THE G-20 LONDON SUMMIT 2009
RECOMMENDATIONS FOR GLOBAL POLICY COORDINATION

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Introduction

Leaders of the Group of 20 (G-20), representing 85 percent of the global economy's output, face a long list of agenda items when they gather on April 2 in London for their second summit. As the world combats a "great recession," the leaders must address how to help stabilize financial markets and re-start economic growth, reform the global financial system, and aid developing and emerging economies.

Amidst this background of critical issues, Brookings' global economic and development experts explore a range of recommendations for global policy coordination in advance of the summit and note which issues the leaders should address at the table—and beyond—in order to stem the crisis and avoid future ones.

- **Stimulate, Reform, Coordinate: A Macroeconomic Agenda for the G-20:** Eswar Prasad proposes a set of policy responses, including macroeconomic stimulus, regulatory reform, global policy coordination and reform of the international financial architecture, that should receive immediate attention and action by G-20 leaders.

- **Tame Protectionism and Revitalize Trade:** Paul Blustein discusses the threat of global economic protectionism and how leaders can realistically address the trend and tackle through next steps with the World Trade Organization.

- **Speed the Flow of Money to Poor Countries:** Homi Kharas addresses the impact of the financial crisis on poor countries, and proposes that the focus of the G-20 should shift from calls for new money to speeding the flow of money already committed.

- **Mobilize the G-20 to Respond to the Global Economic Crisis**: Colin Bradford and Johannes Linn discuss the nature of the G-20 summit and propose seven specific measures that the lead-

ers should act on in order fight the current economic and financial crisis.

- **Empower the Regional Development Banks:** Mauricio Cárdenas makes the case for increasing funding to the regional development banks while mobilizing additional resources for the IMF in order to leverage immediate solutions.

- **Aid Africa:** Ernest Aryeetey and John Page address Africa's economic landscape and how policymakers in Africa can respond to the crisis as well as how the international community can support Africa through aid and trade.

- **Good Governance: Learn from the Missing Countries**: Daniel Kaufmann explores the fundamental issue of governance and how governance weaknesses contributed to the financial crisis, what can be learned from countries with good governance models and how the G-20 should utilize these lessons to implement reforms.

- **Focus on What Asia Wants:** Lex Rieffel looks at Asia's perspective on the summit meeting and the global financial crisis, noting the core issues surrounding agreement on increasing resources for the IMF.

- **Understanding and Addressing Political Instability:** Raj Desai examines the issue of political instability in the wake of the financial crisis and proposes a set of action items to help governments ease economic challenges for their citizens.

STIMULATE, REFORM, COORDINATE:
A MACROECONOMIC AGENDA FOR THE G-20

Eswar Prasad

Framing the Issue

The global economy remains in crisis. Advanced economies are in dire straits, brought to their knees by broken financial systems and shattered consumer confidence. The troubles have now enveloped emerging markets and low-income countries, with many of them at the brink of economic disaster.

The situation demands firm and decisive leadership to restore economic growth and financial stability. Various policy challenges must be tackled simultaneously—in particular, recovery of financial systems and macroeconomic recovery are inextricably tied together. Moreover, collective action on a global scale is necessary to deal with a crisis of this scope.

Policy Considerations

There are a number of complex and interconnected points of tension in the world economy today.

Short-term vs. long-term aspects of macroeconomic stimulus

In the short run, forceful macroeconomic stimulus is essential to lift economies out of their slump. Conventional monetary policy has run its course, especially in economies such as the U.K., U.S., and Japan where short-term policy rates are already close to the nominal interest rate floor. Quantitative easing through central bank purchases of financial assets (including government bonds) remains an option, one that has already been exercised recently by the U.K. and U.S. central banks.

Fiscal stimulus in the form of increases in public expenditure and tax cuts is the other option. Many G-20 countries have made significant commitments to fiscal stimulus. However, the size of these commitments has been quite uneven across countries. Implementation of the measures has also been uneven; revisions in the size and composition of fiscal packages are required to cope with the rapidly deteriorating macroeconomic situation.

Monetary and fiscal stimulus can give a short-term jolt to an economy but there are longer-term risks. Quantitative easing may lead to a surge in inflationary expectations. This seems a benign prospect when the immediate risk is of deflation, but inflationary spirals are difficult to manage once they get out of hand.

The U.S. already has a large level of government debt (debt held by the public is about 45 percent of GDP) and large increases in the deficit would fur-

ther increase the debt burden on future generations, increase the cost of financing the debt and crowd out private investment. Concerns about debt sustainability could also feed rapidly into inflationary expectations and raise interest rates, thereby stunting any incipient recovery. Similar dynamics are at play in many other advanced and emerging economies.

A further problem is that, with dysfunctional financial systems, neither form of macroeconomic stimulus is as potent as in more normal times.

Reviving financial systems

The financial regulatory system and oversight based on existing regulations in the U.S. and other advanced economies have both proven to be failures, allowing the build up of huge systemic risks at the national level and cross-border risks at the global level. Regulatory reform is essential but there is a tension between strengthening financial regulation and reviving the financial system. This tension needs to be resolved creatively in the transition to a more stable financial system. A rush towards "more" regulation may be counter-productive if undertaken in the heat of the crisis without getting core principles right.

Government intervention now seems essential to revive frozen financial systems in economies such as the U.S., but this could create more problems in the future. Incentives become distorted when there is an implicit government backing for all financial institutions; this almost invites reckless behavior by investors and investment managers. Ceding to government the entire role of monitoring of financial institutions and thereby enervating the forces of market discipline is neither practical nor advisable. But market discipline by itself is clearly not sufficient.

Domestic vs. international policies

This is a time when countries should be pulling together to tackle the common challenges that they face. Instead, countries have turned inward, often focusing on their narrow domestic interests and, in some cases, paying little regard to the detriment their actions cause to the global trade and financial systems.

Given difficult domestic circumstances, it is understandable—but not excusable—that politicians are turning to protectionist policies, both implicit and overt. This could easily degenerate into a round of retaliatory actions, thereby affecting world trade—which has already taken a beating—and further dampening consumer and investor confidence. Currency wars, which could be set off if countries try to intervene excessively in currency markets to maintain their competitive advantage, represent another potentially dangerous manifestation of these tendencies.

International cooperation is also necessary in another dimension. In an integrated world economy, the effectiveness of stimulus is contingent on how coordinated it is across countries. If the sizes of the stimulus packages (relative to domestic GDP) are very different across countries or if some countries' stimulus packages are backloaded, then there could be "leakage" of stimulus from countries that act early and forcefully.

The international financial architecture

Global macroeconomic imbalances—manifested in low interest rates and excess consumption in the U.S. fueled by excess savings in China and other emerging market countries—were not the principal cause of the financial crisis. But these imbalances certainly fanned the flames, leading to a cataclysm. In the process of extricating itself from this crisis, the world economy could find itself facing larger imbalances.

The crisis is likely to encourage emerging markets to export and save even more in order to build up larger stocks of foreign exchange reserves and thereby protect themselves from future financial turmoil. Self-insurance through reserve accumulation is costly, but emerging markets see little choice; borrowing from the IMF carries a stigma and remains a toxic proposition for emerging market politicians. In tandem with rising U.S. government borrowing, this could result in larger imbalances and greater risks. Thus, the world economy again faces the classic collective action problem of how to align countries' incentives so they take into account the effects of their policies on global financial stability.

Action Items for Global Coordination

There are no simple or straightforward solutions to any of the challenges facing the world economy. This is a time for concerted action on multiple fronts to revive economic and financial systems.

Macroeconomic stimulus

Reversing the economic contraction and setting the global economy on the way to short-term recovery is the key priority. This will require forceful stimulus measures with all available policy tools in each country, even if these measures are likely to deliver less of a punch than in normal times because of financial sector problems.

