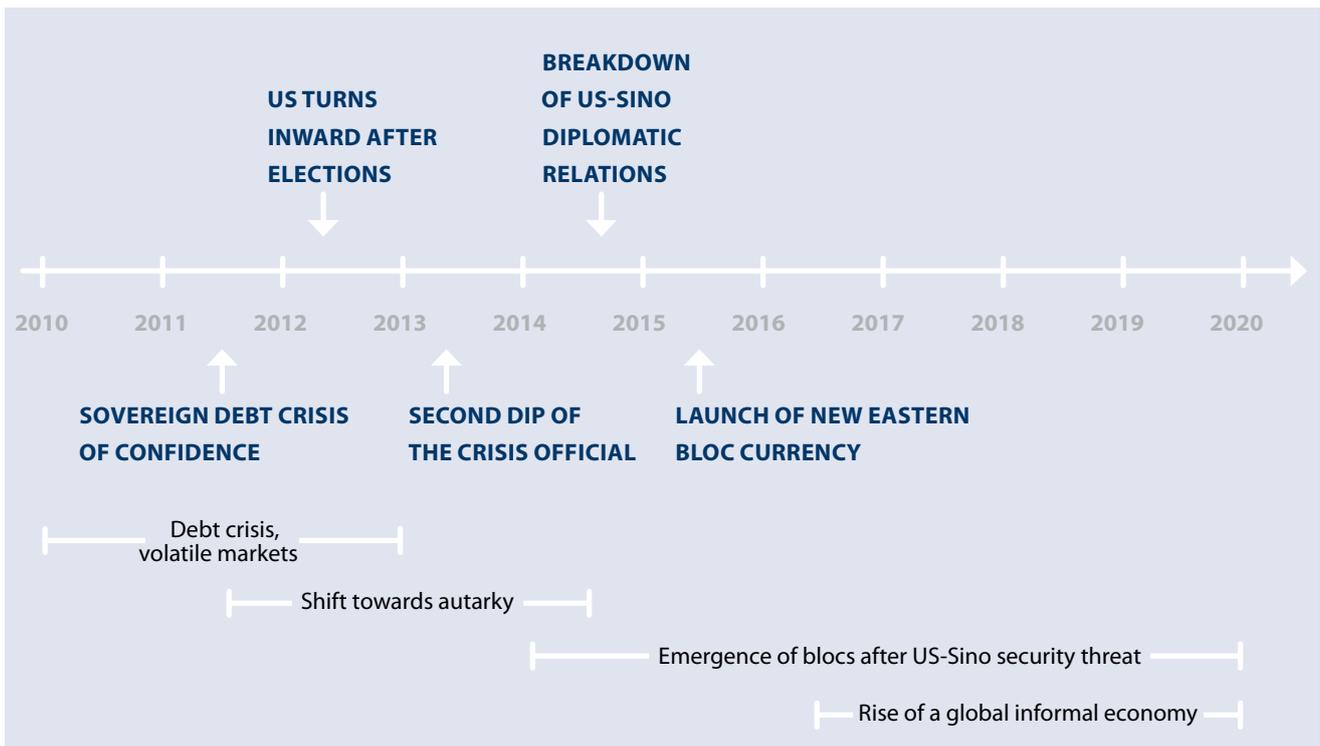
## Scenario 3: Weltschmerz (A Divisive Global Economy)

### The Situation in 2020

In scenario 3, Weltschmerz (A Divisive Global Economy), the big-two – US and China – are in the midst of a power struggle, with ideology being the principle cleavage. The world is divided, much like we saw during the Cold War, except that the Eastern axis is aligned with China. The Americans claim that China is undermining the integrity of the global economy by adhering to mercantilist economic policies. Conversely, the Chinese feel that the

Americans only superficially adhere to neoliberal policies and in reality are acting in a way that is both unfair and detrimental to the global economy. A grey zone exists between the axes, where a thriving black market has taken over a substantial share of the global economy. Continued economic stagnation around the world and increasing militarization have led to market warfare.

