The G-20 Financial Summit: Seven Issues at Stake

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INTRODUCTION

THE G-20 GLOBAL FINANCIAL SUMMIT: WHAT IS AT STAKE?

This Saturday, November 15, 2008, leaders of the G-20 countries will gather for the first time to address a financial crisis whose evolution highlights a dramatic shift in the contours of the global economy. As the world looks to China and other emerging powers to act as the engine for global recovery from a financial crisis that emanated from Europe and the U.S., the established economic and financial order is being turned on its head. Between 1960 and 2000, the fate of the world economy could reasonably be understood as the fate of the G-7. The G-7 share of output remained at roughly two-thirds of the global share of output. Since 2000, however, the G-7 share has fallen below sixty percent and, according to Brookings scholar Homi Kharas, is likely to fall to around a third by 2030. In contrast, the G-20 share has remained stable at 90 percent of the world economy since 1965 and is likely to remain there into the foreseeable future.

Can the G-7 remain the global economy's steering committee or is it time to pass the baton? The G-20 finance ministers forum was set up following the Asian Financial Crisis to create a more representative body to discuss issues of pressing global policy importance. Like the other international institution set up in the late 1990s—the Financial Stability Forum—the G-20 has not yet lived up to its promise. Now, for the first time, the G-20 is meeting at the Heads of State level rather than the Ministers level. This summit should mark the first step towards a more prominent role for the G-20 in global economic governance.

The G-20 meets at a key moment for the world economy with world leaders facing critical challenges of both a short- and long-term nature. So, what is at stake for the first G-20 summit and what can be done by the leaders who will gather seeking solutions? In this new report, Brookings Global scholars outline the seven key issues at stake and offer recommendations for strengthening the global financial architecture and its governance.

The possibility of a global recession will need to be met with a swift policy response. Just as the U.S., Europe and even China are engaging in expansionary macroeconomic policies, so too other emerging economies should be given the policy space for countercyclical policies where appropriate. Finding ways to maintain aid flows to the poorest countries should also be a priority. The global trading system must be reinvigorated if trade flows are to serve as a critical channel for global recovery.

The current crisis has also highlighted several longer term challenges of economic governance that this summit should begin to address. The functioning of financial regulation needs to be re-examined to establish the appropriate balance between financial innovation and risk management. The role of the IMF will also need to be rethought: whether this means an expanded role with strengthened macroeconomic surveillance or a diminished role in favor of regional financial cooperation is an open question.

1. **Financial Regulation and Supervision**. Eswar Prasad outlines the critical issues facing the leaders, including the need to redesign regulatory structures for increasingly complex financial systems and to increase transparency in the operation of specific markets and financial institutions.

2. **Stabilize Emerging Economies**. Mauricio Cárdenas notes the need for emerging market policymakers to deploy countercyclical policies in the face of depressed global demand and falling commodity prices and lays out several measures in support.

3. **Reform the Aid System to Fix the Slow-Burning Global Poverty Crisis**. Homi Kharas argues that leaders must look to maintain aid flows now more than ever at this critical financial inflection point, particularly as developing nations may be hit hardest and long-term global stability depends as much on reducing poverty as it does on fixing the regulations governing global private capital.

4. **Beyond the G-20: Why the WTO Is More Important than Ever**. Paul Blustein argues that the financial crisis proves the World Trade Organization is more relevant than ever for avoiding the beggar-thy-neighbor trade wars that deepened the Great Depression, and recommends that leaders use the summit as an opportunity to reinvigorate the multilateral trading system and refrain from any actions that would undercut the vitally critical contribution of trade to restarting growth.

5. **Now Is the Time for Permanent Governance Changes**. Colin Bradford and Johannes Linn applaud this first-ever meeting at the heads of state level of the G-20 countries and call for a permanent shift to the G-20 from the G-8 in order to make the governance of the global financial order more representative and more effective.