There are legitimate questions about the effectiveness of fiscal stimulus, especially in economies where the financial system has imploded. Moreover, excessive government borrowing to finance large budget deficits could itself raise serious concerns about medium-term sustainability of fiscal positions and generate instability. The risks of future sustainability of rising public debt have to be weighed against the prospect of greater and more prolonged economic disruption that could result from weak policy responses. Given the fast-deteriorating economic situation, G-20 economies have little choice but to engage in frontloaded fiscal expansion. The consequences of timidity, as history teaches us, could be even worse.

Focus on the long term, including thorough clear plans for future deficit reduction once the recovery gets underway, should be made consistent with the emphasis on short-term stimulus. Indeed, one reason to not lose focus on the long term is precisely to remove long-term uncertainty and the perception that today's remedies might lead to more bitter medicine in the future.

It is also important for policymakers to send a strong signal that their measures are considered ones and are not merely mortgaging the future for the present. Well-targeted spending on infrastructure is a good example—the short-term stimulus would then feed

into longer-term productivity gains. China's stimulus package contains elements of this approach. In the U.S., by contrast, the lack of emphasis on infrastructure spending in the past few years means that America has relatively few shovel-ready projects, which will delay the short-term impact. We need other creative solutions that tie together short-term stimulus with longer-term benefits.

Regulatory reform

This is a difficult area and one where careful consideration will have to be given to rethinking the fundamental principles of regulation, including the balance between private and government monitoring. This balance was clearly off kilter, with weak government monitoring compounding the problems created by ineffectual private monitoring (including the role of rating agencies).

The origins of the crisis and the ongoing futile attempts to revive the major financial institutions show the dangers of partial or implicit government intervention in the financial system. In the short run, however, we must not dismiss even drastic solutions like public ownership of systemically important institutions that are now too weak to stand on their own; partial solutions only appear to make matters worse. We will eventually need an exit strategy that preserves the government's essential roles in effective regulatory oversight and prevention of systemic risks but leaves in place incentives for innovation, risk-taking and private monitoring of financial firms.

There is a natural rush toward more regulation in the midst of a crisis that was partly set off by regulatory failures. But a more considered approach to reforming the regulatory systems, both at the national and international levels, is needed. There are risks to undertaking massive regulatory reforms in the midst of a crisis, when short-term prerogatives may overwhelm generally sound principles. For instance, mark-to-market accounting is making a bad situation worse as markets for some financial assets have all but disappeared. However, the fundamental concept underlying mark-to-market accounting, that the true economic value of assets should be reflected on firms' balance sheets, is a sound one; abandoning it altogether could come back to haunt us.

In any event, regulatory frameworks clearly need a massive overhaul, along with a reconsideration of the nature, scope and coordination of regulatory mechanisms. Eventually, the cross-border dimensions of this issue will also need to be tackled, although wide differences in the levels of financial development and regulatory capacity across G-20 countries make this a particular challenge perhaps best left for calmer times.

Global coordination of policies

Greater coordination of macroeconomic stimulus measures would increase the global bang for the buck of individual countries' policies. Such coordination would not only have a direct effect by preventing leakage of any one country's stimulus measures, but would also bolster confidence.

At a time when consumer and investor confidence are fragile, it is also important for G-20 leaders to

make an explicit commitment to free flows of goods and capital, and to refrain from protectionist policies. On this front, words do need to be backed up with actions rather than giving in to temptations of appeasing domestic constituencies. It does little good to espouse free trade in global forums and then accede to protectionist measures when leaders return home.

Reform of the international financial architecture

The G-20 has displaced the G-7 as the de facto agenda-setting body in the international economic policy arena. This is a positive development as the G-20 includes a broader set of key stakeholders in the international financial system. Expansion of membership in the Financial Stability Forum to the G-20 is another positive step. But a lot more needs to be done.

Substantive governance reforms of the international financial institutions, especially the IMF, are essential for global macroeconomic stability. Emerging markets need to be given a more prominent role at the IMF so they are more vested in the effective functioning of the institution in terms of both its surveillance and lending functions. The IMF needs more resources but also has to up its game to provide more credible and balanced macroeconomic surveillance of all of its member countries.

Even with major governance reforms and additional resources, it will take time to build up confidence in the IMF's role in providing insurance against financial and balance of payments crises. In the meantime, creative solutions to dealing with the insurance needs of emerging markets can play a useful role in reducing incentives for these economies to accumulate larger reserve stocks and reducing the probability of large global imbalances being built up again.

From the embers of this global conflagration could arise a new and more inclusive international economic order that brings countries together in creating a system that promotes global macroeconomic and financial stability. This calls for visionary leadership from the G-20 countries and an understanding that there is a commonality of interests that needs to be recognized and acted upon. The alternative for G-20 leaders is to put narrow domestic interests and political expediency above long-term benefits to the global economic system—this would prolong the crisis and ultimately pull down all countries. The choice is clear.

TAME PROTECTIONISM AND REVITALIZE TRADE

Paul Blustein

Framing the Issue

The global trading system is at risk of following the global financial system into crisis. Governments around the world have responded to pleas from beleaguered industries and workers by enacting a variety of protectionist and quasi-protectionist measures. Although the effect of these steps on trade flows has been minimal compared with the much more damaging plunge in global demand, it is easy to imagine how the trend could spiral out of control, conceivably leading to an outright trade war. So the G-20 leaders, weary as they may be after dealing with all the other weighty issues on their agenda, will have to take up trade as well.

Policy Considerations

It is tempting to say, as many commentators have, that the G-20 should vow to shun all new acts of protectionism, including any raising of tariffs or more subtle forms of import barriers such as "buy local" provisions in government stimulus programs. Unfortunately, such blanket pledges are likely to be no more credible than abstinence campaigns among teenagers. The G-20 must be ambitious on trade, but it must also be practical. Minimizing long-term damage to the trading system should be the leaders' overarching goal.

The G-20's attempt to take a stand on trade at its first summit last November was loaded with high-mindedness—and, as it turned out, hot air. The leaders said they would "strive to reach agreement" in 2008 on the central elements of the Doha Round of trade negotiations, which have dragged on for seven years. They also promised to "refrain from raising new barriers to investment or to trade in goods and services" for at least 12 months.

Alas, violations of both the spirit and letter of the declaration materialized within days of its promulgation.

An effort to convene a meeting of trade ministers to advance the Doha talks failed for lack of adequate convergence of key issues. Meanwhile, Russia raised duties on cars, pork and poultry. India raised tariffs on certain steel and soy products, and banned imports of Chinese toys. Indonesia imposed onerous customs requirements on a number of imported goods that compete with Indonesian manufacturers.

More worrisome, in some respects, are other actions that have protectionist implications even though they aren't the classic sort that involve restrictions on imports. Prominent among these is the

"Buy American" provision in the economic stimulus package passed by Congress last month. Although watered down to ensure compliance with various international trade obligations, the law would still allow new infrastructure spending to discriminate against, say, steel from China or India. Furthermore, numerous governments—with Washington in the lead—have started bailing out their national auto industries, which clearly helps domestic firms at the expense of foreign ones. Banks receiving public funding are being directed to concentrate their loans at home rather than abroad.

As worries mount that a self-reinforcing cycle of economic nationalism could ensue, proposals abound for the G-20 to approve not only a "standstill" on all tariff hikes but a ban on buy-local preferences and subsidies that favor national producers. Also widespread are exhortations for the G-20 to take a "just do it" stance on the Doha Round.

Desirable though it would be to see such an enlightened approach both endorsed and implemented, the G-20 needs to guard against another blow to its credibility if it is to be effective in steering the global economy. Let's face some lamentable facts: Auto industries are going to be bailed out, and in a discriminatory fashion. (Congress simply isn't going to give federal loans to Toyota or BMW, even though those companies have large plants in the United States.) Anti-dumping cases are going to soar, as are "safeguard" measures (the temporary raising of duties on a good to counter a flood of imports). More righteous verbiage from heads of state will do nothing to close wide gaps among trade ministers in the Doha Round.

