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REFINING THE G-20 AGENDA

WHAT IS THE PROBLEM?

The G-20 Leaders will meet in London in April, faced by the most serious economic downturn for seventy years. The London agenda bears two heavy burdens. First, financial markets are expecting a confidence-boosting rabbit to be pulled out of the international policy hat, and no such magic trick exists. Second, the agenda has become the repository of all the ideas to make the world a better place, ranging from poverty alleviation to climate control. A meeting with such a wide-ranging agenda is bound to disappoint.

WHAT SHOULD BE DONE?

First, the agenda needs to be pared back, by passing it through dual filters: what is urgent, and what is international. The most urgent international issue is: how to maintain international capital flows to the emerging countries which will have trouble attracting funds in an increasingly inward-looking world. The IMF is the vehicle for this job, but it will be unable to do this effectively with its existing governance structure. The Fund has demonstrated its inability to reform through internal processes. The task should now be taken up by the G-20 Leaders.

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What began as the sub-prime crisis in America is now universally recognised as a Global Financial Crisis (GFC). While the consequences are clearly global, however, the required policy responses may be largely domestic, as indeed they have been so far. Nevertheless, financial markets are looking to the forthcoming G-20 Leaders' London meeting in April, in the hope that it will produce confidence-boosting measures. Realistically, what can be done at the international level? The central issue to be explored here is the extent to which an *international* response is relevant to the GFC, in the form of policy coordination or cooperation in rule-setting of the kind that could be orchestrated by the G-20 Leaders.

It is argued here that what is needed now is a medical approach: triage, focusing on the most urgent issues, with structural reform put off until the situation is stabilised. Almost all of this urgent action is in the domestic domain. The crisis has, however, thrown up one issue which is both intrinsically international and urgent: maintaining the flow of international capital to the emerging countries. Addressing this effectively requires fundamental reform of the International Monetary Fund's governance arrangements. The G-20 Leaders have the opportunity to take this issue forward in a way that the internal reform process within the Fund has been unable to do. The current tightly-packed London agenda will provide the excuse for platitudes rather than reform. Paring down the agenda is the first step to achieving some concrete reform.

What went wrong and why?

While our understanding of exactly what went wrong is not yet complete and balanced, the broad outline is clear enough. Fundamentally, there was too much leverage. A long period of stable growth bred over-optimism among borrowers and lenders, and lulled regulators into a false sense of security, forgetting that good times make people too optimistic, and then this optimism over-reaches. Monetary policy, targeting CPI inflation, had no instrument to address asset-price bubbles.

Securitisation meant that risk was distributed, not to those most capable of bearing it, but to those who least understood it.[1] The complex layering of the securitisation process made the instruments opaque and hard to value. As much more of the financial sector was 'marketised', this larger proportion had to be marked-to-market (i.e. had to be brought into the accounts at the current values). When markets became pessimistic and unable to value assets because of the 'lemons' problem,[2] the market delivered very pessimistic price discovery, which triggered losses.

Regulators were, inevitably, 'bloodhounds chasing greyhounds', well behind the pace on innovation and focused on individual institutions rather than on systemic risk. This was exacerbated in the US by institutional arrangements which owe more to historical accidents and bureaucratic jealousies than to logic or effective organisation. The prudential instruments – capital ratios, reserve ratios, loan-to-valuation ratios, and collateral requirements – were pro-cyclical, loosening their constraints as asset prices rose. Rating agencies, with perverse incentives and a very

narrow view of their function, gave strong endorsement for weak risks. Risk management was misunderstood, and in particular systemic risk was ignored by the private sector and fell uncomfortably between the remit of central banks (which seemed to have the responsibility) and the prudential regulators (which had the policy instruments that might have been used). Prudential rules (even such basic ones as capital requirements) were gamed, arbitraged and subverted by accounting tricks and off-balance sheet obligations. This complexity was exacerbated by the break-down of the Depression-legacy Glass-Steagall division which kept commercial banks separated from investment banks and brokers.