### Scenario 3 Timeline



## Stages and Triggers

### **Stage 1: Continued Stagnation in Global Markets Leads to Ever Increasing Levels of Protectionism**

#### **Trigger 1: In Advanced Economies, Debt Crises Extend Over Multiple Years and are Exacerbated by a Second Dip**

Developed countries found themselves burdened by extreme levels of debt in the immediate aftermath of the first part of the global financial meltdown. Levels of debt kept rising significantly in the EU and in the US between 2011 and 2013. The financial market crisis that started in 2008 developed into a debt crisis for the advanced economies of the West. The G20 had set a goal to address debt by early 2011 but the US, battling high unemployment and stagnant growth, decided to spend its way out of the crisis. EU member states were paralyzed by itinerant workers who were recalcitrant to any effort to make welfare spending more manageable, leading to continued deficits.

The EU debt crisis spread from Portugal, Ireland, Italy, Greece and Spain to the rest of the EU member states. The inability to reign in deficits by 2012 hurt sovereign creditworthiness. By 2013, a second phase of the global economic meltdown exacerbated the threat of default among many large economic powers. Economic brakes were temporarily imposed in markets to fend off stock market collapses and bank failures, breaking the trust of market actors for a number of years. Stagnant growth and increasing populist pressures recharged autarkic interests, reversing liberalization trends. Inward looking economic policies in both the US and the EU led to hostile attitudes towards Chinese monetary policies and to excessive, poorly directed intervention in the global market.

#### **Trigger 2: An Autarkic Turn in US Domestic Politics**

The year 2012 saw the election of an inward looking congress and president in the US. An election promise was to aid the struggling US economy by toughening US policies towards China due to China's continued currency manipulation and disregard for

WTO rules. By 2014, after repeated requests to address the Chinese currency situation passed unheeded, the US increased import taxes for Chinese goods to a level that the treasury department deemed equivalent to the subsidization rate of the renminbi. The EU allied itself with the US in this policy move, primarily because of domestic populist pressures. Further, the Western economies agreed to continue economic cooperation between states that allow markets to govern their economies and to shun those that have state-led growth policies – especially China. The Chinese viewed such a position as hypocritical given the amount of state intervention in Western economies during periods of crisis. The political and economic standoff led to a shortage of capital in global capital markets.

## **Stage 2: Opposing Ideologies Are at the Core of a US-Sino Dispute That Affects Trade and Financial Markets Globally**

### **Trigger 3: Economic Activity is Restrained by Security Fallout After the Second Dip**

Faced with the fallout from the second dip of a credit crisis in 2013, the US and EU had little capital left for large-scale stimulus packages. Experts urged leading global economies to cooperate but both the Western powers and China remained stubborn, rendering the G20 an ineffective forum for dialogue on global economic policies. This rift was comparable to the Cold War-era divergence, where communism challenged capitalism. While an ideological divide might not seem as threatening, the global economy began to split between an American and a Chinese camp. Exacerbating the divide, at the end of 2013, a skirmish in the Taiwan Strait led to the strait's becoming a formally recognized militarized zone. Furthermore, in 2014 the Chinese sponsored regime change in North Korea (following domestic unrest); this was to ensure that a suitable buffer existed between them and the American-aligned South Korean state. Both sides viewed the other's actions as hostile and a military standoff between China and the US emerged.

The resulting militarization meant that diplomatic relations between the US and China was functionally non-existent. Without diplomatic ties to support negotiation, international institutions that traditionally served to restrain behavior were no longer relevant. As a result, the formal economic relationship between the big-two collapsed, limiting trade to within the key economic blocs. On one side was the West (led by the US, EU, Japan, Korea, India, Australia and the Middle East), while on the other side was the East (led by China, Russia, Central and Southeast Asian countries, African countries, Iran and Argentina). The former were generally characterized by free markets and democracy, whereas the latter had state-run economic models and centralized leadership structures. Between 2013 and 2015, intra-bloc trade expanded rapidly, forcing a re-adjustment of the global value chain. Given the formal split and the Eastern abandonment of the dollar, formal trade

routes between the blocs froze. Financial markets followed suit.

In Europe there was notable political and economic fallout after a second phase of the financial crisis because a number of states were forced to abandon the euro. Despite surviving the first financial crisis, debt pressures continued unabated. Fiscal policy suffered in a number of ways. At the domestic level, periphery states were unable to overcome the political fallout, and anti-EU sentiments (expressed through austerity measures and successive years of deficits) created serious problems in sovereign debt markets. Moreover, within the EU, states failed to agree on a revised stability and growth pact and a revised Maastricht Plus fiscal convergence policy. As a result, the role of the euro as an international reserve and transactional currency was significantly weakened.

