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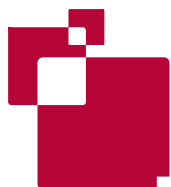
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Highlights

- With the crisis, the G20 has largely substituted the G7 as the key forum for international economic cooperation. The 'G20 paradox': the group includes both the developed and developing countries, but so far its agenda and outcome have not differed much from what the G7's would have been.
- Developed countries have taken a direct hit on their banking and financial systems and are looking to boost financial regulation and supervision. Emerging economies have been hit by the collapse of trade and capital outflows and are seeking to ward off the reemergence of protectionism in trade and finance.
- Emerging countries also want more say in setting the agenda of international institutions: so far, the G20 has been dominated by management of the crisis, provision of financial resources to countries in crisis, and rebuilding of financial regulation – a rather G7-like agenda. But it has been silent on issues such as global imbalances.

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THE G20 IS NOT JUST A G7 WITH EXTRA CHAIRS¹

AGNÈS BÉNASSY-QUÉRÉ, RAJIV KUMAR AND JEAN PISANI-FERRY, SEPT 2009

IN THE WAKE OF THE GLOBAL CRISIS the G20 has largely substituted the G7 as the key forum for international economic cooperation. However, G7 and non-G7 members of the G20 come to G20 meetings with different priorities. Developed countries have taken a direct hit on their banking and financial systems as a result of the crisis and they accordingly give priority to strengthening financial regulation and supervision. Emerging economies have been primarily affected by the collapse of trade and (mostly in emerging Europe) the outflow of capital. Their priority is thus to ward off the reemergence of protectionism in trade and finance. As newcomers, the emerging countries are also focused on the distribution of power and they adamantly claim that they need more say in international institutions. So far, the G20 agenda has been dominated by the management of the global turmoil, the provision of financial resources to countries in crisis, and the rebuilding of financial regulation – a rather G7-like agenda. Meanwhile, it has been silent on the issue of global imbalances, where it could have made a difference. In the future, the G20's agenda will have to evolve and better reflect the variety of concerns of its members.

THE PARADOX OF THE G20

A striking outcome of the global financial crisis has been the acknowledgement that global coordination needs to be handled by a wider group than the traditional G7, which only brings together advanced economies. Indeed, while the crisis clearly originated in the (perhaps too) sophisticated banking sectors of the advanced

economies, it rapidly grew into a global one through the collapse of trade and of commodity prices and through the sudden reversal of capital flows to several emerging and developing countries. Some of the countries hit hardest by the crisis are emerging economies, especially in Europe.

The creation of the G20 recognises that interdependence cannot be managed by developed countries alone and that non-G7 countries should have a say both in the design and in the management of the global economic and financial system. In recent past the developing world was invited to the top table when development issues were on the agenda. This time it has been given permanent seats and has been asked to participate in the solution of a global problem. This fundamentally changes the nature of the discussion². The meeting of G20 leaders is symbolic in this regard, but the same applies to other bodies: emerging economies have also been invited to be represented in other formerly exclusive institutions where financial regulation is made, such as the Basel Committee and the Financial Stability Board. This is a game change in international governance.

Still, both G7 and non-G7 members of the G20 may not yet have entirely realised that the G20 is not just an extended version of the G7. Its agenda has so far been determined by the urgent responses needed to tackle an unfolding crisis whose epicentre was located in the US. Hence, the creation of the G20 has not yet served to shape the international discussion. This is what could be

1. This paper draws on the discussion among participants at the Bruegel-ICRIER-CEPII conference on 'International Cooperation in Times of Global Crisis: Views from G20 countries' held in New Delhi on 14-15 September, 2009. We are grateful to Olena Havrylchuk for coordinating a first draft of this document with Dony Alex, Mathew Joseph and Héléne Vuillermet. We would also like to thank Manmeet Ahuja, Chantal Bartholin and Arpita Mukherjee for their key roles in the conference. All references without details refer to papers or presentations discussed during the different sessions and can be found at the following link: <http://www.economieinternationale.eu/anglais-graph/communications/pdf/2009/14150909/14150909.htm> (accessed 21 September 2009).

