Global Economy and Development at BROOKINGS

SEPTEMBER 17, 2009

G-20 SUMMIT

RECOVERING FROM THE CRISIS

ERNEST ARYEETEY
CHAD P. BOWN
COLIN BRADFORD
MAURICIO CÁRDENAS
KEMAL DERVIŞ
MWANGI S. KIMENYI
JOHANNES LINN
DOMENICO LOMBARDI
WARWICK MCKIBBIN
ADELE MORRIS
JOHN PAGE
ESWAR PRASAD
PETER WILCOXEN

CONTENTS

INTRODUCTION

KEMAL DERVIŞ

As the outlook for the world economy has improved since the London Summit last April, the G-20 leaders will meet again in Pittsburgh on September 24. There is the prospect of financial and economic recovery—albeit fragile—and the question is how to ensure that it is sustainable. While it is too early to withdraw the substantial fiscal stimulus and monetary easing, the task that G-20 leaders have to confront now is one of coordinating the composition and timing of their policies so that the world economy progressively gains in strength while the long-run health of public finances does not threaten the recovery process.

This is a potentially more daunting task than the one G-20 leaders faced in the winter and early spring of 2009. Then, they made clear that they would respond to the severity of the crisis by adopting unprecedented expansionary policies and by strengthening the International Monetary Fund so as to firmly counteract potentially devastating effects of the crisis on emerging market economies. Now, more fine-tuning is needed as well as greater support for the poorest countries and for employment generation worldwide.

The timely actions in committing substantial financing to the IMF and in endorsing the Special and General Allocations of Special Drawing Rights for an amount of $283 billion have generated a confidence-building effect among emerging market and developing economies. Leveraging on this record, the G-20 should focus on the next steps needed to consolidate the prospects of a steady recovery and long-term sustainable economic growth; and broaden the scope of their discussions by including other key issues like climate change and food security.

The Pittsburgh G-20 Summit marks the first summit that President Obama will chair. Leveraging on a more inclusive forum—than that of any enhanced version of the G8 into a G13 or G14 can offer—President Obama and the other leaders should develop a shared consensus on the broad governance reforms needed by the IMF as well as the other multilateral institutions.

Moving forward, G-20 summits should continue to be the important—albeit informal—platform through which leaders from systemically-important economies generate some shared understanding of their common pressing challenges. They cannot, however, replace the decision-making of formal treaty-based multilateral organizations, as their governance bodies are the only ones legitimated to make decisions on the governance, mandate, and policies of their respective organizations.

To enhance global coordination and to implement effective financial recovery policies, fellow Brookings experts provide recommendations on how the G-20 can overcome current global governance and economic challenges.

The G-20 and the World Economy: Sink or Swim: Eswar Prasad recommends that the G-20 maintain momentum on reforming the international institutions and advance international regulatory reform for the betterment of the overall global economy.

Confronting the Protectionism Spawned by the Crisis: Chad P. Bown makes the case for re-affirming the G-20 economies' commitment to the World Trade Organization and curbing trade-restricting policies created by the crisis.

The G-20 and IMF: Their Future Roles in the International Monetary System: Domenico Lombardi proposes that the G-20 should focus on supporting effective measures to reform the International Monetary Fund.

To the G-20: Don't Overlook Africa During the Recovery: Ernest Aryeetey, Mwangi Kimenyi and John Page assess the impact of the financial crisis on Africa and urge the G-20 leaders to support African economic recovery and growth.

Welcome to the New Era of G-20 Global Leadership: Colin Bradford and Johannes Linn assess the effectiveness of the G-20 summits and how to move the G-20 forward as the global steering body.

International Financial Redesign: A Latin American Perspective: Mauricio Cárdenas calls for international financial regulatory reform in order to address Latin America's need for greater financial development and to prevent future crises.

The G-20 and Climate Change: Achieving Comparable Effort Through a Carbon Price Collar: Warwick McKibbin, Adele Morris and Peter Wilcoxen propose G-20 leaders to focus on the challenges associated with climate change negotiations leading up to the United Nations climate conference in December.

THE G-20 AND THE WORLD ECONOMY: SINK OR SWIM

ESWAR PRASAD

FRAMING THE ISSUE

In early 2009, the world economy seemed to be headed into an irreversible decline. But a strong dose of stimulative monetary and fiscal policies—perhaps with an assist from the natural resilience of the market economy—seem to have done the trick in stabilizing the financial system and setting the stage for global recovery. Flows of private capital to emerging markets have been revived and world trade has begun to rise back to levels seen before the crisis hit. Consumer and business confidence is back on the rise.

While the overall sense of doom has been replaced by one of hope, the recovery has been highly uneven. The U.S. economy, which was at the epicenter of the crisis, still faces a long, hard slog in returning to decent growth. The continental European economies, especially France and Germany, have bounced back with surprising alacrity but are unlikely to record high growth. The emerging markets are another story altogether, with China and India, in particular, returning to remarkably high growth rates after their economies seemed to hit the wall at the end of 2008. Many other emerging market economies that were hit hard by the crisis, especially those in Eastern Europe, are still in the doldrums.

This leaves three questions on the table for the Pittsburgh G-20 Summit: What needs to be done in the short run to secure the recovery? What are the medium-term risks that the world economy faces? What does all this bode for global macroeconomic and financial stability?