6. **Keep the IMF at the Center**. Lex Rieffel argues that the IMF must stay at the center of the international financial architecture but can do so only if its responsibilities, funding, and governance are reformed to reflect the growing importance of emerging powers and to apply its powers of surveillance to all members including the United States.

7. **What the U.S. and Asia Should Do: Establish a Global Financial Crisis Secretariat and an Asian Financial Facility**. Wing Thye Woo argues that Asia should adopt a regional financial swap facility to complement the IMF, much as the regional development banks complement the World Bank.

1 THE FUTURE OF FINANCIAL REGULATION

Eswar Prasad

What's at Stake

The recent global financial turmoil has brought into sharp relief the need to rethink many aspects of financial market regulation. There is clearly a need to redesign regulatory structures for increasingly complex financial systems and to increase transparency in the operation of specific markets and financial institutions.

These issues are a high priority for industrial countries as they try to put their financial systems back on their feet and prevent further collapses. But the need is equally pressing for emerging markets, even though financial systems in most of them have not been ravaged to the same extent. For these economies, the challenge is to rethink the financial development paradigm and the right lessons they should take from the crisis.

Let us review the five big considerations that national governments face as they survey the newly altered financial landscape and consider how to harness its potential while managing the risks it entails.

What Should Be Done

1. How to deal with the increasing complexity of financial institutions and markets?

The financial landscape has changed in important ways that will ultimately not be reversed even by the crisis. Even if some of the more exotic securities and derivatives products implicated in the crisis disappear forever, financial institutions in virtually every country now have a broad reach, both domestically and across national borders. Regulating these institutions as unified entities may make more sense than regulating specific parts of each of them.

The reality, however, is that the best-conceived regulation has its limits. Recognizing that reality, rather than maintaining the illusion that that the goal is to achieve a perfect regulatory system, may actually yield a more creative approach in terms of thinking about what is necessary to make market discipline work better and augment formal regulation. One lesson from the crisis in the U.S. is that implicit government involvement (in the government-sponsored enterprises such as Fannie Mae and Freddie Mac, for instance) and tight regulation of just part of the financial system can make matters much worse as this combination can distort the forces of market discipline.

2. How to strike a balance between financial innovation and management of systemic risks?

The broad concept of financial innovation has gotten tarred with the same brush applied to the exotic instruments that precipitated the crisis (in tandem with regulatory negligence and outright fraud). But the reality is that some innovations have improved the efficacy of financial intermediation and are here to stay. For instance, currency derivatives are essential for hedging

foreign exchange risk in open economies. Similarly, commodity derivatives can smooth income fluctuations for agricultural producers. This is not to say that such products are without their risks. But the role of the government should not be to block these markets but rather to foster them and bring them out into the open, where they can be regulated more effectively. Blocking the development of products for which there is a real demand simply drives them underground. Over-the-counter derivatives contracts, such as OTC currency derivatives, are harder to regulate and can in many circumstances be much riskier than exchange-traded products.

The key challenge for regulation is how to encourage and manage beneficial financial innovation without stifling it. It would be optimal to create some regulatory space for innovations, but the problem is that innovation that gets too far ahead of regulation can generate risks of its own. Recent events suggest the need for caution; while this is reasonable, it is worth keeping in mind that translating caution into regulatory overbearance that kills innovation has its own costs. Striking the right balance is the problem, and not an easy one to solve.

3. Should governments rethink the notion of promoting financial development?

There is an important difference between basic financial development and financial innovation in the form of exotic derivatives products. In many emerging market economies, the challenge is to develop markets that will allow for efficient financial intermediation of savings (both domestic and foreign) into productive investment. For economies such as China and India, this not only means strengthening their banking systems but also fostering a broader range of markets, including corporate bond markets and exchange-traded currency derivatives.