2. As observed by Montek Singh Ahluwalia (Deputy Chairman of the Indian Planning Commission) in his remarks at the opening of the conference.

'So far, the G20 agenda has been rather G7-like – dominated by the management of the global turmoil, but silent on the issue of global imbalances. In the future, the G20's agenda will have to evolve and better reflect the variety of concerns of its members.'

called 'the paradox of the G20'.

For example, the outcome of the G20 finance ministers' meeting of London (4-5 September 2009) is much more specific on financial regulation and remuneration, which mainly concern G7 countries, than on other issues that interest most emerging ones – trade liberalisation and the reform of Bretton-Woods institutions. But this is to a large extent because emerging countries have not yet produced consistent proposals on how they want to use their new responsibilities in international governance. Trade, global imbalances, and the reform of global financial institutions are three cases in point:

- i Emerging countries have suffered most from the fall in international trade during the crisis, but the bulk of tariff hikes have come from emerging and developing, rather than from developed, economies³;
- ii Economic growth in emerging economies relies heavily on global growth, but given that consumers in Anglo-Saxon countries are bound to save more and spend less, global growth will itself depend on how East-Asian countries manage to rebalance their growth models;
- iii Discussion on reform of the Bretton-Woods institutions is still confined to the admittedly important question of quotas and voting rights, while the bigger issue of their role in the prevention of crisis and the acceptance of corresponding encroachments on national sovereignty remains highly sensitive, especially in Asia⁴.

Consistently, G20 communiqués are rather vague on trade, almost silent on global imbalances, and noticeably unspecific on the surveillance role of the IMF.

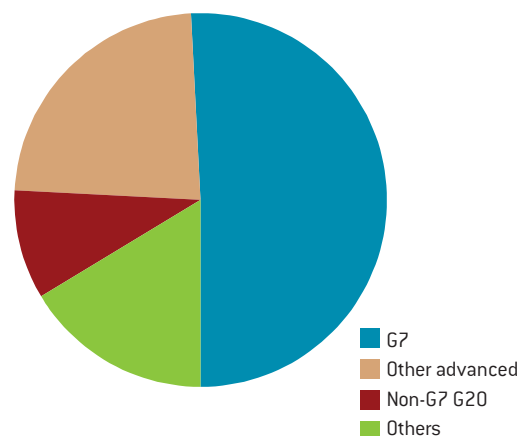
Additionally, G20 leaders should acknowledge the fact that, like the G7, the G20 will not be the appropriate configuration forever. Indeed, while many people speculate about when China will overtake the US as the leading global power, little attention is paid to the fact that Africa is forecast to overtake China, as well as India, in terms of

population by 2030. More strikingly, the size of its young population is already almost equal to that of China or India, while Africa also accounts for a large share of land and natural resources available globally⁵. The G20, however, includes six European countries (the four G7 ones, Russia and Turkey) plus two semi-official ones (the Netherlands and Spain), three Latin American countries (Argentina, Brazil and Mexico), but only one African country (South Africa). It will need to evolve in the future to better represent this region of the world.

THE NEW RULES OF GLOBAL FINANCE

The urgency of strengthening the regulation and supervision of financial-market institutions was highlighted in the first two G20 meetings in November 2008 and in April 2009. Over the last few months, a large number of academic papers, official reports and white papers have been published in the US and in Europe, and international organisations have also contributed. Much less, however, has come from the non-G7 G20 countries, not least because their participation in global financial integration is much more limited: the G7 countries and other advanced economies account for the bulk of cross-border holdings of assets and liabilities, and the non-G7 G20 countries for a mere 10 percent (Figure 1).

Figure 1: World distribution of external assets and liabilities*, 2007



* Total assets + total liabilities. G20 excluding the Netherlands and Spain. Source: authors' calculations using Lane and Milesi-Ferretti data.