POLICY CONSIDERATIONS

Economic Recovery

The global economic recovery is tepid and far from assured. The U.S. economy still faces enormous headwinds, including weaknesses in the commercial real estate sector, a rising unemployment rate and weak consumer demand. On the plus side, there is still a great deal of stimulus wending its way through the economy, inventory rebuilding has begun and confidence indicators are up. A few other advanced economies are in better shape but domestic demand still remains weak in most of them. While the major emerging markets are growing strongly, they are not capable of pulling in large volumes of net imports from the rest of the world and thereby serving as engines for world growth. Even while industrial production and GDP are beginning to bounce back from their lows, employment growth continues to remain weak even in the fast-growing economies.

Despite all the concerns about the efficacy and dangers of the stimulus measures, withdrawing monetary and fiscal stimulus prematurely is a greater risk at this stage when economies, markets and sentiments remain fragile. An important question to ask is whether the measures taken to stanch the crisis might be steering the global economy toward the edge of another cliff.

Global Imbalances

The deep irony is that the recovery is setting the stage for a resurgence of global macroeconomic imbalances, which contributed to getting us here in the first place. While the root causes of the financial system lie in weak regulatory systems and regulatory failures, global imbalances—a consumption binge in the U.S. and a few other industrial economies financed by excess savings in Asia and other emerging market countries—permitted the problems to fester and blow up in our face. Indeed, as we come out of this crisis, some of the growth patterns are getting entrenched and global imbalances could well bounce back.

China still needs exports to generate jobs and sell the surplus output that is going to result from its investment spurt and that cannot be absorbed by domestic household demand. Large economies like Germany and Japan also remain dependent on exports to power their recoveries. In sum, the rest of the world still seems to be looking to ride the coattails of the U.S. This could hold back the U.S. recovery itself and create trade tensions. Of course, in the U.S., private household demand may remain weak in the short term but government spending is more than making up for it, leading to large dissaving at the national level.

From a long-term perspective, emerging markets now have stronger incentives for self-insurance through reserve accumulation. First, emerging markets have seen that even large stocks of foreign exchange reserves can shrink very quickly. For instance, India and Russia lost nearly a fifth of their respective reserves stocks in just a few months at the height of the crisis. Second, even the IMF's expanded resources may not be enough to offset a simultaneous swoon in multiple large emerging markets. In this crisis, even countries that borrowed from the IMF found that accepting IMF conditions attached to those loans did not lead to a surge of private capital. Third, many emerging market politicians see borrowing from the IMF as a toxic proposition—there remains a deep stigma associated with turning up at the IMF's door with a begging bowl.

In short, the conditions may soon be ripe for the crisis that many macroeconomists were more concerned about—a plunge in the value of the dollar that eventually requires a painful macroeconomic adjustment in the U.S. and the rest of the world. What can be done about this? Not surprisingly, one part of the answer is for each country to do the right thing. But this will have to be supplemented with measures to strengthen the international monetary system.

Domestic Reforms

The U.S. needs to get its fiscal house in order. Given the sheer size of the U.S. economy, high levels of U.S. deficits and debt could create global instability. Recent official estimates of a deficit of $1.6 trillion (11.2 percent of GDP) this year followed by an overall deficit of $9 trillion over the next decade suggest that the U.S. government could soak up a lot of U.S. and global savings. This would leave a lot less for private investment and also indirectly crowd out this investment if the scale of government borrowing drove up interest rates. It is premature for the U.S. to pull back fiscal stimulus, but a well-articulated plan that lays out a path for restoring fiscal stability is essential.

In China, the bank-financed investment boom may have exacerbated the pattern of investment-led growth that is weak on employment creation. If employment and household income growth do not keep pace with output growth, China could face a situation of simultaneous price deflation and bubbles in asset markets, including real estate and equity markets. The Chinese government has attempted to boost household consumption by strengthening the social safety net, raising public expenditures on healthcare, and providing incentives to consumers to purchase durables. These efforts will take time to bear fruit and may not amount to much if there isn't serious reform of the financial system (including incentives faced by banks) that would allow bank credit to flow to small- and medium-sized private enterprises that are more dynamic and could serve as engines of employment growth. Financial sector and other reforms, including a more flexible exchange rate that would allow for a more independent monetary policy, are all important components of this process.

Other major economies, including Japan and the key European countries, have their own long reform agendas, including labor and product market reforms, along with measures to strengthen their financial sectors.

International reforms

The G-20 has taken impressive steps to coordinate global stimulus efforts, make progress on financial regulatory reform and increase the stability of the global financial system. But the report card is still mixed. For instance, the IMF now has a lot more resources, but reforms to give the emerging markets a more significant voice in the institution have come to a grinding halt. In the absence of serious institutional reforms, the emerging markets will be reluctant to rely on the IMF. Instead, they will continue to self-insure and do whatever it takes to accumulate reserves.

The G-20 has become a useful forum where key emerging markets have a more powerful voice. But there remain major substantive and philosophical rifts among different groups of countries within this forum. These fault lines could become increasingly apparent now that the worst of the crisis is behind us and various economies are reverting to type. The U.S. and the U.K. maintain a healthy Anglo-Saxon respect for market forces while France and Germany lead the continental European economies in wanting to increase the scope and tightness of regulation. The main emerging markets are most concerned about how a new international regulatory framework could be intrusive and push them to a place where they would rather not be in terms of financial development and regulation.

G-20 leaders should make a serious attempt to tackle some of these substantive differences frontally rather than papering over them with lofty-sounding sentiments. Reform of the IMF's governance structure is also overdue and the G-20 should move beyond baby steps on this front.

ACTION ITEMS FOR THE G-20 SUMMIT

Leaders of the G-20 need to maintain momentum on reforms. One risk is that memory may prove short, as it often does, and the drive for both domestic and international reforms may be thwarted by domestic politics in each country as well as the rent-seekers in the financial system who helped precipitate the crisis in the first place.