Action Items for Global Coordination

So the principles guiding the G-20 should be these: Make sure that the rules-based trading system survives. Don't try now to open markets more than they already are; rather, focus on keeping protectionism, and quasi-protectionism, from becoming long-lasting features of the international economy, so that globalized trade can help the world recover and prosper anew. To the extent that anti-market policies are adopted, aim to keep them temporary and limited in scope.

In concrete terms, this means first of all shoring up the World Trade Organization. The WTO is the ultimate guardian of open markets for goods and services; it keeps a lid on the import barriers of its 153 member countries, and adjudicates trade disputes that might otherwise flare into trade wars. Its centrality to the system is in doubt, both because of the Doha Round's travails and the proliferation of bilateral and regional trade agreements. One way the G-20 could give a shot in the arm to the WTO would be to declare a moratorium on new bilateral and regional pacts.

Even better would be rescuing the Doha Round. The difficulties of bridging differences among WTO members should not be underestimated. Still, the G-20 has to address the round, and there may be a way out of the negotiating morass.

The big problem with the round is that the tentative deal on the table is scorned—with some justification—for failing to accomplish much. It falls far short of the round's original goal to boost development

in poor countries; it wouldn't significantly reduce current trade barriers; and it doesn't deal with major new trade problems relating to the food crisis, climate change, currency manipulation and other issues. Where it would provide value, though, is in gradually lowering many countries' "bound" tariffs—the legal ceilings that WTO members can impose without triggering sanctions. In this sense the round would contribute substantially toward insuring against protectionism in years ahead.

Probably the best way for the G-20 to impart new vitality to the Doha Round, therefore, would be to propose recasting it as an emergency anti-protectionism round rather than a development round. This would mean, first of all, narrowing the prospective deal down to the package of measures concerning farm subsidies, agricultural tariffs and manufacturing tariffs that was under consideration last year. Tough as it would be to get agreement on something like that package, it shouldn't be impossible once business interest and policymakers focus on the importance of preserving open markets. The other parts of the round—talks on anti-dumping rules, services, duty-free treatment for poor country exports, etc.—could be saved for the next round, together with climate and other new issues, and negotiating on that round could start as soon as slimmed-down Doha was completed.

Even more is needed from the G-20 than steps to strengthen the WTO, because for the most part, the quasi-protectionist measures that countries are adopting are legal under WTO rules.

Subsidies to struggling industries are an especially thorny problem, because there's a huge danger that countries will descend into a "subsidies war," which could inflict long-term costs and inefficiencies on the global economy, and would be grossly unfair to countries that can't afford to prop up their manufacturers.

Here, the G-20 needs to borrow a leaf from Catholic theology and draw a distinction between "mortal" and "venial" sin—promising never to commit the former, while treating the latter as forgivable. To qualify for venial sin treatment, subsidies should meet a series of tests. The two most important are that 1) the industry being subsidized is systemically critical to the national economy, and 2) the subsidy being provided is clearly temporary, and will be withdrawn by a specified time period (say, two years).

Here's hoping the G-20 shows that they mean business about countering protectionism—and that their next statement holds up a lot better than their first.

SPEED THE FLOW OF MONEY TO POOR COUNTRIES

Homi Kharas

Framing the Issue

The last time the G-20 met, the talk was of the collapse in rich country economies. Emerging markets were seen as "still experiencing good growth but as being increasingly impacted by the worldwide slowdown." Poor countries were not mentioned. In 47 items listed in the Action Plan, the only one really relevant to poor countries was a lukewarm commitment by leaders to "review the adequacy of the resources of the [International Financial Institutions] and stand ready to increase them where necessary."

What a difference a few months make. The talk today is of a development crisis and emergency. UNESCO, the IMF, the World Bank and the Asian Development Bank have all come out with reports in the last month suggesting the impact on low-income countries will be far greater than expected, as commodity prices, trade, remittances and infrastructure project finance dry up. The official forecasts for growth in Africa have been almost halved to 3.5 percent for 2009, and some predict further slowing in 2010. Per capita income growth in Africa is expected to virtually stop. UNESCO goes further in suggesting a 20 percent decline in incomes for the 391 million Africans living on less than $1.25 per day, the new international poverty line. It goes on to add that infant mortality could increase by between 200,000-400,000 a year. The World Bank predicts an extra 46 million people in poverty in 2009.

Prospects for poor countries have soured quickly because they are more exposed to capital stops than had been thought. The depth of the crisis has meant that even sources of finance that were considered safe have proven to be at risk. Trade credit, which underpins about $2.8 trillion in cross-border transactions each year, has shrunk by 40 percent in the last quarter of 2008. About one quarter of new infrastructure projects in developing countries has been delayed or canceled, even though financing had earlier seemed secure.

It is not surprising that private capital would shift away from low-income countries as international banks feel the liquidity squeeze at home. It is more disappointing that official capital flows to poor countries—official development assistance—are also declining. These flows, already tiny at an average of less than 0.3 percent of the rich countries GDP, are shrinking in absolute value in the face of political pressures to contain budgetary spending. What is more, their value is falling as the currencies of the most generous donors, like the Scandinavian countries, depreciate. Currency movements by

themselves could reduce the real value of aid by $4 billion in 2009.

Grim though they are, these statistics do not persuade everyone that the rich world should do more. Even African voices, like Dambise Moyo in her new book "Dead Aid," suggest the continent should be more self-reliant. That may have a grain of truth behind it, but the reality is that a recession is not the time to become virtuous about financial independence.

In fact, the world should worry about the effects of the crisis on poor countries because the consequences for growth, development, children's health, and civil war will be much more expensive to manage than the cost of preventive aid now. There is ample research that shows that the frequency and depth of downturns is more important for long-run average growth in poor countries than growth accelerations. Almost all countries have accelerations at some point in time. What differentiates successful developers is that they are able to minimize the size of downturns.

In other words, growth in poor countries is not symmetric. The costs of slow growth are larger than the gains from rapid growth. This asymmetry shows up in many development indicators. For example, infant mortality tends to rise during recessions but does not return to previous levels during the ensuing recovery.

One channel through which this asymmetry works is civil war. Paul Collier, the pre-eminent scholar on the economics of conflict, estimates that each percentage point decline of growth is associated with a one percent increase in the probability that a low-income country will be embroiled in civil war within five years. If the crisis lowers growth in Africa by 3 percentage points on average, it will raise the probability of civil war for each of 48 sub-Saharan countries by 3 percent. And we know that the costs of responding to conflict are many-fold greater than the costs of aid to prevent the conflict in the first place.

Policy Considerations

The key issue is how to get more resources to low-income countries so they too can implement a fiscal stimulus. The World Bank estimates that only one quarter of vulnerable developing countries are in a position to expand their fiscal deficit or undertake significant countercyclical spending. The IMF is of the same view. Based on this analysis, the Bretton Woods institutions have urged poor countries to limit their additional spending to any incremental concessional finance they can raise. Both the Bank and the Fund have promised to help raise such funds, with President Zoellick calling forcefully for rich countries to contribute 0.7 percent of their stimulus packages into a Vulnerability Fund for poor countries.

The problem with this approach is that it is not yet working and may be too slow given the urgency of the needs. The key issue is to make more money available without conditions that poor countries find too onerous. Because of worry about debt levels in poor countries, the IMF has lent only $260 million

from its concessional resources to six low-income countries over the last six months, for an average of 35 percent of quota for each program. Contrast this with its much larger programs for eight middle income countries, to whom the Fund has lent $46.1 billion (650 percent of quota). The International Development Association (IDA) has indicated it is willing to front-load credits and grants, but only if countries agree to cut back in 2010 and 2011. There are few takers. As a result, IDA only managed to commit $4 billion in the second half of 2008. Without resources, no poor countries have been able to undertake fiscal stimulus.