3. As of 1 March 2009, about 78% of all trade and trade-related measures have been announced by developing countries. See Peter Draper (South African Institute of International Affairs), 'Cross-border trade and emerging protectionism'.

4. Shigeo Kashiwagi (Policy Research Institute, Japanese Ministry of Finance), 'Don't let globalization go into reverse'.

5. Jean-Joseph Boillot (CEPII's Business Club, Paris and Euro-India Economic Business Group), 'Economic Balance of Powers after the crisis'.

'Advanced countries should learn from experience, including that of emerging countries: the lesson from most previous crises is that non-transparent balance sheets tend to deepen the crisis, due to late recognition of problems, and to unnecessarily delay the recovery.'

While non-G7 countries are now fully fledged members of the bodies in charge of setting the rules of global finance, they have not yet clarified their own priorities. Some suggest that the global rules should be set 'for Nanos instead of Ferraris'⁶. But some of the emerging countries' banks and financial institutions are an integral part of financial globalisation. If a distinction needs to be made, it is not between countries but between global and local players.

For the time being, however, rules are being set by the G20 but at the initiative of advanced countries.

The agenda starts with capital requirements and accounting, whose pro-cyclicality has been widely viewed as having considerably deepened the financial crisis, since they incited banks to sell assets and cut credit, which aggravated solvency problems through the fall in asset prices and the drying up of some markets. Consistently, the G20 has been considering not only raising capital requirements for 'systemic' financial institutions but also introducing counter cyclical capital or reserve buffers. As for mark-to-market accounting, a number of politicians, notably in France, have called for accounting standards reform, insisting that 'market' value is not always 'fair' value, and have expressed support for model-based or historical-cost accounting. The argument behind this stance is that the first approach makes sense from the point of view of idiosyncratic risk in stable conditions, but it may be far from optimal when viewed from a systemic viewpoint. However, advanced countries should learn from historical experience, including that of emerging countries here: the lesson from most previous crises is that non-transparent balance sheets tend to deepen the crisis, due to late recognition of problems, and to unnecessarily delay the recovery. Consequently, many economists propose to continue relying on fair-value accounting, while

applying filters to mitigate the pro-cyclicality of accounting standards, or supplementing them with stress-testing exercises that would provide more long-term views of solvency⁷.

Next comes the scope of financial regulation and supervision, which is widely regarded as having been inadequate. This concerns not only institutions that were unregulated and non-transparent such as hedge funds but, more importantly, the most regulated of all financial institutions – banks! The key point here is that banks escaped capital regulation by using off-balance-sheet special investment vehicles (SIVs) to buy asset-backed securities while financing these investments mostly through short-term asset-backed commercial paper. However, the corresponding risk was not transferred since banks extended guarantees to their SIVs, or even held asset-backed securities while transferring their loans to SIVs in order to reduce in-balance-sheet risk. In short, this is as if banks themselves had bought asset-backed securities (ABSs), but without respecting the corresponding capital requirements. When in the wake of the crisis the short-run funding dried up, ABSs (now called 'toxic assets') were transferred back to banks' balance sheets (where capital requirements apply), leading to a sudden undercapitalisation of the banking sector and to the subsequent disruptions in financial markets⁸. This clearly demonstrates that failure to regulate the 'shadow' banking sector is at the root of the crisis.

However, regulatory arbitrage will always exist and banks may find other gaps in order to escape regulation. Fighting such arbitrage will necessitate close coordination between supervisors both within and between countries and an incentive device to make each country resist reaping gains from allowing financial institutions to expand through regulatory gaps – which makes the G20 a much better forum than the G7.

6. Andrew Sheng (University of Malaya, Kuala Lumpur), 'Political consequences of the economic profession: G20 and the emerging markets'.