The world 'savings glut' – big external surpluses in Japan, the Middle-East oil producers, China and Germany – pushed down the risk-free world interest rate and provided ready funding for US under-saving.[3] This was exacerbated by monetary policy in the US, where the Fed's efforts to boost the economy after the 'Tech-Wreck' of 2000-2001 kept interest rates so low that loans were made to people who would not be able to afford to service the loan when interest rates returned to normality, and to make matters worse, there was such competition and disregard for default risk that credit margins were bid down to absurdly low levels.

What is needed to address this?

The London meeting envisages[4] a far-reaching and wide-ranging agenda that could be summarised as:

- Sustaining global growth and employment
- Maintaining open markets and resisting protectionism
- Reforming financial supervision and regulation
- Reforming the international financial architecture
- Protecting the world's poor
- Safeguarding the environment.

G-20 Leaders have a choice: they can either recycle the usual platitudes on this wide range of topics, endorsing good sentiments and making general commitments to right-thinking. Or the agenda could be dramatically pared back and they would have a chance of advancing truly new ideas and commitments on a much smaller range of issues. There is not time to do both.

If action is to be taken commensurate with the seriousness of the situation, this agenda should be put through a double-layer filter:

- Is it urgent?
- Does it require international (as distinct from domestic) action?

Sustaining growth

This certainly meets the 'urgent' criterion. Whatever the longer-term policy measures needed to address structural issues, the shorter-term urgent priorities are twofold. First, to adopt Keynesian policies which counter shrinking demand and output, because a self-reinforcing downward spiral is underway. Secondly, to stabilise the crumbling financial sector so that it can support economic activity through the ongoing provision of credit.

Stabilising economic activity requires the sorts of measures which many countries have already taken – more expansionary monetary and fiscal

policy. These actions did not require any international coordination, nor would further action. Different countries will have different capacities to move, so setting a global target (e.g. fiscal expansion equal to 2 percent of GDP) makes no sense. The extent of feasible fiscal expansion depends on government debt sustainability: the starting-points between countries are quite different and their capacity to sustain larger debt will differ. For what it is worth, G-20 Leaders can urge countries to be bold and they can bring peer pressure to bear ('name and shame'), pointing out that countries which take a conservative attitude are free-loaders on the beneficial external effects of other countries' fiscal expansion. Concerted efforts, whether fiscal or monetary, may have more public relations impact. In addition, it is important that at a personal level, the G-20 Leaders achieve some agreement between themselves that concerted action to boost global aggregate demand is needed. Without this, financial markets' fragile confidence will be undermined. A loud affirmation of these platitudes is needed in London. That said, these Keynesian expansionary policies are a domestic matter.

Similarly, stabilising the financial sector is essentially a domestic matter, because it requires funding support and guarantees. When the need is identified to recapitalise banks and buy troubled assets, only domestic taxpayers will be ready to contribute. As with fiscal expansion, the financial markets are looking for a strong statement of intent, and this should be provided. Meanwhile, the substantive action is at home.

Avoiding protection

As countries contemplate the dramatic falls in their export earnings and rising unemployment, the domestic political pressures to impose protection will be great. 'Above all, do no harm', the doctors say. In this case: don't beggar-thy-neighbour. Again this meets the 'urgent' test, but again the heavy lifting has to be done at home rather than internationally, to resist these protectionist pressures.

The obvious application of this is in international trade. This danger has been well signaled (and the damage of the Smoot-Hawley tariffs in the Great Depression has been prominent in the discussion, right from the start). Just about every international meeting has included solemn vows to resist this sort of beggar-thy-neighbour protectionism. The first G-20 Leaders' meeting in November last year produced such a commitment, although almost all member countries have done something since then to retreat from this commitment. The forthcoming G-20 Meeting will repeat this mantra.[5] There might be something that the international dimension can contribute here to stiffen up the resistance to protectionism, but once again this is peripheral to the main battle which will take place on the domestic front.