It is the wrong choice to make poor countries adopt fiscally conservative postures at a time of a global crisis of this magnitude. It is time to recognize that low-income countries have made considerable strides in improving macroeconomic performance over the last decade and can be trusted to do better now. The World Bank's own analysis suggests 70 percent of developing countries have a high- or medium-level of administrative capability to respond effectively to the crisis. Thanks to debt relief programs like the Heavily Indebted Poor Country Initiative, half of all low-income countries have debt below 36 percent of GDP. Half also have fiscal deficits (after grants) below 1.8 percent of GDP. While it is true that these hard won gains should not be casually reversed, the creation of fiscal space through debt relief was done precisely to provide room for necessary spending. If this is not the appropriate time to use the space, then when is?

The real point is that poor countries need help to expand spending now. That means working through existing structures, rather than developing new ones on the fly. The good news is that there is already a considerable amount of money in the pipelines of the multilateral development banks—perhaps $60-70 billion in committed, but undisbursed funds. This money, for projects which have already been vetted for their development impact, has also been included in rich country budgets. It is not an ask for more.

Action Items for Global Coordination

Poor countries are likely to see a major set-back to development progress in 2009. Rich countries should do their best to minimize this set-back in their own self-interest. If they do not, they will be called upon to confront poverty, health and perhaps conflict crises and will see infrastructure assets that have been painstakingly built up deteriorate for lack of maintenance. "A stitch in time saves nine" is true for development.

The focus of attention should shift from calls for new money—the commitment culture—to speeding the flow of money—a disbursement culture. Such an approach would allow poor countries to join the rest of the world in stepping up fiscal expenditures to protect their citizens and their economies. A global crisis requires a global solution—there is no reason to leave poor countries out just because they are small in global terms.

MOBILIZE THE G-20 TO RESPOND TO THE GLOBAL ECONOMIC CRISIS

Colin Bradford and Johannes Linn

Framing the Issue

The world has many international institutions dealing with global issues, including the United Nations, the International Monetary Fund, the World Bank, the World Trade Organization, and so forth. These are formal organizations based on treaties and are universal (or near universal) in their membership. In parallel, the leaders of the systemically most important countries have found it useful to meet for summits based on smaller and more exclusive "groups" (hence the term "G"), which are not formal organizations but rather clubs with self-selected membership.

The current G-8 goes back to a G-6, which was formed in the 1970s by the six largest Western economies in response to a financial crisis. Its purpose was initially to help their leaders develop a suitable crisis response, which they could jointly pursue through their representatives in the international financial institutions. Over time, the G-6 was enlarged to the G-7 and finally, with the inclusion of Russia after the break-up of the Soviet Union, to the G-8. Over time also, the G-8 broadened its horizon beyond the purely economic area, including global poverty, environment, health and certain security concerns. With that, the G-8 assumed for itself the role of a global steering committee, which sought to respond to global challenges in an effective manner.

The benefit of having such a global steering group, especially in times of crisis like today, is that it provides a visible locus of deliberation and decision making at the highest level. This can inspire confidence that effective action will be taken. It can help ensure that the often slow and ponderous machinery of the formal international institutions is jump-started and takes action with deliberate speed.

In recent years, however, as major emerging market economies, especially those in Asia, have rapidly grown in importance, the G-8 has become increasingly unrepresentative and ineffective by excluding key centers of economic and political power in the world. Clearly, these countries need to be included in the process of deliberation, decision making and implementation if the leaders' summits are to be representative and effective, and hence legitimate. It was therefore a major step forward when President Bush invited the leaders of the G-20 to meet in Washington in November 2008 for a summit of a group of countries that represent two-thirds of the world's population and 85 percent of its GDP. With this single step, the promise of a credible and legitimate response to the global financial and economic crisis was visibly enhanced.

Although it is true that the November 2008 event was officially called "The Summit on Financial Markets and the World Economy," and that the April 2009 summit is officially called "The London Summit 2009," both have been widely referred to as the "G-20 Summit" in the media and in the official Web site and in official pronouncements. Moreover, the Italian government has announced that it will invite the leaders of all G-20 countries to attend at least part of the G-8 Summit in Italy in July, and it appears that the London Summit will call for a third G-20 summit.

At the same time, selected G-8 leaders from Europe, Canada and Japan appear to remain unconvinced that the G-20 is the right format. Some would prefer to stick with the G-8, joined by selected guests on an ad hoc basis; others seem to prefer a G-13 or perhaps G-14. The new U.S. administration has not yet announced which summit format it prefers.

In the meantime, countries that do not traditionally belong to the G-20 have been pushing hard to be included in the April G-20 Summit. The Netherlands and Spain had already been invited for the November 2008 event at the strong urging of the French president and are now again apparently joining the April 2009 Summit, along with representatives of selected international and regional organizations. At the same time, the German Chancellor has proposed the creation of an Economic Security Council at the United Nations.

In short, there is a great debate ongoing and the future of the G-20 is far from assured. Nonetheless, the momentum seems to be moving the G-20 forward as the global steering committee for this historic economic crisis and it may well extend itself into other related issues such as climate change and global poverty in the future. Whether or not this happens will depend to a significant extent on the direction chosen by President Obama.

Policy Considerations

Any group necessarily involves a tradeoff between representativeness and effectiveness. The larger and hence the more representative a group, the less effective it is. Any group larger than 20-25 members sitting around a table will not be able to interact effectively. International institutions try to bridge this tension with the use of a constituency system, which allows all countries to participate, while maintaining a relatively small governing council. In practice, however, the constituency system—especially when applied to the summit level—involves a lack of continuity and other possible weaknesses, which can limit effectiveness. In any case, whatever group is formed—unless it is a preexisting one, such as the G-20—gives rise to endless debates about who is "in" and who is "out." It was precisely for this reason, that the G-20 offered itself as a pragmatic response to the need to broaden the scope of the G-8.

This does not mean that the G-20 is the ideal solution. Indeed, in the longer term it may be appropriate to explore improvements. Among these could be the consolidation of European chairs; the inclusion of more African countries; a systematic representation of regional bodies; consultation procedures by which members of the G-20 systematically sound

out non-members in their regions in advance of summits, so as to be able to reflect the concerns of non-members explicitly in the summit discussions. If the G-20 continues to function, a small secretariat should also be formed to assist with the logistics and technical aspects of the preparation and follow-up of summits. And very importantly, only leaders should sit at the main table. If need be an outer circle of chairs can be added for ministers or other participants who do not represent countries or key international institutions.

Action Items for Global Coordination

The London Summit should principally focus on what measures are required to fight the current economic and financial crisis. The G-20 leaders should focus, agree and act on seven specific items:

- The scale, implementation and monitoring of a set of ambitious stimulus measures by enough G-20 countries so that their joint actions will credibly support an early recovery and the beginning of reestablishing global financial balance;

- Strengthening the regulation of national financial markets, the international financial system and reform of the international regulatory institutions, especially the IMF and the Financial Stability Forum, by increasing the role of emerging market economies in them, so as to ensure an effective crisis response and help prevent future crises;

- At least a tripling of resources for the IMF from currently $250 billion to $750 billion through a combination of a generalized quota increase, a sizeable SDR ($250 billion) allocation, a further authorization to borrow under the so-called "New Arrangements to Borrow" (NAB) or ad hoc borrowings from selected surplus countries—following the commitment already by Japan to $100 billion—and other measures to make the IMF a major actor in the global financial system again;

- Serious governance reform of the IMF under which the Europeans would agree to yield some of their dominance currently consisting of 33 percent of the voting shares, eight of the 24 chairs and the right to name the head of the IMF; this should convince Asia that there is a role for them in the IMF and ensure the IMF makes the transition from a transatlantic institution to a truly global one and for the additional resources to materialize;

- Mobilization of significant additional resources for the World Bank and the regional development banks to provide financing for the poorer developing countries to shield them from dramatic reductions in social and environmental investments; this should be linked to governance reform in the World Bank and other development banks to give a greater role and responsibility to developing countries;

- A commitment not to engage in protectionist actions on trade, finance and fiscal policy—such

a commitment was honored in the breach after the November 2008 G-20 Summit; this time it is critical not only that the commitment is reiterated, but that it is honored in full by all; and,

- A commitment that the G-20 will continue to serve into the foreseeable future as the leading body for global leadership that is more inclusive and effective than the G-8 for steering the world through this crisis.