7. Nicolas Véron (Bruegel, Brussels), 'Accounting Standards and Financial transparency'.

8. Viral Acharya (NYU, USA, with Matthew Richardson), 'Causes of the financial crisis'.

One possibility would be not just to regulate institutions, but rather activities, so that capital can be put aside for credit risk whether it is located on the balance sheet or off. Another option would be to switch from home-country to host-country regulation and supervision. This would require banks to operate through subsidiaries rather than branches, with each subsidiary regulated and supervised by the host country. An additional advantage of such an approach would be to allow each host country to engineer macro-prudential supervision in line with its own credit cycle.

A third micro-prudential issue on the G20 agenda is the dangers that are posed by 'too-big-to-fail' institutions such as Lehman Brothers. Ironically, the crisis has spurred mergers and acquisitions that have led to an even larger number of systemically important institutions whose activities are spread over numerous countries. One way to deal with this issue, proposed by the US Treasury, is to apply stricter and more conservative prudential standards for these institutions in terms of capital and liquidity ratios and risk-management standards. Another possibility, proposed by Lord Turner from the Financial Services Authority in the UK (FSA), is to force the biggest banks to pre-plan their own demise by writing 'living wills'. This should not only make bank resolutions easier and faster but, in planning their own resolution, banks would be encouraged to better track their exposures and might eventually simplify their legal structures. As with the question of supervisory scope, tackling 'too-big-to-fail' institutions is hampered by the willingness of national governments to attract financial activities and to promote national champions.

WHAT MACROPRUDENTIAL SUPERVISION?

The debate on macroprudential supervision is quite different since there was no macro-prudential supervision before the crisis (although this is not a new concept). It is increasingly accepted that financial stability cannot be provided by the combination of monetary policy

and time-invariant capital requirements. Now that both the EU and the US have made moves in this direction, the question is what role macro-prudential supervision will play in the policy regime.

G20 leaders have agreed to consider countercyclical capital requirements, which would ensure that banks build buffers in good times that they can draw down when conditions deteriorate, and the Financial Stability Forum, the Basel Committee on Bank Supervision and the Committee on the Global Financial System have been charged with devising a framework for this by the end of 2009. The problem is how to determine when times are 'good' or 'bad', and who is in charge of this task. On the 'how' question, a number of methods have been proposed, such as the use of 'through-the-cycle' internal ratings (already suggested by the FSA and advised by the Committee of European Banking Supervisors), autoregressive adjustment of capital, as well as using a multiplier to adjust capital, which could depend on lending growth, credit spreads, GDP growth, or asset prices⁹. However, research has shown that none of these measures performs perfectly as each crisis is different in nature. This lack of consensus suggests that one should not rush to devise a rule-based approach, but rather experiment with constrained discretion - have principles but leave room for discretionary decisions. This can also be viewed as a learning process¹⁰.

On the 'who' question, there is still no broad consensus either. The best-equipped institution to define 'good' and 'bad' times would be the central bank of each country. However, this would imply departing from the existing framework where many central banks have a single instrument (the interest rate) and a single target (consumer-price stability). More importantly, the interconnection between macrofinancial supervision and bank bail-outs (which have strong fiscal implications) could put central bank independence at risk.

The need for the above reforms is widely recognised in developed economies, even though

9. Avinash Persaud (Capital Intelligence, London), 'Macro-Prudential Regulation: Fixing Fundamental Market (and Regulatory) Failures'.