In addition to the macroeconomic issues discussed above, the G-20 must advance critical financial regulatory reform in order to prevent future implosions of the financial system, especially in advanced economies. G-20 leaders need to redouble their commitment to beat back protectionist impulses, not just in words but also in deeds.

The financial crisis has clearly shown the world is very interconnected—there is now a national as well as international dimension to all of these problems and their solutions. We will all swim or sink together.

CONFRONTING THE PROTECTIONISM SPAWNED BY THE CRISIS

CHAD P. BOWN

FRAMING THE ISSUE

The financial crisis led to a global economic recession that, in many nations, inevitably spawned industry demands for protectionism in the form of new import barriers. To prevent a full-scale proliferation of new trade restrictions, the G-20 economies must re-affirm their commitment to the World Trade Organization system in two ways: by better adhering to WTO rules on when and how to impose new restrictions, and by exercising a leadership that declines to impose such restrictions whenever possible, even in the face of difficult domestic politics.

POLICY CONSIDERATIONS

Historians will one day examine the current global economic crisis in retrospect and confront the efficacy of the WTO system and the G-20 leadership with a series of questions. First, how well did the WTO architecture limit the initial incidence of protectionism? Second, did WTO firewalls prevent somewhat inevitable initial acts of protectionism from spreading? Third, how quickly did the system allow leaders to subsequently dismantle the new protectionism once the crisis had subsided?

The data indicates that major developed and emerging economies have increased their use of trade-restricting policies such as antidumping, safeguards and countervailing measures since the onset of the crisis. For the 25 countries covered by the World Bank-sponsored *Global Antidumping Database*, new requests for administered protection rose 34 percent in 2008 relative to 2007 levels, and the first half of 2009 saw an additional 18.5 percent increase relative to the same time period in 2008. Because many of these newly initiated investigations take over one year to complete, the imposition of new trade barriers is likely to continue to trend upward into 2010 and perhaps beyond, despite any imminent improvement in the global macroeconomic environment.

That countries are resorting to *this kind* of protectionism overall during the crisis is both good and bad. One upside to a permissive system that allows individual industries access to import-restricting trade remedies is that it may help to limit protectionism at the national level. While use of trade remedies leads to individual acts of small scale protectionism—higher tariffs for certain products and/or against certain trading partners—this may be better in some instances than an alternative of larger scale protectionism that results in the imposition of massive tariffs or new quantitative restrictions across entire industries or national economies. This is the kind of protectionism that took place in the Great Depression era of the 1930s, which had a more destructive effect on trade.

While there is some upside to this kind of protectionism, it is also important to understand that most of the decision-making of whether and how a country imposes new trade barriers under this type of system has become bureaucratized. The rules require that the bureaucracies making the decisions on protectionism only impose new trade barriers if there is evidence of injury to the domestic industry, and if this injury is *caused by* dumped, subsidized, or surging imports. How strictly these bureaucracies follow WTO rules and guidelines can vary substantially across countries due to quality and oversight. The implication is that the bureaucracies themselves are also a contributor to the scope and scale of new protection that gets implemented.

The use of trade remedies has seen a measured increase during the recession, and we are a long ways of being "out of the woods" on the concerns over protectionism spawned by the crisis. Nevertheless, it is useful to both take stock of what problems have arisen thus far and to consider the implications of this for the future.

First, whether examining the data in either levels or in shares, it is clear that a tremendous amount of new protectionist activity is being directed against China's exports in particular. Globally, industry demands for new import restrictions against China under country-specific trade remedies such as antidumping and China-specific safeguards were up 23 percent in 2008, and they are on pace to be another 10 percent higher in 2009. Since January 2008, over 75 percent of the WTO membership's total industry requests for new import restrictions under these policies have specifically targeted products from China. Whether the policy-imposing nations are from developed (U.S., EU), emerging (India, Brazil) or developing (South Africa, Turkey, Argentina) economies, China's exports are a major target for new trade barriers.

Second, India is the one major economy that does stand out for its use of trade remedies during the crisis. Beginning in 2008, India's industry demands for new trade barriers against imports make up roughly 25 percent of the total use of trade remedies by the 25 countries covered by the *Global Antidumping Database*. Not only is India's use sizable relative to its use in other economies, these new trade barriers have the potential to affect a major share of India's trade. Up to 2 per cent of the value of India's 2007 imports were in product categories that would subsequently be subject to antidumping or safeguard investigations for new trade barriers in 2008-2009, more than double the amount of any other policy-imposing country.

These first two points combine to highlight what may be the ultimate legacy of the crisis-spawned protectionism—that developing countries are imposing new trade barriers against exports from other developing countries. Because most of these new barriers affect "South-South" trade, a risk is that these newly-created trade barriers may slow developing economy recovery efforts. Many developing countries rely on potential exporting sectors that, if not shut out of these foreign markets, may otherwise be well-positioned to contribute to their economies' overall growth and recovery strategy. Furthermore, many countries rely on imports of inputs and other intermediate products to allow their domestic firms to grow and compete in the global economy. A final concern is that an increase in South-South trade barriers spills over to introduce new frictions complicating the political relations between economies that may have otherwise been showing signs of coordination on key multilateral issues such as the Doha Round of trade talks or even climate change negotiations.

Because the imposition of new trade barriers during times of economic recession is somewhat inevitable, a final question is how well-positioned is the WTO system to encourage leaders to dismantle the crisis-spawned protectionism resulting from new antidumping and safeguard measures? While purely speculative at this point, in large part the answer to this question will depend on how WTO members ultimately choose to respect the negotiated WTO rules on sunset provisions as well as the evolving WTO dispute settlement system's case law and jurisprudence.