Moreover, for these economies there is still the key imperative of financial inclusion—bringing into the ambit of the formal financial system a large swath of the population that currently has no access. This is essential to give much of the population (particularly in rural areas) access to credit to promote entrepreneurship; saving instruments; and instruments to manage risk. Simple innovations such as creating exchanges for trading warehouse receipts electronically can also provide a huge boost in terms of agricultural finance. Financial inclusion is relevant in rapidly-growing economies not just for financial stability but also for socioeconomic stability (by providing opportunities for the economically underprivileged).

4. Where do macroeconomic policies fit in to this discussion about financial markets?

There is in fact a deep connection between financial markets and macroeconomic policies. The absence of a good financial system makes the transmission of monetary policy a lot less efficient and can therefore complicate its conduct. It is equally true that stable macroeconomic policies are a key building block for financial reforms. Using banks as a conduit for redistribution or as a device for financing large government budget deficits crimps financial development and reforms, and has large hidden costs that are ultimately borne by depositors and taxpayers. Here again, the challenge for emerging economies is to figure out how to move simultaneously on both fronts—better macro policies and financial reforms—in a mutually-reinforcing way.

5. Is there a role for global coordination of financial regulatory policies?

This sounds like a good idea but it is far from obvious that it is desirable, let alone feasible. There are certainly regulatory challenges posed by institutions that span multiple countries and could easily engage in regulatory arbitrage. Nevertheless, the logic of trying to de-

velop common regulatory standards across countries is not clear. Instead, what would be more productive is to use forums such as the IMF and the Financial Stability Forum to develop common principles for regulation, based on different countries' experiences and expertise, and then leave it to each country to apply those principles in a manner that takes account of domestic circumstances.

An important priority is to use a forum such as the IMF to coordinate and maintain oversight of macroeconomic policies in different countries. There are huge negative externalities to the global economy from misguided policies in systemically important countries. Even consensual behavior among big economies such as China and the U.S. has to be analyzed and understood in the context of the global implications of their policies. Recent events show that innocent bystanders can get caught up in the whirlpools created by such consensual behavior, especially as financial globalization has created tight linkages among countries and international spillovers have become larger and more rapid.

The IMF ought to be the institution that maintains global oversight of both macroeconomic and financial policies, but for this it should have some teeth—leverage over its member countries—rather than just hope that moral suasion will work. To be an effective institution, it needs capital and, more importantly, legitimacy—it has to be seen as an even-handed advisor and arbiter, rather than just as a tool of the U.S. and other advanced economies. Creative solutions will be needed to solve the twin problems and break the logjam that currently exists in these dimensions.

The Bottom Line

These are difficult times with many challenging issues on the table. While there are no easy answers to the complex questions posed in this note, framing the issues in the right way is half the battle. The Global Financial Summit is a good opportunity to get started.

Eswar Prasad is a Senior Fellow at the Brookings Institution and the Tolani Senior Professor of Trade Policy at Cornell University.

2 STABILIZE EMERGING ECONOMIES

Mauricio Cárdenas

What's at Stake

Recent events in financial markets, as well as the prospect of a recession in the U.S. and other industrial economies, have created new challenges for emerging countries. Avoiding major set backs in reducing poverty and inequality should be one of the issues to be discussed at the G-20 meeting. For reasons that are not entirely under their control, many emerging countries have a long record of pro-cyclical policies that, if pursued again, will potentially create social unrest and political instability.

In contrast, the U.S., Europe, and now China, are rapidly adopting counter-cyclical policies to offset the decline in aggregate demand. Central banks have lowered interest rates while the executive and legislative branches have moved fast in terms of providing fiscal stimulus. The debate in OECD countries is not on issues of substance, but on fine- tuning questions such as how much to lower interest rates and finding the right combination of lower tax rates and higher government expenditures.

Unfortunately, with few exceptions like Chile and China, in emerging countries little is being done to stabilize demand and output. No doubt the inability to adopt counter-cyclical policies in part reflects the countries' own institutions and policy preferences, but the workings of global financial markets also play a role. The upcoming meetings of the G-20 offer a unique opportunity to fix that part of the problem.