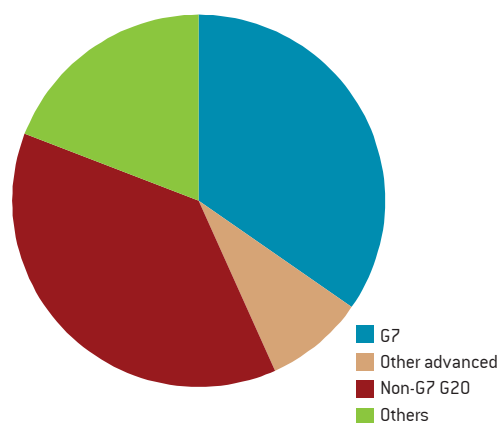
10. Olena Havrylchuk (CEPII, Paris), 'Comments on Avinash Persaud and Sylviana Vatnick'.

opinions differ on the depth and details of implementation. However, the G20 may not have taken into account the views of emerging economies. The introduction of higher and countercyclical capital requirements would probably increase the cost of financial intermediation. While this cost is justifiable in countries with deep financial markets in order to achieve financial stability, emerging economies – with a significant share of the population still excluded from banking markets – would prefer a differential country-by-country approach. Finally, counter cyclical credit policies may prove tricky in open, emerging countries where credit tightening in a boom may be offset by a rise in capital inflows.

GLOBAL IMBALANCES

Global imbalances are a G20 topic because unlike gross capital flows, which mostly go North-North, net flows of savings go both North-North and South-North. Significantly, 35 percent of total current-account surpluses and deficits are accounted for by G7 countries and 38 percent by non-G7 G20 countries (Figure 2).

Figure 2: World distribution of absolute current account balances*, 2012



* Sum of absolute values of current account balances. G20 excluding the Netherlands and Spain. Source: IMF.

There is no consensus among economists on the role played by global imbalances in the crisis. Some claim that the excess of saving over falling investment in East Asia is one important reason why long-term interest rates were so low for so long, encouraging leverage, pushing house prices up and giving incentives to asset managers to seek high-yield products¹¹. Some object that while US macroeconomic conditions were indeed conducive to the crisis, they were fundamentally determined by domestic developments. Furthermore, they observe that the US current-account deficit as a proportion of world GDP actually diminished from 2005 to 2008¹².

Nevertheless, there is broad consensus that the current situation is not optimal for a number of reasons. First, global imbalances have played a role in the transmission of the crisis across borders: emerging economies with large current-account deficits, for example in central and eastern Europe, have been more vulnerable to reversals of capital flows. Second, imbalances reflect domestic problems and distortions, such as a lack of social insurance and poor corporate governance coupled with financial repression (as is the case in China) and low private savings (as is the case of the US and the UK). Third, they may constitute an obstacle to a sustained recovery of global growth in a context where failing US consumption needs to be replaced. Finally, to the extent that imbalances are financed through liquid capital flows, they are a potential source of disruptive adjustments.

Although there seems to be some agreement that global imbalances need to be reduced, the 'how' question is much debated, which may explain the reluctance of the G20 to make clear statements on this issue. In particular, it is difficult to imagine how a double-rebalancing of growth, from the public to the private sector and from deficit to

11. See David Vines (Oxford University and CEPR), 'The Financial Crisis, Global Imbalances, and the International Monetary System'.

12. See Gian-Maria Milesi-Ferretti (IMF, with Olivier Blanchard), 'Global Imbalances: Past, Present and Future', and Ted Truman (Peterson Institute for International Economics, Washington), 'Comments on Milesi-Ferretti and Vines'

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surplus countries, could be achieved without significant real exchange-rate adjustments. The US advocates a further appreciation of the renminbi, but Chinese experts are puzzled by the fact that the 2005 decision to move to gradual appreciation was in fact followed by a rise in the country's external surplus¹³. Furthermore, China fears that an appreciation of the renminbi could trigger a massive capital loss on its accumulated reserves in US dollars. However, a gradual appreciation of the renminbi may not be advisable either since it could trigger speculative capital inflows into China. All in all, there will be an interconnection in China between, on the one hand, monetary reforms (currency convertibility, making the exchange rate more flexible, liberalising capital flows) and, on the other, structural ones (allowing banks to extend loans according to credit rather than political criteria, accelerating the provision of safety nets, discouraging excess capacity, cutting export subsidies...).