Taken together, these decisions will instill a measure of confidence and trust among the markets and the general public around the world that the leaders are decisive in moving forward with addressing the global crisis.

What should not happen is a protracted and unresolved debate about the appropriate future summit format. Not only would this distract leaders from a clear focus on the coordinated fiscal, financial and institutional actions they need to take urgently; it would also send a signal to the world that the leaders remain indecisive on the highly visible question of what will be the group that will help guide the world through the worst of crises in recent history.

EMPOWER THE REGIONAL DEVELOPMENT BANKS

Mauricio Cárdenas

Framing the Issue

There is clear evidence that economic conditions in emerging and developing countries are rapidly deteriorating. In Latin America, optimistic projections suggest no growth for this year in contrast to 4 percent last year. While some countries in the western hemisphere will continue to grow at low rates, others—such as Argentina, Mexico and Venezuela—are expected to contract by as much as 2 percent. In Africa, where the collapse of export prices and the reduction in access to international lending are taking a dramatic turn, a decline seems unavoidable.

Policy Considerations

Containing the ramifications of the crisis from North to South needs to become a focal point for G-20 leaders. If the discussion on the changes to the international financial regulatory and supervisory system dominated the agenda during the November G-20 Summit, now is the time to put together concrete actions to avoid a serious economic setback in low- and middle-income countries. There are good reasons to do this, including the fact that a deep recession in the South will put off the revival of growth in the North.

Protectionism is making matters worse. The "Buy American" clause in the American stimulus bill, the absolute paralysis in U.S. trade negotiations—including the pending trade agreements with Colombia, Panama, and South Korea—and lack of progress in the Doha Round suggest that trade policies in the developed world are not going to help the developing world.

Very few developing and emerging countries have been able to implement the recommendations of the IMF to put in place fiscal stimulus of 2 percent of GDP each year for 2009-2010. The main reason is that, for some countries, private capital flows have come to a halt. Those that that continue to have positive inflows fear losing them if their fiscal deficits go up. Thus, multilateral financial institutions should be ready to increase lending to support aggregate demand and offset any real or potential shortage of private capital.

Action Items for Global Coordination

The top priority is to increase the IMF's firepower. To begin, G-20 heads of state should support the IMF's proposal to set aside a $25 billion facility to assist low-income countries under concessional terms and reduced conditionality. But emerging countries

are likely to demand at least 10 times that figure. To address this situation an agreement should be reached on how to increase IMF resources substantially. Raising the permanent quotas is the natural step but will require a major reallocation of voice and representation, which will not happen before January 2011. Concrete action cannot wait that long.

In the short run, the IMF could borrow from surplus countries, from financial markets, or from the group countries that form the quota-based mechanism known as the New Arrangements to Borrow (NAB). The problem is that an expansion of the current NAB requires legislative approval, at least in the U.S.

Many analysts have argued for a substantial allocation of Special Drawing Rights (SDR). On first appearances, this is a costless and easy solution. But the allocation would have to be proportional to the current quotas which may not reflect the countries' needs. A post-allocation redistribution to countries that need more support is possible but will require time.

In the case of the World Bank, raising more capital will not be addressed until April 2010, when the new governance guidelines should be finalized. Between now and then, the Bank can increase its lending operations by raising more funds in capital markets and widening and streamlining its lines of operation.

Given the complexities associated with the mobilization of resources for the IMF and the World Bank, more emphasis should be given to the capitalization of regional development banks in order to enhance their capacity to assist emerging countries. Contrary to what has been agreed by G-20 finance ministers, this problem goes beyond the capital increase for the Asian Development Bank.

Take the case of the Inter-American Development Bank, which needs more capital even under conservative disbursement scenarios. In contrast to what happens with the IMF or the World Bank, there are no major governance issues to be addressed in terms of chairs and shares. The additional contribution is not large—around a billion dollars in the case of the U.S.—and the payoff can be high in terms of stability in the region. Based on what happened since the last capitalization a decade or so ago, each additional dollar of disbursed capital leverages 90 dollars in development loans. A discussion in the U.S. Congress on the need to capitalize all the regional development banks should not face strong opposition. Of course, it is necessary to get the Obama Administration fully behind the initiative as part of the U.S.'s reengagement with Latin America.

There are too many items in the agenda for the next G-20 summit: financial stabilization, regulatory reform, macroeconomic stimulus, prevention of protectionism, and containment of a backlash in emerging and developing countries. Adequate attention should be given to this last point, which calls for a two-track approach involving resource mobilization for the IMF and, importantly, capitalizing the regional development banks.

AID AFRICA

Ernest Aryeetey and John Page

Framing the Issue

When the global financial crisis hit there was a tendency in most circles to view it as largely an OECD problem. Now, as China, Eastern Europe and the newly industrialized Asian economies show signs of being seriously affected, discussions of how to deal with the crisis have broadened, but there has been relatively little discussion of how the crisis affects African countries and how they should deal with it.

The shift from a financial meltdown to a global recession will hurt Africa, precisely at a time when it had shown signs of sustained growth. Africa was one of the faster growing regions of the world over the last five years, with growth exceeding 5 percent on average. This recovery after nearly 20 years of economic stagnation came on the back of greater integration into the world's commodity markets. With rapid growth in China and India, African exporters gained considerably from significant increases in volume and prices. But beyond good luck, good policies also mattered for growth: Africa's economies were better managed. Macroeconomic policies in particular did much to avoid the growth collapses that had plagued the 1980's and 1990's.

The IMF estimates that growth in Africa in 2009 will be slightly more than 3 percent, about a half of what was expected a year ago. Even this modest growth may prove difficult to sustain in the medium term, unless action is taken both by African governments themselves and by the international community. The G-20 should consider the following economic landscape for Africa when it meets in London and pursue ways to aid Africa as part of its basket of policies.

Policy Considerations

How Has the Global Recession Hurt Africa?

Initially, Africa's economies were not severely affected by the meltdown in global financial markets, largely because their financial systems were not deeply integrated into international financial markets. As the crisis deepened throughout the world, however, and a global recession set in, the impact on African economies became more apparent.

What the crisis and the recession have done is to take away three major sources of recent growth for African economies. Commodity prices and volumes have tumbled and are projected to continue to decline. For example, the price of copper—Zambia's major export—has fallen to less than a third of what it was year ago. In addition to the direct effects of reduced demand, African countries are expected to

suffer reduced private capital flows as the financial crisis in the U.S. and Europe curtails the availability of capital for investment in the region. A number of African countries also depend on remittances to provide major sources of foreign exchange and of spending in poor households. The World Bank projects that these flows will fall substantially with major impacts on the poor.

How Should African Governments Respond to the Crisis?

Economic management in Africa today is vastly different from what it was during the first oil shock of the 1970s. At that time many countries failed to adjust their economic programs to match the resources available. The result was a large number of mismanaged and poorly functioning economies for over a decade. Today African countries realize that the shock to their economies could last longer than the short term. Adjusting budgets to match expected financial resources has become generally accepted across most countries. In Ghana, the newly elected government has prepared a budget that seeks to reduce the deficit from a whopping 14.9 percent of GDP in 2008 to 9.4 percent in 2009.

But maintaining the continent's hard won macroeconomic stability will come at a substantial cost. There is a growing danger that as countries seek to contain their expenditures within limits and ensure macroeconomic stability, they would be doing so at the expense of medium- and longer-term growth and development. Maintaining macroeconomic stability, while sustaining longer-term growth and development, is best done by being creatively selective in public expenditures. Expenditures that enhance productivity must be protected, while those that do not are scaled down. For example building human capital is not a simple matter of maintaining the entire education budget intact. Areas of wastage in the education sector, such as paying the salaries of teachers not present in the classrooms, may be taken out without any negative consequences. Roads that serve only a political purpose may be suspended.