But a more subtle and insidious form of protection is appearing, relating to international capital flows. The implosion of financial institutions in important international banking centres would by itself have substantially cut international capital flows. Citi, BoA, and UBS are no longer in a position to lend much internationally. The shadow banking sector in the US has disappeared and the commercial paper market has dried up. Hedge funds have lost their funding base. The

rating agencies which facilitated international intermediation are discredited. Investors have retreated from risk into the comfort of safe domestic securities. To the extent that financial institutions are being supported by government intervention, domestic taxpayers will not want to see their funds used to support foreign lending. In short, global finance has turned inward. 'De-globilisation' is occurring, leaving those countries which had come to rely on international capital flows in a seriously exposed position.

On top of these organic outcomes of the GFC, governments are guaranteeing national bank deposits and borrowings. The reduced flows of global funding will go predominantly to the countries which can provide the strongest guarantees. Ireland began the game of bank guarantee, setting off a self-protective round of guarantees from other governments, as they competed with each other to prevent funding from being sucked away by foreign government guarantees.

As UK Prime Minister Gordon Brown noted, 'This is mercantilism in a new form. It is a form of financial protection.'[6] But the policy dilemma represented here is well illustrated by the case of Australia. The Australian Government has offered its AAA rating to guarantee the continued foreign borrowing of Australian banks, which rely (to the extent of about one-third of their balance sheets) on foreign funds to finance their domestic loans. At the macro level, this inflow is needed to fund Australia's long-standing structural external deficit. Australia is using its AAA rating to suck its accustomed level of finance out of the greatly-diminished global funding pool, leaving less for other countries which cannot back their borrowers with an AAA rating. The alternative to maintaining this capital inflow would be worse: a speedy and very painful trade adjustment through lower growth, which would contract world trade flows in precisely the way everyone agrees should be avoided.

This problem will get significantly worse. The Institute for International Finance predicts that private capital flows to emerging countries will be down to $165 billion this year, compared with $US 929 billion in 2007.[7] The full effect of this has been buffered so far by the strong initial position and reserve holdings of many of the emerging countries (especially in East Asia, where memories of the 1997-8 crisis had led to conservative policies).

So here is an issue which is both urgent and international. Unlike trade protection, which should be resisted *per se*, the answer here is not a vow of abstinence. It is to create an alternative or additional international flow which can meet international funding needs, particularly of the emerging countries. This identifies the main policy opportunity available to the G-20: reform of the international financial architecture so that it can provide the replacement funding. It is both urgent and squarely in the international domain. The next section sets out what needs to be done.

Reforming the international financial architecture

The International Monetary Fund has the organisational structure to be the channel for substantial replacement funds. It can gather increased funds for its conventional and short-term facilities (Japan has already offered an additional $US100 billion), and SDR

allocations could be increased.[8] Both these sources will be needed if the drying up of flows foreseen by the IIF lasts for a significant time, which seems likely. The London meeting could agree to very substantially increase the funds available to the IMF, following the suggestions of both US and the European members.

There is, however, a stumbling-block. If the Fund is to gather the very substantial sums of money needed from the full range of countries that can supply it, it will need radical alteration of its governance, and this can only be achieved by similarly radical intervention by the G-20. For ten years the Fund's governance reform has proceeded at the snail's pace that suits the existing vested interests of the over-represented countries. The result of this decade of reform has left Benelux with more votes than China, and Belgium alone with more than India. If the Fund is to attract serious funding commitments from the likes of China, it will have to move urgently to radically change its governance.

The past ten years have shown that the Fund is not able to change through an *internal* process of self-generated reform. Such is the urgency of the need to replace the diminished private sector international flows that the G-20 should in effect take over this reform process and use its overwhelming preponderance of numbers and quotas to require that this change be implemented forthwith. Just as G7 has asserted its dominance of the IMF in the past (e.g. over the HIPIC initiative for debt forgiveness of the most-indebted poor countries, which was decided at Gleneagles rather than at the IMF's International Finance and Monetary Committee), the G-20 could, in principle, decide on a fundamental restructure of quotas so as to reflect the current realities, and use its weight to impose this on the IMF. This would essentially put the G-20 in an oversight role over the Fund and create an international architecture that makes more sense than the current arrangements, with institutions such as the Fund, the World Bank, and the Financial Stability Forum all reporting to it, as a high-level governance board with the political weight to bring about necessary reform and guide ongoing policies[9].