Emerging economies have already been impacted by the global financial crisis. Notwithstanding the lack of up-to-date information on capital flows, the IMF recently estimated that global portfolio flows to emerging markets are retracting at an accelerating pace. New issues of emerging countries' debt fell to $80 billion during the third quarter of the year from nearly twice that figure in the second quarter. Not surprisingly, EMBI spreads are on average 400 basis points higher than a year ago.

For commodity-dependent countries, especially in Latin America and Africa, the reduction in commodity prices has been another piece of bad news. Relative to a year ago, prices of industrial metals are down by 45 percent, energy prices by 32 percent, and agricultural prices by 24 percent. Although prices were above their trend levels, the magnitude of the decline has put pressure on the current accounts. Low demand in the U.S., Europe, and Japan is affecting other non-commodity exports as well, while the decline in economic activity is affecting workers' remittances, which are a significant source of income for certain regions of the world, such as Central America.

Therefore, it is not surprising that the output gap—measured as the difference between potential and actual growth—is already positive throughout the emerging world, and next year is expected to be close to two percentage points. In Latin America alone, the output gap is likely to be higher. The important point is that,

with some coordination, there are ways to narrow the gap and minimize its negative consequences on social progress.

What Should Be Done

An important number of emerging countries have adopted inflation targeting as the framework for monetary policy, in which central banks announce a target for inflation and make use of all the information and modeling available to set the interest rate in a way that is consistent with that goal. Although the explicit numerical target increases the central bank's accountability in controlling inflation, it also reduces the degrees of freedom of monetary policy, especially in cases where credibility is low.

Even if monetary authorities know that in the medium- to long-term inflation will be consistent with the adopted targets, in the short run inflation can be higher for reasons not entirely under their control, such as high food prices or a depreciation of the currency. For example, Mexico's annual inflation rate rose to a seven-year high in October (5.8 percent), led by electricity, gasoline and food, while Brazil's annual inflation rate rose to a three-year high last month (6.4 percent), after a 26 percent depreciation of its currency (relative to a year before). Under these circumstances, central bankers fear an exacerbation of inflationary expectations and are thus reluctant to cut interest rates, even if the output gap would justify it. In other words, monetary policy is not helping to smooth out the negative external shock.

The contrast with the U.S. monetary policy could not be sharper. Inflation is expected to be close to 4 percent by the end of the year, a full one percentage point higher than in 2007. That has not been an obstacle for the Federal Reserve to cut its rate by 350 basis points during the last year, mainly because inflation is expected to fall to 2 percent in 2009 due to the recession.

So what can be done about inflation targeting in emerging countries? There is a considerable debate, especially in Asia, on whether inflation targeting is the right framework for emerging countries. In Latin America, which still needs to consolidate low inflation, the question is how to make inflation targeting work well. In that spirit, G-20 countries should ask the IMF to recommend that Latin America and Caribbean countries focus on medium-term inflation, and not on short-term targets. One way of doing this is by encouraging countries to adopt wider ranges for the inflation target, on the order of two percentage points in each direction. The IMF could also help reinforce the credibility of central bankers in emerging countries by producing country reports that explain why exceptional international circumstances cause inflation to be temporarily above the target.

In the case of fiscal policy, it is well known that emerging countries tend to behave pro-cyclically. In particular, fiscal deficits go up during booms and down in recessions, while the opposite happens in OECD countries. One reason is that in bad times, credit supply dries for emerging countries limiting the capacity to run deficits. Of course this is related to the fact that in good times developing countries do not save enough, reflecting deeper institutional problems. One popular explanation is that in good times the common pool problem becomes more severe and there is more rent extraction. But regardless of what that fundamental explanation is, in practice the IMF reinforces the pro-cyclical pattern by advocating fiscal adjustment in response to the reduction in credit supply.

There are no easy solutions to the challenges posed by pro-cyclical fiscal polices. Without doubt, country level actions are indispensable. Political and fiscal institutions need to provide the incentives and constraints that result in credible and flexible fiscal policies. But there are steps that the international community can take as well.