The crisis also presents African governments with an opportunity to strengthen structural reforms. The resource rich economies can use the crisis as an opportunity to put into place better practices in the management of natural resource revenues. Governments can continue and accelerate reforms of the business climate. Institutions affecting agriculture, such as land tenure systems, can be improved. All of these reforms come at little or no fiscal cost but they can position Africa's economies to respond more fully to an eventual global recovery.

Action Items for Global Coordination

The international community has a major role to play in supporting Africa during the crisis through aid and trade. While there are understandable pressures to curtail aid budgets in the OECD, these need to be resisted. For the vast majority of Africa's economies there is no alternative to official development finance: just as their isolation from the global financial system gave them a measure of protection from the financial melt-down it will prevent them from participating in the eventual recovery. Aid has traditionally been pro-cyclical in Africa, rising during good times

and falling during economic contractions. This time the response of the international community needs to be different. OECD governments need to maintain their Gleneagles commitments, and if possible expand them.

The global crisis has also brought a disturbing return to protectionism. The World Bank reports that since the beginning of the financial crisis roughly 78 trade measures have been proposed or implemented, of which 66 involved trade restrictions. Of these, 47 measures were actually implemented, including by 17 of the G-20. These restrictions will limit Africa's prospects for participating in an eventual recovery and should be resisted. Indeed the G-20 should be giving serious thought to expanding and streamlining trade preferences for African products, not restricting their market access.

GOOD GOVERNANCE:
LEARN FROM THE MISSING COUNTRIES

Daniel Kaufmann

Framing the Issue

Consider a different and unheralded "group-of-eight," comprised by these countries: Botswana, Chile, Mauritius, Uruguay, New Zealand, Norway, Singapore and Switzerland. Do they have any relevance for the G-20? Hardly, at first. None of them are invited to the G-20 heads of state London Summit on April 2. They are not G-20 members, since neither their economic size nor their population are large enough, and they lack the global "systemic significance" of most G-20 members. None of them belongs to the EU, so none in this group of eight can be represented by proxy in the G-20. And they do not really exist as a formal body.

But to argue for this particular group-of-eight small nations to be invited to the G-20 summit in order to represent their people (or their GDP) is to miss the point. Instead, in today's turbulent times, there is a forgotten rationale for the G-20 summit leaders to pay attention to this particular set of uninvited countries. Like the G-20, they comprise a rather diverse group of countries from different regions of the world, and are also at various stages of industrialization. But, unlike most of the G-20, this group of eight countries has exhibited high quality of national *governance*.

Let us review comparative performance of this good-governance-group-of-eight (ggg-8) by focusing on three of the relevant dimensions of governance, namely the extent of: 1) government effectiveness, 2) the quality of the application of rule of law, and 3) the effectiveness in controlling corruption.

The governance performance in each one of these dimensions is high in the ggg-8. As we can see in Chart 1, governance levels among this ggg-8 not only far surpass the G-20, but are even a bit above the rich G-8 club, even though the ggg-8 includes four developing countries (Botswana, Mauritius, Chile and Uruguay).

Further, over the past decade, governance has improved on average somewhat in the ggg-8, in contrast with the G-20 (Chart 2).

This significant difference in the quality of governance between the G-20 and the ggg-8 does not mean that each country member in the G-20 exhibits subpar governance, or that each country in the ggg-8 has already attained exemplary governance in all dimensions. Canada, a member of the traditional G-8, and of the G-20, stands out for its high level of governance in all dimensions, and not surprisingly, it is the only member of the G-8 that has

had fiscal surpluses and whose financial house has been relatively in order. Conversely, one member of the ggg-8, Singapore, which does have exemplary governance ratings in political stability, regulatory quality, government effectiveness, judiciary and control of corruption, has subpar ratings in the "voice and democratic accountability" dimension (although even on that component it does rate above some G-20 members, such as Russia, China and Saudi Arabia). But in general, the countries in the ggg-8 do stand out in their governance performance, towering over and above the G-20.

One specific area of governance weakness for the United States in particular, but also for the G-8 and the G-20 generally, is the extent of "legal corruption," which also encompasses the distortive role of money in politics, as well as regulatory capture. As shown in Chart 3 already five years ago—well before the financial system imploded—evidence was already available about the glaring weaknesses in the US and across the G-8 in terms of legal corruption and capture, which are relevant for understanding some of the antecedents of the financial crisis, as well as drawing the lessons for public policy. Consequently, sheer power, country size, and systemic imperatives drive the particular constituency of the G-20, yet these have not been synonymous with world-class country-level governance in recent times.

Policy Considerations

Therefore, for the G-8 and the G-20 to claim a higher moral ground for appropriately representing the priority global concerns, and for appropriately acting on the crisis and beyond, it will need to be uncharacteristically candid in acknowledging and understanding their own lessons of recent governance failure. And it would also benefit by drawing from the positive lessons that emerge from countries outside the G-20. The ggg-8 demonstrates that good governance is attainable, with each country offering valuable case studies in particular dimensions of governance relevant for today's challenges. It is precisely some of those good governance lessons that need to be "represented" and put into practice among the G-20.

An important set of lessons to be considered by the G-20 can be gleaned from Chile's experience with a financial crisis almost 30 years ago, in the early 1980s. As in the US in recent years, prior to its own major crisis Chile underwent an ideologically-driven financial deregulation in finance, mismanaged its macro-economic policies; had ballooning corporate debt, and vested private corporate interests unduly influenced regulations and policy.

Yet the serious financial crisis in 1982 did trigger concerted and decisive action in Chile, including: 1) sound macro-economic management, with fiscal, exchange rate and monetary policies that nowadays are regarded as world-class; 2) effective Central Bank initiatives in loan restructuring and in a temporary and conditional purchase of non-performing loans from viable banks, as well as in the intervention of troubled banks and sale or liquidation of insolvent banks, and, 3) a revamp of the prudential supervision and regulatory framework, including the institution of an effective Securities and Exchange Commission, and the overhaul in oversight, disclosure and prudential regulations.

The case of Chile exemplifies the paramount importance of decisive and comprehensive public policy action to tackle a major financial crisis (minimizing the short-term direct cost to the taxpayer was not the major objective). Today, the Chilean economy is on sound footing and does not require a bailout. A countercyclical fiscal stimulus plan is now in motion to counter the effects on the (very open) real economy. This stimulus is funded from Chile's large stabilization fund, the result of years of budgetary surpluses, and it has a very effective and balanced composition between social and infrastructure expenditures—devoid of "pork" and unproductive special interests projects. Further, over the years Chile has grappled with campaign funding reforms, which are still ongoing, so as to mitigate the perverse impact of money in politics and regulatory capture.

Not every detail of the Chilean experience is applicable to G-20 countries today, and it is far from the only case deserving in-depth study. But the Chilean case has not received sufficient attention, in contrast to the focus on the Swedish lessons from their 1992 financial crisis (e.g. Richardson and Roubini recently wrote "we are all Swedes now").

Other countries in the well governed group of the ggg-8 have also exhibited sound macro-economic management. In recent years, Botswana, Singapore, Norway and Switzerland (alongside Chile) have each had significant budgetary surpluses, averaging an impressive 7 percent of GDP. In fact, the ggg-8 as a whole had an average fiscal surplus of about 5 percent of GDP during 2005-2008, in sharp contrast to both the US and the UK which run high fiscal deficits, amounting to 3 percent of GDP (among the G-7 only Japan managed to fare worse).

Action Items for Global Coordination

Unsound *macroeconomic policies* were also a determinant of the financial crisis, suggesting that particular attention by G-20 leaders during their summit needs to be paid to present and future fiscal and monetary policies, as well as to regulation. The U.S. and other economic giants in the G-20 will need to implement decisive policies, including an *effective financial bailout plan*, which is not overly generous to the traditional large bankers and poses future moral hazard (yet it does include banking triage), as well as carrying out a productive fiscal stimulus package. Yet these urgent measures need to be balanced against the paramount objective of a fiscally responsible medium-term program that restores and institutionalizes macro-economic stability.