The one outcome that should be unacceptable for Australia is to significantly increase the funds available to the IMF *without full governance reform*. Half-hearted reform would run the risk of seeing a European-dominated Fund use up its limited resources in bailing out the creditors of Eastern Europe and the Baltic states (whose excessive external deficits were patently unsustainable), leaving the cupboard bare when other countries of greater national interest to us come to the Fund for assistance. There is an important distinction to be made here. The Fund's extra resources should be used to sustain ongoing *new* capital flows, not to bail out foreign creditors for their past mistakes.[10] European banks have been foolish in supporting the excessive borrowing of these troubled countries (Swedish banks alone have lent Latvia amounts equal to 20 percent of Latvia's GDP) and they should bear the consequences of these past mistakes, if necessary bailed out by their own national governments and taxpayers.

If the Fund is unable to reform itself and the G-20 unable to impose reform on it, then the best policy for Australia would be to channel its support through regional arrangements such as the Chiang Mai Initiative (CMI) and the Asian Bond Fund Number 2. At the moment

Australia has not been invited to join the CMI, but if China recognises that the Fund governance cannot be reformed to give it an appropriate role, then China might be open to the idea that regional arrangements have to do the job, and it might see Australia as a natural ally in this second-best alternative.

Reforming international prudential supervision

One feature of the current GFC has been the startling way that the ripples which began with the US 'toxic debt' problems have rapidly magnified and spread out across the world. In response, many reform proposals have been put forward, including greater international uniformity in regulatory standards in the financial sector, better harmonisation of accounting rules, clearer prudential arrangements, and so on.

These issues are doubtless all important. However, what needs to be reformed urgently is not international, and what needs to be reformed internationally is not urgent. The pressing issues are domestic (e.g. should the weak US banks be nationalised?). It is worth noting that a number of countries managed to avoid the mistakes of the supervisory regimes in the US and the UK, and these success stories operated within the same international rules as the US and the UK. The problems in the US and the UK differ (simplistically, UK supervision was too 'light touch' and lacked investigative authority, while the US regulatory system was fragmented, and operated within an overwhelmingly powerful 'laissez-faire' culture) but neither was capable of delivering adequate prudential supervision. Just as the weaknesses are idiosyncratic and can be traced back to domestic characteristics and philosophies, so too the reform of these systems will be an almost entirely domestic process, with the global regulators in Basel and elsewhere being mere observers of the process.

Whatever needs doing to the current international banking regulatory framework (Basel II), it is no more urgent than the putting in place of Basel II itself, which took almost ten years.

Poverty alleviation

No-one disputes the need to keep funds flowing to the poorest countries. The issue is whether it is sensible to divert the scarce time of the G-20 Leaders' meeting to the issues of the poorest countries where, realistically, there is no prospect of a short-term breakthrough nor anything new to be said. The true disaster for the world's poor would be to forego the opportunity to sustain overall world growth.

Climate change

This fits into the same category – important but without the prospect of G-20's being able to contribute significantly, so better left to the forthcoming Copenhagen meeting.

International imbalances

The one *international* factor often cited as the key cause of the GFC is the 'global savings glut', usually identified with China's external surplus.[11] [12] Curiously, perhaps, this does not rate a mention on the London agenda, and there are no plans for international policy coordination to address the international external imbalances. The explanation might be twofold. First, the 'blame China' connotations of this argument would certainly be unhelpful in London, especially as it is hard to justify making this the key factor in the face of the

many policy-making and regulatory weaknesses in the countries most affected by the GFC. Even Fed Chairman Bernanke, the inventor or at least populariser of the 'global savings glut' view accepts that, without the serious deficiencies of regulation and policy in the US, the global savings glut would not have caused the GFC.[13] Secondly, an early response to fix the imbalances would seem quite inappropriate in the triage stage of the GFC. While the United States will eventually have to address its savings/investment imbalance through more household saving and the US budget deficit will have to be brought down again, this is not the time to pursue these structural issues. Even for the countries with external surpluses (China, Japan, Germany, the Middle-East oil producers), their capacity to help through running Keynesian expansionary fiscal policies depends more on their government debt position than on their external surplus.