### **Trigger 4: Formalization of an Economic Bloc in the East Through the Issuance of a Regional Currency**

Another side effect of the bipolar world was that China stopped buying US debt. As a result, China had to re-peg the currency to a broader basket. The basket was constructed with a range of currencies, including the Russian ruble and smaller Southeast Asian currencies. As a hedge, the Chinese tried to unload some of their dollar securities on the international market, but the US frequently intervened and forced allied nations to refuse these securities, essentially leaving China with a significant loss in assets. In response, a new currency was launched in the East. The new currency operates on a model similar to the IMF's Special Drawing Rights but is managed in Beijing.

The world was officially split into a free market bloc in the West, and a state-based economic bloc in the East (centered around China). A grey zone, however, also existed. These states either did not find it necessary to align economically in the face of a second phase of the financial crisis, or were not in a geopolitical position to align, or were able to benefit from a burgeoning black market specializing in East-West trade (eg, Brazil, India and Indonesia respectively).

Between 2013 and 2020 the US did not fully recover from the second dip despite the fact that its debt liabilities to China decreased rapidly. Indeed, most sovereign lenders and investors considered US debt and the US dollar significantly risky due to their de facto default on debt held by China. Global sovereign markets were in a state of crisis after the US administration's clumsy attempts to curtail the flow of US securities unloaded by the Chinese.

### **Stage 3: Political Discord Leads to the Rise of a Burgeoning Informal Economy**

#### **Trigger 5: The Emergence of Poles and an Informal Economy**

In the latter part of the decade, governments decided that international institutions were to be preserved to help with market governance issues. In the Western bloc, the international institutions that were in place before – the G20, the OECD, etc. – continued to exist. The key modification was simply in the group of member states. In the Eastern bloc, new institutions emerged. Significantly, despite the clear political division, the economic division was not as distinct. A black market began to take over in the area around the Pacific Ocean. Despite efforts from the big-two to decouple their economies, it was only successful in a formal sense. In reality, a very different picture emerged after 2015.

The middle states began to realize that acting as a trade intermediary between the big-two and the two blocs would generate substantial revenue. Countries like Malaysia, Indonesia, Singapore and Papua New Guinea profited by acting as go-betweens for Chinese and American products. To facilitate trade between these two entities, a black market currency exchange developed and came to dominate Asian Pacific Island economies and, to a lesser extent, Southeast Asia. The Singapore dollar became a key trading and exchange currency between China and the US. Furthermore, supply chains stretching across blocs re-established themselves in Malaysia, Singapore and the Pacific Islands. The big-two viewed the development of informal trade as less threatening. Officially, they continued with the standoff, but unofficially the

informal trade environment was permitted to operate relatively unobstructed.

In the informal economy, non-state actors were forced to adapt to a new environment that lacked formal regulation. Multinational corporations saw potential costs and benefits associated with this environment. Only the most nimble and well-connected companies were able to take advantage of the situation. On the cost side, the breakdown of traditional supply chains increased the costs of production and led to narrower profit margins. The firms that benefited were able to leverage global networks and liaise with newly established entities in the non-aligned states and key trading hubs to arbitrate and profit from misaligned Eastern and Western markets.

## **Scenario Summary**

With the breakdown of Chinese-American economic relations, both states suffered considerably. The US lost its chief financier and witnessed rapid inflation in the economy, which led to a sharp increase in interest rates. Domestically, the US underwent a painful economic restructuring, which led to prolonged periods of low productivity and lower wages for workers. At the international level, America's role in the global economy declined in the period from 2011 to 2020. Broadly speaking, the world's two major diplomatic powers, the US and the EU, were forced to turn inwards. Europe remains marginalized because of continued economic stagnation and domestic turmoil. The perpetual fight against sovereign default in the Eurozone periphery contributed to a decade of deflation in Eastern and Mediterranean Europe and has been a severe drain on resources in the core of Europe.

China, on the other hand, faced great pressure to become more international in its economic policy outlook. The economy faced major challenges after the government's US dollar holdings lost liquidity in the newly re-aligned global marketplace. The export-driven sector of the economy fell into shambles since China could no longer rely on the Western economies to sustain its export model. China

tried to restructure its economy by encouraging domestic consumption. Strong incentives for domestic demand were provided in October 2015 in the 13th five-year plan. A vast domestic manufacturing base for both high- and low-value goods had to adjust to produce for domestic consumption. This provided a suitable base to begin reorienting the economy. China had to take a leading role in the Eastern economies and developed into a regional leader through the issuance of a new regional currency that was primarily backed by the Chinese economy.