Further, the *financial regulatory system* needs to be revamped in earnest, making history of the ineffective and captured regulatory institutions, as well as ceasing the national and cross-border regulatory "races to the bottom" (financial institutions 'shopping' for the most lenient treatment among competing regulatory institutions, both within the U.S., and also between the New York and London financial centers). And the nefarious impact of *money in politics on the resulting performance and capture of financial regulations and policies* can no longer be ignored. Countries like Norway have fared better on many of these issues, and the lessons ought to be reviewed by G-20 leaders.

A focus on governance and anti-corruption by the major world powers is a particular priority now also because of the major ongoing shift in the role of government, which in the most prominent countries is already becoming a major provider of: 1) infrastructure and other large investments; 2) massive bailout funds to selected financial institutions; 3) ownership of major financial and other (previously private) assets and institutions, and 4) special social safety and housing programs. And the government role as a regulator is about to be transformed as well. These require specialized initiatives on governance, transparency and integrity.

Another consideration for G-20 leaders is how Norway, Chile and Botswana have also effectively *managed their oil and mineral wealth*, in contrast with most every other resource-rich country. Further, each one of the ggg-8 countries provide case studies for *controlling corruption*, a pending challenge in most countries in the world, including within the G-20 constituency.

And each country among the ggg-8 have also exhibited *open trade policies*, shying away from protectionist tendencies that plague some in the G-20, where right now the specter of further protectionism, including in finance, looms large. Further, it is not countries in the G-20, but Switzerland and Norway from the ggg-8 instead that lead the world in terms of *environmental performance.* Costa Rica, New Zealand and Colombia are also among the top 10 environmental performers, while France, ranked 10th, is the only individual member of the G-20 among the top 10. This is noteworthy, since the G-20 is expected to seriously address global climate change, and therefore it may want to draw on the good experiences outside of their own members.

Last, but not least, the G-20 needs to concretely offer initiatives to help address the enormous plight of the poor in many *developing countries* in crisis, which need urgent assistance. Again, Norway has shown to be a model for donor countries, a rare example in a world where *"aid effectiveness"* has been elusive. Norway balances a generous commitment to fund development with a clear focus on selectivity and on governance in their aid programs and in recipient governments.

Being aware of the serious recent failings in the U.S. economy and polity, President Barack Obama has mentioned the need to address some of these broader governance challenges, including special interest politics. A few other G-20 leaders also recognize the need for major reforms.

In times of such deep crisis, there is both an opportunity and a responsibility to transcend local politics and implement far-reaching changes. This could enable a major leap forward in governance, and in regaining trust and credibility around the world, and in the major markets.

Some individual countries in the G-20, like Canada, and some within the EU, like Finland, Sweden, Denmark and the Netherlands, also offer some relevant examples in good governance. But as important is to draw from the experience of some other countries which have performed well, even if they are far from the table at the G-20 Summit in London.

FOCUS ON WHAT ASIA WANTS

Lex Rieffel

Framing the Issue

Five Asian countries will participate in the G-20 London Summit: China, India, Indonesia, Japan, and South Korea. As a group, they represent 44 percent of the world's population. In GDP terms, however, they represent only 18 percent of global GDP, with Japan leading and Indonesia trailing the group.

The London Summit is all about the global economic and financial crisis. Because the United States has the world's biggest economy, and because the crisis originated there, the American voice at the London Summit will without question be the dominant one. Two factors reinforce this special status: the unrivaled military power of the United States and the phenomenal global popularity of its new president, Barack Obama.

Added together, these factors put the United States in an impossible position. The constraints on U.S. action are as great as the expectations. President Obama's policymaking team is far from being fully staffed and cannot have engaged in the consultations with its global partners to the extent demanded by the circumstances. The risks posed by the London Summit for the United States and the world may be much greater than people are generally assuming.

While the United States is not a "region" per se, it is big enough to be considered as one in this context. After the United States, Europe views itself as the most important region represented at the Summit, but a case can be made that Asia deserves the number two ranking. The case begins with its population weight, close to half of the world's population. Although we live in an increasingly democratic one-person-one-vote world, policy lags seriously behind this reality. The more fundamental reason for giving priority to Asia over Europe at this moment is Asia's position as the major source of the high savings and the large balance of payments surpluses that mirror the low savings and balance of payments deficit of the United States. A strategy that is not seen as leading to the correction of this imbalance will not be credible.

The Asian region, however, has two handicaps relative to Europe: history and culture. Events in the past hundred years have left scars within the region, especially between Japan and the rest and between China and India. Deeper cultural differences divide the region along religious and ethnic and development lines. Such differences also exist in Europe but are muted. Nowhere in Europe do they approach the difference within the smaller 10-nation ASEAN community between wealthy, over-governed Singapore and impoverished, miserably-managed Myanmar.

Policy Considerations

The headline issue in the run-up to the London Summit has been the tug of war between the United States seeking to give priority to global fiscal stimulus and Europe seeking to give priority to regulation of financial institutions and markets. None of the Asian countries seem to have strong views on the regulation part of the agenda, presumably reflecting their relatively repressed financial systems. On the fiscal stimulus issue, China's position is critical, and it is isolated. Although it has announced the largest stimulus package in dollar terms among the five Asian participants, China came into the crisis from a position of fiscal surplus and appears to have room to do considerably more. The other four Asian participants would like to see China do more to stimulate domestic demand because of the direct and positive impact on their own economies.

A core Chinese concern in the run-up to the London Summit was revealed on March 13 when Prime Minister Wen Jiabao said he was "worried" about the U.S. Government's huge indebtedness to China. This concern is not exclusive to China. Japan has a comparable exposure and the other three Asian participants also have substantial foreign exchange reserves that are heavily invested in U.S. Treasury securities. The Asian participants are united in placing the blame for the crisis squarely on the United States and expecting the United States to do the most to overcome it. Asia's concern is by no means new. The lead headline in the *Financial Times* on November 23, 2004, was "China tells U.S. to put its house in order."

A third issue, however, looks like the critical one for the five Asian countries going to the London Summit: the future role of the International Monetary Fund (IMF). On economic grounds, the case for increasing the resources of the IMF is compelling, but the politics of such an increase are daunting for Asia on three levels. First, the financial crises in Thailand, Indonesia, and Korea in 1997 left Asian countries feeling mistreated by the IMF. They have been saying since then that they must maintain large foreign exchange reserves because they cannot be certain of getting timely, sufficient, and fairly-conditioned help from the IMF the next time a crisis erupts. Second, it is difficult for Asian countries (except for Japan) to make the case domestically for contributing more resources without a substantial increase in their voting shares, which are now too small but almost all measures. Third, China's voting share is now the sixth largest while Japan is in second place after the United States. It will be hard for China to be "invested" in the IMF as long as its voting share is smaller than Japan's, but Japan does not appear ready to accept sharing second place with China (France and the United Kingdom are tied for fourth place).

A decision to increase the IMF's resources is greatly complicated by the existence of four distinct routes. The route in normal times is a general quota increase that raises the quotas of all members in the same proportion. A doubling of quotas, which can be justified easily on economic grounds, would raise total quotas from $320 billion to $640 billion. The route already in place for times of stress involves activating two lines of credit: the General Arrangements to Borrow (GAB) and the New Arrange-

ments to Borrow (NAB). The United States favors this route, by adding $500 billion to the existing arrangements, which together now total $50 billion. A third route used in the past has been bilateral loans to the IMF. Japan has already committed $100 billion in this form, which could be matched easily by China and other countries with ample foreign exchange reserves such as oil producers like Saudi Arabia. The easiest route could be for the IMF to issue its own currency—Special Drawing Rights (SDRs)—to all members in proportion to their quotas. The IMF issued SDRs twice in the 1970s, but not again since then. Ted Truman, a highly regarded former U.S. Treasury official, has floated a proposal for a third issue now on the order of $250 billion. None of these routes are mutually exclusive; any combination is possible.