The historical record of country behavior on how and whether they remove safeguards versus antidumping is quite different. With respect to safeguards, the rule is that the trade barriers are typically allowed to remain in place for three or four years before they must be removed. Furthermore, each year following the imposition of the initial barrier should result in a "relaxation" of the trade barrier—either a reduction in the size of the new tariff or an expansion in the size of the imposed quantitative limit on imports. The historical record on safeguards is relatively good, as most implementing countries have followed the rules and removed them when so required, also when such barriers were found under formal dispute settlement to have been WTO-inconsistent. For antidumping on the other hand, the historical record is not as charitable. While the rules indicate that new trade barriers are supposed to be removed after five years, in many instances in many countries, the barriers are not removed. One of the key elements to the speed of the global economic recovery may be whether this pattern is broken at the conclusion of the current crisis.

ACTION ITEMS FOR THE G-20 SUMMIT

The rules-based WTO is a critical component to the international economic system. The ultimate historical record on how the global economy responded to the inevitable demands for protectionism in the midst of the current economic crisis will largely be judged by G-20 actions from this point forward. First, did these economies really follow the rules? While many industries were injured during the recession, did the G-20 reign in the actions of their trade remedy bureaucracies by limiting the imposition of new trade barriers to instances in which the *cause of* the injury was dumped, subsidized, or surging imports, as the WTO rules require? Second, in instances in which G-20 leaders could exercise political leadership by declining to impose new trade barriers—did they?

THE G-20 AND IMF: THEIR FUTURE ROLES IN THE INTERNATIONAL MONETARY SYSTEM

DOMENICO LOMBARDI

FRAMING THE ISSUE

The G-20 Summit in Pittsburgh provides prime opportunity for President Obama and other global leaders to put their weight behind the International Monetary Fund Managing Director's efforts by chartering a time-bound, concrete roadmap for IMF reform based on the recommendations formulated through recent discussions in the governance bodies of the IMF, previous G-20 summits and by leading experts and global civil society.

POLICY CONSIDERATIONS

In the midst of a deepening global crisis that was increasingly threatening the stability of the world economy, and just days before the London G-20 Summit, the IMF announced a significant overhaul to its lending framework. Its heightened stature in the global economy has resulted in a rapid increase in Fund financing—from admittedly historically low levels. Leaders at the London Summit subsequently agreed upon a rapid and substantial increase in the Fund's lending capacity. The mobilization of unprecedented resources has aimed to ensure that the IMF can comfortably meet potential demand from member countries while bolstering public confidence in that international spillovers can be adequately managed. Recognizing that a general quota increase may require time, Fund resources have been supplemented by official borrowing: direct bilateral lines of credit, issuance of notes, or the expansion of existing credit arrangements within the so-called New Arrangements to Borrow (NAB).

The Fund established the new Flexible Credit Line, providing for uncapped resources to countries with a sound track in policy implementation. In an unprecedented move, three countries—Mexico, Poland and Colombia—requested IMF precautionary assistance under the FCL terms. Access limits to Fund resources under the other facilities have been doubled and unused facilities have been dropped while conditionality has been simplified by scrapping structural performance criteria in favor of greater reliance on program reviews and ex ante policy measures.

Further, the Fund has stepped up its concessional lending framework for low-income countries. Besides doubling concessional lending access limits, the Fund capacity has been increased to up to $17 billion through 2014, including up to $8 billion over the next two years, from an annual concessional lending capacity of roughly 6 billion in 2008. This exceeds the call made by the G-20 in London to double concessional lending. Thanks to the mobilization of additional resources, including those from sales of IMF gold, the Fund will grant interest relief, with zero payments on outstanding concessional loans through end-2011, to sustain low-income countries while they cope with the crisis. Moreover, interest rates will regularly be reviewed so as to preserve the concessionality of the resources loaned to poor countries. Finally, facilities for low-income countries have been overhauled with the aim of better meeting their needs and alleviating their challenges.

These measures aimed at greater institutional effectiveness have not been followed up by any substantial governance reform. Several internal reviews have been conducted inside the IMF, the G-20 (where IMF reform has been the focus of a dedicated working group), and through other initiatives fostered by independent institutions, NGOs and experts. Moreover, the final report to the IMF Managing Director on the consultations that the IMF has held with the "fourth pillar" (academia, think-tanks and other civil society organizations) on its governance reform process was recently finalized. While these initiatives have produced a wealth of analyses and reflections, there is a unanimous feeling that action is now critical.

How should the G-20 and IMF shape their relationship? For the first time in history, heads of states and of governments have discussed IMF governance and initiatives—a task they traditionally mandated to their respective finance ministers. What this means in the long run for the role of the IMF is unclear. Two scenarios can be envisaged.

First, member countries could use this opportunity to address the greatest challenge that the IMF has faced since the end of the Bretton Woods era in the 1970s—when its member countries withdrew political capital from the institution, making it ineffective as a forum for multilateral discussions. That shift in authority away from the Fund and back to member countries was a defining feature of the new IMF role that emerged after the demise of the Bretton Woods system, whereby national policymakers claimed for themselves absolute discretion in formulating their economic policies.

To counteract this shift and its effect on the Fund, member countries would have to be willing to delegate some sovereignty over their economic policies to the institution, to make the Fund a true solution-finding forum. So far, however, the IMF's own ministerial committee—the IMFC—has played a marginal role in the current reform process. This has renewed calls from officials, analysts, and civil society organizations for the activation of Schedule D in the IMF's Articles of Agreement: establishing a decision-making ministerial Council. While this would give greater political impetus to the IMF's decision-making, its role—under this scenario—cannot be merely subordinate to that of the G-20.