One priority is the development of a regional bond market. With deeper regional capital markets, financing countercyclical fiscal policies will become less of a constraint.

What G-20 countries need to do is to ask multilateral banks and foreign government agencies to issue bonds in these markets, and encourage countries with large levels of reserves to invest in them. The Asian Bond Market Initiative is a positive step in this direction which could be expanded and implemented in other regions, such as Latin America.

The IMF announced a short-term liquidity facility to countries that "have been assessed very positively" with "track records of sound policies, access to capital markets and sustainable debt burdens." Although well intentioned, there is a significant risk that, if pursued according to past practices, this strategy will basically provide funds to countries that do not need them. What needs to be done is to coordinate actions so that central banks in emerging countries begin lowering interest rates soon, and steps are taken so that in the future countercyclical fiscal policies can be adopted. Although this would require institutional reforms at the domestic level, regional capital markets must be developed for countries to be able to borrow in the bad times. The new financial architecture should emphasize these arrangements, rather than pursuing the strategy of strengthening one particular entity.

The Bottom Line

Current policies in developed and emerging economies reflect two profound asymmetries. Countercyclical fiscal policies are a luxury of countries that have a fluid access to international financial markets, while only a few central banks are able to lower interest rates without losing credibility. There are some concrete steps that G-20 heads of state could take to ameliorate these problems, allowing emerging countries to stabilize their economies more effectively.

Mauricio Cárdenas is Senior Fellow and Director of the Latin America Initiative at the Brookings Institution

3 REFORM THE AID SYSTEM TO FIX THE SLOW-BURNING GLOBAL POVERTY CRISIS

Homi Kharas

What's at Stake

As the heads of state of the G-20 countries meet in Washington on November 15 for their first ever summit, they should spare a thought for the world's poor. The summit is focused on the crisis in global financial markets, which indirectly affects most developing countries. But it should not ignore the problems with official development assistance (ODA) which directly affect the Main Street in the poorest countries. Long-term global stability depends as much on reducing global poverty as it does on fixing the regulations governing global private capital. So global leaders should take this opportunity to consider how to make ODA less volatile and more suitable for financing sustainable development.

Today's crisis emphasizes two old lessons of finance. Financial markets penalize policy weaknesses and mistakes. And financial markets amplify economic cycles. For many emerging markets these truths have meant that access to foreign finance has been a mixed blessing. It has permitted faster, and oftentimes more efficient, fixed capital accumulation. But it has also been associated with crisis and development set-backs. Not surprisingly, the empirical evidence on the link between external finance (excluding FDI) and development is weak. Some of the emerging economies that have been hardest hit by the current financial crisis, like Hungary, the Baltics and Iceland, are among those that enjoyed earlier growth benefits from capital opening, but must now face the consequences of their risky approach.

Most emerging markets have chosen a safer strategy, with cautious opening of domestic capital markets and an emphasis on stability. These countries have learned that the downsides of instability and the risk of crises can outweigh the efficiency gains from integrating rapidly with global finance. Their development policy has emphasized mobilization and use of domestic savings and the pursuit of macroeconomic stability with low and stable inflation and exchange rates.

Poor countries have found it harder to resist external finance in the face of limited domestic resources and large needs. They are heavily reliant upon ODA in the form of grants or cheap credits to build infrastructure and provide needed education, health and other social services. But just like private capital, ODA is subject to sudden stops and starts. And just like private capital, volatility in ODA undermines its effectiveness as a tool to finance sustainable development.

One problem with aid is that it is unpredictable. Rich countries promised to increase their ODA to $130 billion a year by 2010 at the Gleneagles G8 Summit in 2005, while doubling aid to Africa. But after a burst of large increases, primarily for debt relief, aid flows have declined in the last two years and the Gleneagles targets now seem unreachable. In today's environment, with domestic fiscal stimulus and bank bail-outs stretching deficits in rich countries, the prospects for rapid increases in ODA are dim. Thankfully, emerging market donors who are members of the G-20, like China, India and Korea, are picking up part of the slack. But

these new donors have not formally announced specific future aid commitments, and in some instances they compete with other donors instead of complementing their efforts.