The US has long been blaming China for its undervalued currency, threatening to raise tariffs on Chinese exports if China does not revalue hard. Unfortunately, China has suffered very much from the nose-dive in international trade and has endured rising protectionism, especially from Europe and the US¹⁴. This is not to encourage the Chinese authorities to do a U-turn in their growth and monetary strategies. But, more generally, the way advanced economies deal with domestic protectionist temptation in the face of growing unemployment will be key to encouraging East-Asian countries to remove distortions in favour of their tradable sectors.

REFORM OF THE IMF

As already mentioned, one key driver of global imbalances has been the accumulation of foreign-exchange reserves by some emerging countries,

particularly China. The rationale for this is either foreign-exchange intervention or self-insurance against balance-of-payment crises – a major motivating factor for many small and medium-size countries, especially in Asia where trust in the International Monetary Fund was severely undermined by the experience of the late 1990s. The softer and more flexible conditionality recently adopted by the IMF in central and eastern Europe is widely regarded as resulting from a change in the IMF's approach to crises. But it can also be interpreted – and is indeed interpreted by some – as resulting from Europe having a greater stake than Asia in the governance of the Fund.

Large accumulation of reserves for self-insurance purposes can be considered inefficient both from the point of view of the country that accumulates reserves (it sterilises resources that could be invested more productively) and from a global macroeconomic standpoint (countries aiming to accumulate reserves they seek to save more, which dampens global demand). Alternative arrangements, such as the establishment of credit lines, reserve-pooling arrangements, swap lines or other forms of insurance are therefore preferable. The G20 decision (in April 2009) to increase IMF resources to 750 billion US dollars points to a push to enhance the role of the IMF as a lender of last resort. Moreover, the establishment of the Flexible Credit Line can be viewed as giving it the role of 'lender of first resort'. But this is unlikely to convince Asian countries to return to the Fund unless IMF governance undergoes in-depth reform. This is where macroeconomic reform meets reform of the Bretton-Woods institutions.

A second reason to reform IMF governance is to improve its ability to carry out effective bilateral and multilateral surveillance. As regards the former, Financial Sector Assessment Programmes had been conducted neither in the US nor in China

13. He Fan (CASS, Beijing), 'Comments on David Vines and Gian-Maria Milesi-Ferretti'.

14. Min Tang (China Development Research Foundation, Beijing), 'Emerging Trade Protectionism: A Case in China', Natalya Volchkova (New Economic School and Center for Economic and Financial Research, Moscow), 'Cross-Border Trade and Finance: Emerging Protectionism'.

prior to the crisis. As regards the latter, the Multilateral Consultations of the mid-2000s are considered promising by some, pointless by others but effective by no one. Furthermore, the attempt to revive exchange-rate surveillance has been a failure. In fact, effective policy assessment requires both independence and legitimacy. A way to increase the independence of surveillance could be to relieve the Executive Board of its surveillance duties and to focus it on the overall strategy of the Fund. But to raise the legitimacy of the Fund requires more fundamental change. Output legitimacy (in the handling of the tasks assigned to the institution) is important but it is no substitute for enhancing input legitimacy through a significant shift of voting rights and

executive power away from Europe to emerging and developing countries¹⁵. Furthermore, these changes should go hand in hand with a reduction of the 85 percent-majority threshold, which currently gives the US a power of veto, and with at least partial consolidation of the European chairs.

In this respect the creation of the G20 is likely to have profound implications. Having gained a seat at the top table, emerging and developing countries cannot continue to accept a minor role in the Bretton-Woods institutions. Neither can they be satisfied with insubstantial changes and a promise that more will happen in the future. Gradualism was a possible reform strategy in the pre-crisis world. It is no longer an option.

15. Louis Pauly (Toronto University), 'Crisis, Collaboration, and Confidence: The Global Economy and the Future of the Bretton Woods Institutions', and comments by Stormy-Annika Mildner (German Institute for International and Security Affairs (SWP)), and Shigeo Kashiwagi (Policy Research Institute, Japanese Ministry of Finance).