Ideally, the G-20 Finance Ministers could be dissolved into the IMF's ministerial Council. But historically, member countries want to retain flexibility by having their own inter-ministerial forums in which to discuss economic issues of common concern, in addition to multilateral forums. As a result, the relationship between the new ministerial council and the G-20 may be one of co-existence, the contours of which will have to be defined as experience is gathered.

In the second scenario, the G-20 would indeed become the global steering committee, with the IMF serving as an executive arm (despite the existence of a ministerial council), as it is highly regarded for its fast, competent implementation capacity; its political capital, however, would still be provided by entities outside the institution. This alternative, and perhaps more realistic, scenario is more in line with recent history.

What are the implications for the future role of the IMF? Both scenarios do hinge on the IMF as the international agency for overseeing the international monetary system. The former does so by providing the institution with greater political capital and legitimacy; the latter by assigning it to be more of a "implementing agency."

ACTION ITEMS FOR THE G-20 SUMMIT

Consistent with both interpretations is the renewed interest in the IMF shown by the G-20 countries, who significantly stepped up the Fund's lending capacity in order to build confidence that the financial crisis would not spill over, unchecked, into emerging-market and other developing countries.

Under the first scenario, such enhanced lending capacity would be geared toward underpinning the institution's main role of provider of "the machinery for consultation and collaboration on international monetary problems," as stated by Article I of the IMF's Articles of Agreement. Under the second scenario, more simply, the lending capacity would underpin IMF support for medium- and small-sized members when hit by a crisis, upon their request.

The scope and nature of the next institutional reforms will determine what role the membership intends to attribute to the IMF. The Pittsburgh G-20 Summit may outline what that role is going to look like.

TO THE G-20: DON'T OVERLOOK AFRICA DURING THE RECOVERY

ERNEST ARYEETEY, MWANGI S. KIMENYI AND JOHN PAGE

FRAMING THE ISSUE

As the G-20 Summit convenes in Pittsburgh, there are increasing signs that the global economy may have turned the corner on its worst recession in four decades. Global economic growth is now projected by the IMF to reach 2.5 percent in 2010. Those meeting in Pittsburgh may be tempted to focus their attention on efforts to speed the recovery in the major economies seated around the table—a conversation from which African voices will be largely excluded—but to ignore both the damage done to Africa by the global crisis and the opportunity for the G-20 to speed its recovery would be a serious mistake.

POLICY CONSIDERATIONS

After one of the longest periods of sustained economic growth in Africa's post-independence history, the crisis has hit the continent hard and threatens to erode the gains made over more than a decade. Economic growth in Africa for 2009 is now projected to be only about 1.5 percent compared to the 5.4 percent in 2008, and growth prospects for the near future are not encouraging.

The prices of many African export commodities have dropped by 40 percent or more, lowering the export revenues that are an important source of government finance. Remittances have fallen by more than 4 percent and Foreign Direct Investment has declined by about 10 percent. The shortfall in export revenues is predicted to be about $251 billion in 2009 and $277 billion in 2010. At the same time, food prices have increased dramatically resulting in a large proportion of Africans who are food-insecure.

The crisis is likely to have long-lasting impacts on Africans because prior gains in health, education and access to public services are at risk. When economic times are bad in Africa, there is a rapid decline in indicators of human development, such as maternal and infant mortality, education enrollment and completion rates, and women's employment opportunities. But when economic times improve, they do not recover with the same speed. For this reason, if Africa is to maintain momentum toward the Millennium Development Goals, protecting human development outcomes is essential.

In sharp contrast with earlier economic downturns, Africans have worked hard to adjust to the crisis. To preserve macroeconomic stability many countries have significantly restricted their fiscal programs to reflect the reality of declining resources. Today, African economies are more open, governance has improved, and prudent financial regulation and the independence of central banks are the norm, rather than the exception. Governments have been making investments in both "hard' and "soft" infrastructure to improve the investment climate. Without these reforms, African countries would have been even harder hit.

But, as crisis turns to recovery, there is a crucial need for partners such as the G-20 to support Africa in securing the gains already achieved. We propose that those in Pittsburgh commit to action on three broad fronts:

Focus on Vulnerability: Dealing with the increased vulnerability brought on by the crisis remains the most urgent need. African governments are currently faced with tight budget constraints and have limited flexibility to increase support to the poor. Already several countries are facing serious shortfalls in financing public services, especially those that target the MDGs. Resources are needed to sustain investments in education, health, and water and sanitation. In addition, and especially with the increase in food-insecurity, the G-20 could greatly help the poorest Africans through financing the provision of safety nets.

Halt economic decline: Public expenditure alone, however, cannot eliminate the risk that human development progress will be significantly retarded. Jobs and household incomes are also needed. For this reason it is crucial to commit resources to prevent economies from sliding further into recessionary traps. African economies urgently require substantial fiscal stimulus to reduce unemployment and generate incomes, but most lack the revenues to do so on their own. In 2008, African countries recorded a budgetary surplus of 2.8 percent of GDP; due to the crisis, they face a deficit of 5.4 percent of GDP in 2009. Budget support remains an essential tool for spurring the recovery.