Like private capital, official aid tends to be concentrated on a few countries with good reputations. By design, ODA is sensitive to the policy and institutional environment of recipient countries. A handful of "donor darlings" that adopt orthodox economic policies, as defined in the capitals of the West, get the bulk of official aid. In some cases, this link is explicit: the threshold approach of President Bush's Millennium Challenge Corporation (MCC) and the allocation formula of the International Development Association (IDA) formally link aid volumes with policy measures. In other cases, the link is more implicit, dependent on a variety of factors, including non-economic considerations. Regardless, recipient countries have learned that being a "donor darling" one day is no guarantee of being a darling in the future. When countries change course, the aid tap can be turned off. Ownership and accountability for results in aid recipient countries suffer accordingly.

Again like private capital, official aid is highly volatile. In fact, for the typical aid recipient country, it is five times as volatile as GDP and three times as volatile as exports. As a result, ODA tends to amplify real business cycles in recipient countries. Worse, the aid system can also deliver massive real income shocks. In fact, on rare occasions, aid shocks of fifteen percent of recipient country income have been reported. Shocks of this magnitude have only been experienced by industrial countries during the Great Depression, the Spanish Civil War and the two World Wars.

Large, albeit rare, shocks have long-lasting effects on economies. The impact of shocks is not symmetrical. Investors appear to care much more about very bad outcomes than they do about the potential for bonanzas. In advanced countries, this can be seen in the equity market premium that is required to offset risk. In poor countries, there are several manifestations of high aid volatility. Some countries build financial balances, but that means leaving resources idle with high opportunity cost. In other cases, aid volatility results in distortions in the choice of investment projects. High return, but long gestation, projects are put off for fear that future funding might be hard to come by. Aid volatility is also linked to volatility in fiscal spending and volatility in real exchange rates.

Adding all the costs together, the deadweight loss from aid volatility could reach around 15 percent of total flows, equivalent to $16 billion per year or 2 percent of recipient country GDP. Such large costs suggest that reducing volatility should be a priority for donors.

It is theoretically possible that high aid volatility results from capricious policies in some recipient countries, or from the international response to humanitarian disasters or one-off aid appeals, like coordinated debt relief. In practice, these explanations account for little if any of the observed volatility. Volatility in official aid directed towards projects and programs is even higher than volatility in total aid. And volatility is the same for most recipient countries, regardless of their economic characteristics—income levels, policy performance, aid dependency, or geographic location.

On the other hand, aid volatility does depend significantly on donor country characteristics. Some countries, like the United States, exhibit high volatility (per dollar of grants or credits). Others, notably the Scandinavian donors, show very low levels of volatility. These donors provide steady support to the same countries and the same sectors year after year. Continental European countries and multilateral development banks fall between these groups.

What Should Be Done

Three actions would go a long way towards fixing official aid.

Reducing volatility should be a priority. Measures of disbursement volatility could easily be included in results management systems of aid agencies. As an example of volatility, consider US (non-military) aid to Pakistan. In the late 1990s, the US was receiving $100 million per year from Pakistan in net terms, as loan repayments exceeded disbursements. In 2001, as Pakistan became a front-line state in the war on terror, net US ODA rose to $880 million. A mere two years later, in 2003, aid fell to $113 million. It then quadrupled to $480 million in 2006. Instead of these stops and starts, a strategic approach towards aid to Pakistan would have been much more effective in promoting Pakistan's development and securing US interests in the region.

Multi-year financial programming mechanisms should become standard across all donors. Aid is best used when it supports long term development programs. That means that donors should be prepared to provide predictable indicative funding commitments for the duration of the program. New global funds and programs like the MCC do precisely this, but they are the exception rather than the rule. Most aid depends on annual budget appropriations.