Action Items for Global Coordination

It will be devilishly difficult to reach agreement at the London Summit on a package that will increase the resources of the IMF quickly because of the voting share issue and other governance issues such as the process for selecting the Fund's Managing Director. Moreover, a deal without the full support of Japan, China, and India will probably not provide the fillip to confidence that the London Summit must deliver to put the world firmly on the road to recovery.

Perhaps the biggest question is whether the rest of the world is prepared to accept a Made-in-the-USA deal, even if delivered on a silver platter by President Obama. Politically, the most palatable deal could be one that has a Made-in-Asia label. What better proof that the U.S. is ready to stop preaching and work in partnership with others to build a more sustainable and harmonious world?

UNDERSTANDING AND ADDRESSING POLITICAL INSTABILITY

Raj M. Desai

Framing the Issue

Understandably, recent attention on the G-20 has mainly focused on stabilizing financial markets and restoring growth. But the potential for the current global economic retrenchment to cause political chaos should be of equal concern, even if poorly understood, and deserves attention.

History shows that political instability and recession generally track each other—but very imprecisely (see graph). Increases in the number of countries in recession occurred following the oil crisis in the 1970s, the debt crisis in the 1980s, the collapse of the former East Bloc in the early 1990s, and the crises in emerging markets in the late 1990s. None of these spikes, however, were followed by surges in instability. Instead, the level of worldwide instability rose steadily between 1975 and 1991, dropping off after the end of the Cold War. Despite ongoing conflicts around the globe, the world is now experiencing the lowest amount of political violence since the 1960s. Will the current crisis reverse this trend?

For the first time since the Great Depression, the world economy is expected to shrink in 2009. Across the developing world, shuttered factories, frozen construction sites, empty tourist spots, and rising numbers of jobless are becoming depressingly common. There are forecasts that job losses in East Asian economies could surpass that of the Asian Crisis, even though this time the crisis began elsewhere. In China, no less than 20 million workers have lost jobs primarily in coastal manufacturing cities, many of whom may now stream back into the countryside.

Often there are cross-border consequences to job loss. Over 200,000 expatriates—one out of every 15 workers—may leave Singapore this year. Malaysia is expelling some 100,000 Indonesian workers while thousands of Burmese shoe and textile workers are leaving Thailand. Guest workers in the Persian Gulf kingdoms are losing jobs by the thousands and are facing the loss of work visas and repatriation, while their countries of origin are losing remittance flows.

The Indian state of Kerala, for example—home to approximately half of the estimated five million Indian workers in the Gulf, and which receives remittances amounting to 25 percent of the state economy—is bracing for the return of 500,000 expatriates in a few months. The same pattern is being repeated in many other places: Bangladesh, the Kyrgyz Republic, Philippines, El Salvador, and Tajikistan among others, may see sharp declines in remittances this year as their overseas workers head home. And

along the U.S.-Mexico border, apprehensions of illegal crossers have fallen to levels not seen since the 1970s.

At a time when progress is being made in the fight against poverty, millions risk falling back into destitution. During previous crises, cuts in public health spending and education funding amid recessions pushed millions back into poverty, many who had recently achieved tenuous middle-class status. The World Bank estimates that, this time around, 53 million people will plunge back into poverty. Preventing this involves a $700 billion spending shortfall that international financial institutions and donors will be unable or unwilling to fill.

These events are heightening financial pressures on countries that are ill-equipped to deal with these shocks. As jobless ranks swell, as remittances fall, as poverty rises, and as the global credit squeeze cuts off other financing options, can these nations prevent their social fabric from unraveling?

Policy Considerations

Increases in armed insurrections and internal wars are most likely to be localized in countries with endemic conflicts and weak governments. But recession also creates conditions under which policy disputes can lead to significant amounts of (nonviolent) instability—government collapse, constitutional crises, general strikes, and political uncertainty. In developed economies, the current crisis has already brought down governments (e.g., in Iceland and Ireland, coming close in Greece). Crisis-related protests have erupted in Bolivia, Bulgaria, China, Kazakhstan, Latvia, Lithuania, Madagascar, the Philippines, Russia, and Venezuela.

Of course, the political effects of the global slowdown will depend on a number of country- and region-specific circumstances. But across the developing world, the crisis is likely to manifest itself in several ways:

1. **The (further) spread of anti-Western populism**: More than in recent memory, citizens in low- and middle-income countries may soon be united by their anti-Western and anti-market sentiments. Russian, Chinese, and some Latin American leaders have openly blamed the West for the current crisis. In Russia a majority of citizens now express a dislike of the West in general, and in particular, of the United States. More ominously, the youngest adults are now more anti-Western than their parents. The current crisis may also provide opportunities for leaders in many countries to use disillusionment with the Anglo-American model of capitalism for political advantage (see #2 below).

2. **Rising tensions in authoritarian states**: In good times when autocrats can ensure a steady flow of economic benefits to the population, citizens tend to acquiesce to their lack of voice. But in hard times, this “authoritarian bargain” can come undone. Under these conditions, some leaders may embark on limited political liberalization to survive. Others (e.g., Venezuela’s Hugo Chavez) may choose different approaches, relying on crackdowns, on expropria-

tions of foreign assets, and on anti-Westernism. And there is always the threat that governments may rely on xenophobia, factionalism, or ethnic loyalty to shore up their support, boosting the likelihood of violence.

3. **More violence in fragile states**: In sub-Saharan Africa, recession is expected to hit the most resource-dependent states the hardest: Nigeria, Angola, and the Democratic Republic of the Congo, where the Chinese have recently abandoned 40 copper smelters. In Bolivia, struggles for control over oil and gas reserves may turn violent in a deteriorating economy. And violence in Iraq, Afghanistan, and Pakistan may flare up as al-Qaeda and other militant groups find new recruits from the ranks of the newly unemployed.

4. **An increase in global criminality**: Maritime piracy off the horn of Africa and drug-related violence along the U.S.-Mexico border may both be omens of an increasing criminality among gangs that stretch around the globe, peddling guns, drugs, counterfeit goods, and human beings, and that thrive as economies collapse.

5. **Greater policy uncertainty everywhere**: Even where they can limit traditional political risks (violence, war, expropriation, currency inconvertibility, etc.), governments may find it impossible to resist public pressures to unwind trade and investment commitments, or to change regulatory and tax rules to benefit domestic constituencies over foreign investors. This kind of policy risk remains difficult to insure against, but is more likely to spread during bad economic times.

Action Items for Global Coordination

In hard times it is always difficult for governments to make international economic cooperation a priority. The G-20, representing the world's largest economies, is in a unique position to play a role in establishing dialogues on appropriate national and international responses:

1. **(Re)build safety nets in developing countries**: Beyond increasing short-term allocations for health and education spending, developing nations within the G-20 need to prioritize the reform and reconstruction of their welfare states. In particular, many of these countries lack well-integrated, universally-accessible welfare benefits that provide some form of common insurance against income loss. Instead, safety nets in most of these countries are typically a hodge-podge of public employment schemes, transfers to the poor, and incentives to maintain private employment (e.g., by cutting wages and work hours) alongside a limited social security system.

2. **Promote diversification in resource-dependent economies**: If it has not been abundantly clear until now, commodity-price booms do not make middle- and low-income countries rich. They need competitive, innovate real sectors to create jobs and growth, and to create a middle class that is not in constant danger of having its lower echelons decimated during downturns.

This requires countries to prioritize new skills and new approaches to post-primary education, and to support the establishment and funding of national research and development infrastructures.

3. **Focus on flash-points**: Targeting development aid to potential global hotspots—the fragile states, and states under severe fiscal stress due to debt-sustainability constraints—before conflicts flare may prove critical in the coming year.

4. Emphasize a greater role for regional core states: Large regional economies should take the lead in seeking collective solutions to problems of security and instability, as well as in stabilizing markets, thereby relieving developing nations from having to rely exclusively on richer governments or international financial institutions. Brazil, China, India, and South Africa, for example, are relatively well-positioned to keep regional markets open, to keep smaller regional governments in line, and to exert leadership in difficult times.

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