Support economic transformation: For the vast majority of the region's economies, lack of economic and export diversity act as a powerful constraint on future growth. Reliance on commodities exposes countries to crisis and leaves the authorities with limited policy options. Efforts to restructure Africa's economies have not achieved much over the years. Governments—often at the urging of their development partners—have paid more attention to short-term needs than to longer-term growth and development. In 2005 manufactured exports per person for Africa were just $39, compared with $211 in Vietnam. Bangladesh alone produces as much manufacturing output as all of sub-Saharan Africa (excluding South Africa). So, a key to the region's recovery will be its ability to compete in new product and export lines, which depend largely on better infrastructure.

ACTION ITEMS FOR THE G-20 SUMMIT

What can the G-20 realistically commit itself to do? First, it can honor its existing aid pledges and push for additional financing through the African Development Bank and the Bretton Woods Institutions. The focus of much of this new assistance should be on closing the region's enormous infrastructure gap. Policies that promote African exports are also important. Most G-20 countries have erected new protectionist trade barriers in response to the crisis. These barriers harm Africans and G-20 consumers. It is time to stop protecting and start promoting, perhaps through a G-20 wide system of temporary preferences for non-traditional African exports. Finally, the G-20 can work with Africa to highlight the major changes in policies and institutions that have taken place in the last 10 years—changes that make the continent more attractive to foreign direct investments targeted to manufacturing and value addition in agriculture. While the G-20 may be understandably tempted to look inward to speed the global recovery, it must look to Africa as well.

WELCOME TO THE NEW ERA OF G-20 GLOBAL LEADERSHIP

COLIN BRADFORD AND JOHANNES LINN

FRAMING THE ISSUE

In retrospect, it is likely that history will reveal the London G-20 Summit on April 2, 2009 as being the most successful summit ever. The previous 25 years of G7 and G8 summits have not delivered the same degree of results. The G-20 London Summit has achieved an unprecedented concerted fiscal expansion, which may be the turning point in addressing the worst recession since the Great Depression. It initiated significant national and international reforms in the oversight, supervision and regulation of financial systems and institutions. And it launched a process of reform of the international financial institutions—such as the IMF and the World Bank—which, among other things, should restore the IMF to its pivotal position in the global financial system along with the resources it needs to carry out this role.

More than that, the series of G-20 summits since November 2008 to the upcoming summit in Pittsburgh reveal a gradual increase in the reach of G-20 efforts in addressing broader issues. The initial G-20 summit in Washington, 10 days after the U.S. presidential election, was exclusively focused on the financial crisis and economic recovery. While the G-20 London Summit further concentrated on the crisis and recovery, it also called on the G-20 to accelerate the development of a post-Kyoto framework on climate change. At an expanded session of the 2009 G8 summit in L'Aquila, Italy, 17 countries issued a call for G-20 finance ministers to focus on proposals for funding climate change mitigation and adaptation in developing countries—a major stumbling block in the climate change negotiations—to be presented to heads at the G-20 Summit in Pittsburgh.

So, in less than a year, three G-20 summits will have occurred in which the financial crisis, economic recovery, international institutional reform and climate change will have been addressed and specific actions will have been prepared. This is more than can be said for many G8 summits.

POLICY CONSIDERATIONS

Moving forward, will this lead to summit reform and establishment of a more legitimate and effective steering committee than the outdated G8?

In August, French President Nicolas Sarkozy noted in a meeting with French ambassadors that "the transformation of the G8 into the G14 has taken a decisive step forward." He claims that France supports Brazil's request to terminate the G8 and that the Canadian presidency in 2010 will begin to transform the G8 summit into a G14 summit. President Sarkozy further remarked that France intends to "totally finish the [summit] transformation into the G14 under the French presidency in 2011."

This is a puzzling prognostication of the result of summit reform efforts of recent years. It is puzzling because it is inconsistent in itself, and inconsistent with the pattern and performance of the G-20. Having a G14 is a new idea, not a given idea. The G8-plus-5 (China, India, Brazil, South Africa and Mexico) have been meeting in the sidelines of the G8 since the 2005 summit in Gleneagles and has some record of continuity and acceptance. Italy added Egypt, with French support, to one of the segments of the G8 Summit sequence in L'Aquila. Presumably, President Sarkozy is pushing for a G14 as a result of the G8-plus-5-plus-1 (with Egypt being the added country).

The challenge with this grouping is three fold: It is not widely accepted; it is an extension of the G8 rather than a replacement; and it is overturning the pattern and trend of G-20 summits taking center stage.

Enlarging the G8 to a new G14 has the effect of replacing the G-20 as the global steering group that it has become. If this were to it happen, it would strip out a number of key countries now playing important roles in the new global leadership forum of the G-20: *Australia*, a leader of international reform and advocate of multilateralism; *Korea*, a model country of long-term dynamic economic growth; *Indonesia*, the largest Islamic country in the world; *Turkey*, another Muslim country that is an historic bridge between East and West; *Saudi Arabia*, an Arab Muslim country and leading oil producer; and *Argentina*, perhaps the only country membership in the G-20 that could be seriously questioned. It will also eliminate two European countries—the Netherlands and Spain—which President Sarkozy heavily pushed to include last November.

The smaller G14 has less to recommend in terms of representativeness than the G-20, has no track record, and has little claim to replace the G-20 except perhaps as a device to continue the G8 at the center of a G14 in which the original eight are in the majority. A G13 or G14 might have made sense as a significant summit reform if the G-20 summits had not already emerged as the new focal point for global leadership. Now it is a retrogressive step. If Mr. Sarkozy's real concern is with the large size of the G-20—which is at odds with his push to have countries added not too long ago—then the next logical step is to reduce the excessive European representation, not to push out key emerging economies.