Last, multilateral development banks should be encouraged to develop counter-cyclical instruments that can be deployed to offset the fluctuations in bilateral aid that will inevitably occur as legislatures juggle annual budget priorities. The International Development Association and other regional development banks are well placed to use their funds much more aggressively to smooth total aid flows. They could provide countries with insurance against aid shocks and sharply reduce the macroeconomic volatility caused by aid.

The Bottom Line

The summit serves as a reminder that managing global risk in a proactive fashion is key to avoiding global crises. In addition to the crisis in financial markets, there is a slow-burning global crisis of poverty and inequality that also threatens global stability. We can only hope that the world's leaders will take action to defuse this crisis by reforming the aid system.

Homi Kharas is a Senior Fellow at the Wolfensohn Center for Development at Brookings.

4 BEYOND THE G-20: WHY THE WTO IS MORE IMPORTANT THAN EVER

Paul Blustein

Let's super-size the IMF. No, we should turbo-charge the FSF. Or how about pumping up the BIS?

For international institutions with three initials, ideas abound as world leaders prepare for their November 15 summit on the global economic crisis. Naturally, the institutions just mentioned—the International Monetary Fund, the Financial Stability Forum, and the Bank for International Settlements—are getting much of the attention, because their responsibilities involve the financial problems at the heart of the crisis. But the leaders would be severely remiss if they neglect another tri-initialed institution, namely the World Trade Organization. Shoring up the WTO could be one of the most significant measures the summiteers take, because as a bulwark against protectionism, the Geneva-based trade body has suddenly become more important than ever.

What's at Stake

The specter of rampant protectionism has seemed almost laughably remote in recent years. Despite periodic bouts of hand-wringing about how the world is verging on trade wars like those of the 1930s, when America's Smoot-Hawley tariff triggered a disastrous cycle of retaliation and counter-retaliation, such fears have always proven exaggerated. Now, however, the threat should be taken much more seriously. The spread of recessionary forces to every major region on Earth, combined with the groundswell of revulsion against unfettered capitalism, is bound to generate intense pressure on politicians to raise trade barriers. In the United States, those pressures will be all the greater because the plunge in foreign currencies—from the Korean won to the Brazilian real to the South African rand—will make imported products much cheaper.

The WTO, for all its flaws, plays a crucial role in keeping protectionism in check. It is the current embodiment of the multilateral trading system that was established after World War II to prevent a reversion to the thirties. The WTO's rules keep a lid on the import barriers of its 153 member countries, and members take their trade disputes to WTO tribunals for adjudication rather than engaging in tit-for-tat retaliation. That keeps trade wars from erupting, just as any rule-of-law system helps contain tendencies toward the law of the jungle.

Unfortunately, the WTO's centrality to the global trading system is in doubt, for two main reasons. The first is the prolonged stalemate in the Doha Round, the negotiations that the WTO launched in 2001 with the aim of bringing developing countries into the mainstream of the world economy. The second is the proliferation in recent years of bilateral and regional trade agreements. More than 200 of these are currently in force, ranging from the big and well-known, such as NAFTA, to the small and ridiculous, such as the Singapore-Jordan free trade agreement (yes, there really is such a thing).

Governments are increasingly tempted to think of these pacts as reasonable substitutes for multilateralism, especially as disillusionment deepens with the WTO's ability to foster new deals. Although the WTO is hardly going to disintegrate overnight, the danger is that its authority will erode to the point that members will start to flout their commitments and ignore the rulings of WTO tribunals. That would greatly increase the threat of trade wars and a breakdown in the system that has helped keep trade blocs and protectionism at bay.

The world lost a chance for an even stronger "insurance policy" against protectionism when the latest effort to agree on a detailed blueprint for the Doha Round collapsed in July, after nine days of grueling negotiations. The deal that was on the table, though hardly the bonanza for global growth that its boosters sometimes claimed, would have prevented countries from erecting significantly higher tariffs. It would have left most existing trade barriers in place, but would have lowered "bound" tariffs, the legal maximums that countries can impose without triggering economic sanctions.