# CONCLUSIONS AND POLICY QUESTIONS

Scenarios can easily be misunderstood. The process of scenario building is challenging and requires patience, a willingness to suspend disbelief and ample creativity. In our conversations with various policymakers, public intellectuals and other practitioners in Washington DC, Berlin and Shanghai over the last year, we realized that the methodology is rarely used for policy planning. Most often, confusion or aversion to scenario planning seems to arise from a common misconception that these hypothetical constructions are meant to be predictive. Nonetheless, a key lesson from the GG2020 scenario exercise is that the very process and method of scenario planning is valuable and could benefit today's economic policy decision-makers if used as a policy planning tool.

We emphasize that the above scenarios are not predictions of the future. They rather demonstrate possible future outcomes. While the likelihood of each scenario's realization is open to interpretation, each of the scenarios shares key driving forces. Depending on how these driving forces manifest themselves in the real world, we may experience very different realities in 2020.

The first scenario envisions an integrated world with improved mechanisms of global governance. The increased cooperation, however, comes at a price. Structural change in domestic economies results from liberalization in international markets. Most notably, the Chinese move up the value chain and adapt their labor force and welfare system to transition into a more modern economy. The second scenario suggests development along regional lines, with Asian, American and European blocs dominating the global economy. Trade and financial flows become concentrated within the three blocs. The third scenario draws a dramatic picture where a fallout between the US and China (after a second phase of the financial crisis) leads to a polarized global landscape. An informal economy forms to sustain economic activity between the blocs but politically the two sides are at a standoff.

All of the scenarios offer insights for policymakers. Although they are far short of offering policy prescriptions, these scenarios shed light on potential opportunities to be seized, as well as the consequences of missed opportunities to mold the global economic governance regime in the aftermath of the last global recession. The goal of the exercise was to highlight key issues that policymakers need to think about so that policy design can become proactive rather than reactive. In this way, our scenarios provide a platform for asking better questions and anticipating potential outcomes. Below are a series of implications and related questions that stem from our scenario-planning exercise. This set of implication-related questions is not exhaustive. Instead, it is an initial list meant to spark thought among practitioners concerned with designing forward-looking policies:

1. **Trust in, and the legitimacy of, global governance must be maintained to ensure the success of the G20 and comparable forums.**
  - How can a global governance system primarily driven by large economies reach out to less developed regions or smaller economies and establish the necessary legitimacy?
  - Assuming a lack of successful coordination within the G20, what are institutional alternatives for global economic governance?
2. **Complementary regional integration and global institutions are necessary to ensure a global economic governance system that is flexible enough to accommodate a future dominated by new growth economies and older, slower-growing (or stagnating) economies.**
  - How can we ensure that regional integration in Asia and the Americas contributes to global integration instead of becoming a substitute for it?

- How should international financial institutions ensure that regional financial institutions are complementary to the global governance structure?
  - Will China be able to become a regional leader, and will others be willing to accept it as such?
- 3. The nexus between domestic politics and international developments remains key and will continue to influence the performance and rigor of global economic governance institutions.**
- How can protectionism be avoided in times of weak economic growth and high unemployment in the US and Europe?
  - Are there ways in which the international community can help to support domestic reforms necessary to tackle global problems (eg, minimize the effect on employment levels when appreciating the renminbi)?
  - How can the EU and the US be prepared for a world in which China fails to restructure its economy and lift domestic consumption in the long term?
  - How can domestic stakeholders be encouraged to contribute to a stable relationship between the US and China?
  - What measures should states take to cope with a more sizeable informal economy?
- 4. Balanced regional representation and responsible leadership are two key ingredients for the global economic governance regime.**
- What would be an appropriate role for China to play in global economic governance given its economic size?
  - Can the US government and the EU authorities assist with the development of East Asian regional cooperation?
  - Are the economic costs of a global disentanglement a sufficient deterrent for international conflict?
- What are the implications for the real economy in a hostile and/or militarized environment (specifically in the event of a US-Sino conflict)?

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