ACTION ITEMS FOR THE G-20 SUMMIT

The G-20 is establishing itself as a forum, taking *responsibility* for global macroeconomic policy as an instrument of public policy for the public good. It is asserting *stewardship* of the global financial system on behalf of the public interest, replacing the idea that hands-off market fundamentalism is best. And the G-20 is becoming the *driver* of international institutional reform based on the idea of the *international community* as a keeper of the peace and a protector of all the world's people, rich and poor, filling the void in leadership of the international system. A permanent, but lean secretariat would help ensure an effective function of the G20 in future.

The purpose of the G8 in this context is to yield center stage to the G-20 and to assign itself to the role of caucus for its members. This would give the G8 countries a new role to sort out positions among themselves and to facilitate the functioning of the G-20. It should end the pretense that the G8 is the global steering committee and the masquerade of inviting leaders from the non-G8 world as guests instead of members. Canada and France as hosts of the G8 summits in 2010 and 2011, respectively, have the honorable and high-minded job of scaling back the G8 to a new supportive role rather than being the awkward handmaidens of a new G14 in the new era of the G-20 which has already begun.

INTERNATIONAL FINANCIAL REDESIGN: A LATIN AMERICAN PERSPECTIVE

MAURICIO CÁRDENAS

FRAMING THE ISSUE

As the global economy begins to improve, G-20 leaders should now turn their attention to addressing long-term challenges. Rather than focusing on bankers' compensation rules or phasing out stimulus measures, the Pittsburgh G-20 Summit should examine the underlying causes of the financial meltdown and explore ways to prevent future recurrences. Reforming the international financial regulatory framework should be the top priority.

Latin America, a region that needs greater financial deepening, is represented in the G-20 by the presidents of Argentina, Brazil and Mexico. It would be beneficial to them to put forward some concrete proposals to promote greater financial development, not less. A new wave of ill-conceived regulation and red tape will slow down the financial sector development and will hurt the region's opportunity for growth with equity.

POLICY CONSIDERATIONS

What the region urgently needs is a new international financial architecture that would provide greater stability to capital flows. Creating a new arrangement to mitigate the effects of "sudden stops" in capital flows should be a high priority. The consequences of the Asian and Russian crises in 1997-1998 were devastating mainly because there was no lender of last resort to provide liquidity to emerging countries. Facing a negative external shock and a financial crisis, the region underwent a major "adjustment" that only made the contraction deeper.

This time around, the U.S. Federal Reserve, as well as the IMF and the governments of Japan and China, has made available substantial resources to some key countries. However, these mechanisms have not been available for most countries, especially the smaller ones. Also, many of these facilities are designed for governments and central banks, leaving the private sector without a safety net—at least in the international arena. The costs are apparent. Corporations in Latin America have been unable to refinance their external obligations. Without a rollover facility, many have cut their investment plans. Therefore, in the future, more cooperation will be needed to prevent the loss of access to international financial markets.

While financial deepening and the provision of global liquidity are the top priorities for Latin America, the region should also actively engage in the reform of international financial regulation. The rapid development of cross-border capital flows, combined with the development of near-bank entities and over-the-counter products, not only requires an enhanced level of coordination and communication among regulatory agencies, but also greater diffusion and access to the basic knowledge that an effective supervision demands. The new architecture should make it clear that this particular knowledge is a global public good, which needs to be provided at a very low cost to governments that have lower initial capabilities. Most developing countries need cooperation to train highly competent regulators and supervisors. They also need to retain them, which means upgrading the compensation and incentive schemes.

During the last decade, Latin America has made significant progress in terms of financial regulation and supervision, but that progress is far from uniform. Many countries in the region still have bank-centered supervisory frameworks, even though near- and non-bank financial institutions are becoming an increasing source of systemic risk. A key recommendation is to expand the perimeter of regulation, ideally under a single entity.

Leaders participating in the G-20 meeting should promote measures to reduce the procyclical bias in financial regulations, both in the developed and developing world. This is not new to Latin America: some countries have adopted forward looking provisions that can serve as examples. Countercyclical capital adequacy requirements have been discussed but not established—mainly because more debate is necessary, particularly on implementation. Countercyclical multipliers to variables, such as risk weights, default probabilities, and discounts (haircuts), should consider the product-type and industry of exposure, but also the specific shocks that affect the business cycle and investor and confidence sentiments in each country.

In this context, Latin American leaders must highlight the links between prudential regulation measures in the developed world and financial flows to developing and emerging countries. For example, recent data shows a marked contraction in cross-border lending by foreign banks to Latin America in 2008 and 2009. To a large extent this has been the result of tight inter-bank liquidity and pressure on major banks' capital positions induced by regulators. Reductions in bank lending to developing countries were undesirable, and likely unintended, but they reflect the high degree of interdependence in today's world.

ACTION ITEMS FOR THE G-20 SUMMIT

Leaders from Latin America have much to contribute in the discussions at the Pittsburgh G-20 Summit. They should try to steer the discussion away from bonuses and other compensation matters and toward the issues of liquidity provision and regulation. These issues may have less electoral resonance, but they are far more relevant. G-20 leaders from Latin America should push for progress in these areas to help prevent a future setback in the emerging world.

THE G-20 AND CLIMATE CHANGE: ACHIEVING COMPARABLE EFFORT THROUGH A CARBON PRICE COLLAR

WARWICK MCKIBBIN, ADELE MORRIS AND PETER WILCOXEN

FRAMING THE ISSUE

Climate negotiations are currently at the forefront of global policy debates. Leaders at the G-20 Summit in Pittsburgh should focus on the challenges associated with the negotiations, how the recent economic crisis has affected countries on meeting emission targets, and how to move global climate policy forward. If effective, these discussions could be influential in implementing coordinated policy agreements at the 15th annual United Nations climate change conference in Copenhagen in December.