Conclusion

The London G-20 Leaders' agenda is rapidly becoming the depository for all the wish lists of desirable changes for making the world a better place. It goes without saying that it will fail to deliver on these. This inability to deliver would hardly be a novel outcome for international meetings. But in the current parlous world situation, this matters, in two separate ways. First, the lead-up to the meeting has raised expectations in a world which seems to rely on fragile confidence to maintain its equilibrium, and this failure will damage confidence. So the meeting needs to give strong endorsement for fiscal expansion and financial sector support. Second, there *is* an urgent, important and specific task that could be achieved in London. This is the dual and conjoined task of putting more money at the disposal of the IMF so that it can maintain the flow of capital to the emerging countries, which will require at the same time radically reforming the Fund's governance. To achieve this objective, alone, at London would be a Big Ask. If this challenging objective is confounded with the other grab-bag of desirable reforms, then the opportunity will be lost.

NOTES

[1] John Kay, Same old folly, new spiral of risk. *Financial Times*, 13 August 2007.

[2] Sellers will only want to part with the worst assets because their good assets are being undervalued by the market. Buyers, knowing this, will not be prepared to pay more than a price commensurate with the marketed assets being 'lemons'.

[3] Ben Bernanke. The global savings glut and the U.S. current account deficit: speech to the Virginia Association of Economics. Richmond, VA, 14 April 2005.

[4] See the London Meeting website: http://www.londonsummit.gov.uk/en/summit-aims/ : http://www.londonsummit.gov.uk/en/summit-aims/sustainable-growth/ and : http://www.londonsummit.gov.uk/en/summit-aims/global-deal/

[5] If something more can be added, it might be along the lines suggested by Gallagher and Stoler, to create a public record of protectionist transgressions, to 'name and shame' offenders. Peter Gallagher and Andrew Stoler. *G20 surveillance of harmful trade measures*. 2009: http://www.voxeu.org/index.php?q=node/3199.

[6] Gordon Brown, Behind the moves to restore confidence. *Financial Times*, 10 February 2009.

[7] Institute for International Finance, *Capital flows to emerging market economies*. Press release 27 January 2009

[8] Ted Truman, How the Fund can help save the world economy. *Financial Times*, 5 March 2009.

[9] The IMF's International Monetary and Finance Committee could continue in its present role – as a twice-yearly bun-fest to give the 185 members of the Fund an opportunity to talk. The Executive Board could be replaced by a group of G20 Deputies, which would meet less often and take a less detailed managerial role, along the lines suggested by Mervyn King. Mervyn King. Reform of the International Monetary Fund: speech to the Indian Council for Research on International Economic Relations. New Delhi, 20 February 2006.

[10] This is analogous to the bank-resolution distinction between illiquidity and insolvency: insolvent enterprises need adjustment/bankruptcy; illiquid ones require financing to tide them over until underlying viability is restored.

[11] Martin Wolf, *Fixing global finance*. Baltimore, MD, Johns Hopkins University Press, 2009

[12] Alan Greenspan, The Fed didn't cause the housing bubble. *Wall Street Journal*, 11 March 2009.

[13] Ben Bernanke. Financial reform to address systemic risk: speech at the Council on Foreign Relations. Washington, DC, 10 March 2009. 'In my view, however, it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s. …The global imbalances were the joint responsibility of the United States and our trading partners….However, the responsibility to use the resulting capital inflows effectively fell primarily on the receiving countries, particularly the United States. The details of the story are complex, but, broadly speaking, the risk-management systems of the private sector and government oversight of the financial sector in the United States and some other industrial countries failed to ensure that the inrush of capital was prudently invested, a failure that has led to a powerful reversal in investor sentiment and a seizing up of credit markets.

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