POLICY CONSIDERATIONS

The key to advancing global climate policy is in the United Nations Framework Convention on Climate Change (UNFCCC) 2007 Bali Plan of Action. The Plan highlights the need to ensure the "comparability of efforts" across developed countries while "taking into account differences in their national circumstances." Implementing these goals will require a modified approach to the negotiations that goes well beyond the Kyoto paradigm. The Kyoto Protocol focused on establishing national emissions targets measured as percentage reductions relative to a specified base year. However, differences in economic conditions can easily mean that countries with similar targets will experience very different costs, violating the goal of comparable effort. Indeed, variations in economic growth among developed countries between the Kyoto base year (1990) and the date at which it was to go into effect (2008) have led to large differences in emissions growth and, consequently, in the costs of meeting the Kyoto targets. To ensure comparability of effort, the new agreement implemented in Copenhagen will need to address costs directly. A transparent and robust method for doing so would be to include upper and lower bounds on the price of carbon dioxide emissions, a policy often described as a "price collar."

Expanding the agreement to include a price collar would have additional benefits as well. It would provide a path for rapidly industrializing countries such as China and India to take on gradually increasing commitments without fearing that their growth will be stifled. It would also help stabilize the agreement in the face of major economic disturbances such as the recent financial crisis and global economic downturn. The agreement will need to endure through many economic and political crises, and a price collar would help it do so.

A collar would supplement the emissions targets already under negotiation. It would require that each party undertake at least a specified minimum level of abatement effort, even if the country's target could be achieved with less. In addition, each party would be allowed to exceed its target if it could show that it was unable to comply in spite of undertaking a high level of effort. Specifically, in addition to a cumulative emissions target for the 2013 to 2020 period, major economies would agree on three things, known collectively as the "price collar":

1. A starting floor price on a ton of carbon dioxide-equivalent emissions for 2013;
2. A starting price ceiling on a ton of carbon dioxide-equivalent emissions for 2013; and
3. An annual rate of growth in the price floor and ceiling that reflects the real rate of interest, such as 4 percent.

To be in compliance, each party would demonstrate: (1) that it had imposed a price on carbon-equivalent emissions no lower than the floor over most or all of the commitment period, and (2) that its cumulative emissions were no higher than its announced target OR that its price on emissions had reached the ceiling for an appropriate proportion of the commitment period given the extent of its excess emissions.

This approach has several advantages. The ceiling allows each party to comply even if its target turns out to be unexpectedly stringent and impractical to achieve. The floor ensures that no party's commitment is unduly lax; it reduces the incentive for parties to negotiate overly-generous targets; and it limits the downside risk for investors in low-carbon technologies by guaranteeing a minimum payoff per ton of emissions avoided. Both aspects of the collar help to reduce the risks faced by investors, which will accelerate the development and diffusion of new technology.

A price collar also accommodates developing countries like China that are uncomfortable with hard emissions caps but might be open to imposing a carbon tax. Such countries could adopt a price floor—possibly without an emissions target at first, or with a low price ceiling—and then gradually transition to commitments more like those of industrialized countries.

Several implementation details would need to be negotiated, including guidelines for demonstrating compliance with the price collar. This would include methods of verifying the carbon price and the extent to which the price was effective. Emissions above the cap would need to be accompanied by an appropriate duration of prices at the ceiling and allowances transacted at that price.

The price collar could be implemented by each party in a manner most suitable for its domestic economy. A tax or cap-and-trade system would provide a transparent carbon price. However, regulatory measures could also be used via provisions for calculating an equivalent carbon price. For example, countries could calculate a shadow price on emissions analogous to the way the World Trade Organization converts trade protection policies into tariff equivalents. Parties could include existing fossil energy taxes when determining their compliance with the price floor, but such credit would have to be net of any subsidies to fossil energy or other greenhouse gas emitting activities. Each party would control any revenues generated by its domestic climate policy.

Some environmentalists are uncomfortable with a price collar because they believe that any limit on carbon prices would undermine the effectiveness of the agreement. However, without a price collar, parties to an agreement may be reluctant to undertake aggressive policies and may insist on loose caps, or none at all, rather than risk excessive stringency or non-compliance. Moreover, without a price ceiling, volatile macroeconomic conditions may cause countries to abandon the agreement entirely, a considerably worse outcome than allowing them to exceed their targets briefly.

ACTION ITEMS FOR THE G-20 SUMMIT

Focusing exclusively on reductions from historical emissions has greatly hampered climate negotiations to date, especially in regard to the role of developing countries where uncertainty about future growth and abatement costs is greatest. Combining a clear cumulative emissions target with a price collar would balance the environmental objective with the need to ensure that commitments remain comparable and feasible. Further, the price collar can ease major developing countries into the system by allowing them to adopt only a price floor in the early years. The G-20 Summit is the right group of countries meeting at the right time to steer global climate negotiations in a direction of comparable effort implemented through a price collar rather than by focusing on emissions targets alone.

Note: This paper is a shortened version of W. J. McKibbin, A. Morris and P. Wilcoxen (2009) "A Copenhagen Collar: Achieving Comparable Effort through Carbon Price Agreements" published by the Brookings Institution. The views expressed in the paper are those of the authors and should not be interpreted as reflecting the views of any of the above collaborators or of the institutions with which the authors are affiliated.

BROOKINGS

1775 Massachusetts Avenue, NW
Washington, DC 20036
202-797-6000
www.brookings.edu/global