Some leaders and commentators are clamoring for the summit to order negotiators back to the table so that the Doha Round can be finished quickly. President Bush has even said that he hopes to see a deal struck before the expiration of his term. But calls for such a breakthrough will be dismissed, rightly, as empty rhetoric. The chances are minimal for reviving the July accord anytime soon. Leadership from the United States is essential to any such endeavor, and the Obama administration will need to take time to sort out its trade policy; until then, the negotiations will be effectively frozen. Moreover, economic forces have sharply dimmed the prospects for a deal. Thanks to the slump in economic growth, and the plunge in commodity prices, political resistance is stiffening against the dismantling of trade barriers and farm subsidies.

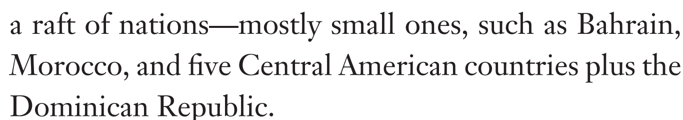
This is not to say that the summiteers should omit Doha from their official declarations; on the contrary, they should include a ringing statement of their determination to complete the round. It is also essential that they strongly vow to resist protectionism and maintain unswerving support for the WTO. But talk is cheap. To bolster their rhetoric, the leaders ought to take some concrete steps.

What Should Be Done

First, they should pledge that they will keep tariffs at their current, "applied" rates, and refrain from using the flexibility that they have to raise duties to bound levels. This wouldn't bar nations from exercising their rights to impose higher "safeguard" tariffs on a temporary basis when their industries need time to adjust to surges of imports.

Second, they ought to impose a moratorium on export bans of the sort that were used by certain countries during the recent food crisis to keep grain prices in check. This would help improve the atmosphere for open world markets. And it should be politically easier for governments to accept, now that grain prices have plummeted.

Third, here's an admittedly unorthodox idea: The leaders ought to accept a moratorium on new bilateral and regional trade agreements. Many bilateral trade deals, while providing nice photo-ops for the leaders of the countries involved, do little to liberalize trade. They typically contain numerous exceptions and exclusions, and while they may expand commerce between the participating countries, they naturally diminish trade with other countries that aren't included in the preferential arrangement. The Bush administration argued that by pursuing bilaterals, it would help generate pressure on recalcitrant countries to agree on a Doha package. But this strategy, dubbed "competitive liberalization," failed, even though Washington signed accords with



a raft of nations—mostly small ones, such as Bahrain, Morocco, and five Central American countries plus the Dominican Republic.

The Bottom Line

The time has never been better for putting an end to the destructive trend toward a trading system splintered into bilaterals and regionals. To be sure, I recognize the irony involved in proposing to fight protectionism by scrapping plans for trade agreements. But forsaking bilateralism, and embracing multilateralism, would send a heartening signal that the world's leaders are prepared to work together, on a worldwide basis, to strengthen an institution against forces that could turn a global recession into something much worse. The WTO needs such a boost, and the world certainly needs the WTO.

Paul Blustein is a Journalist-in-Residence at the Brookings Institution and is currently writing a book on the World Trade Organization.

5 NOW IS THE TIME FOR PERMANENT GOVERNANCE CHANGES

Colin Bradford and Johannes Linn

What's at Stake

The major focus of the first-ever G-20 Summit on November 15 will be on the global financial crisis and how to deal collectively with it. Summiteers will quickly discover that some of their most important choices will be about institutions and governance mechanisms for both deciding and implementing proposals to address the financial crisis. Indeed, one of the most important clusters of issues that leaders can actually decide upon on November 15th is the institutional and governance dimension.

G-20 leaders will face each other in this grouping for the first time to deal with the highest priority issue on the global agenda of the moment—an issue truly warranting a summit. But the G-20 Summit de facto confronts the question of what is the appropriate group of countries to constitute the apex summit on such high profile and high priority issues. It is clear to most observers that the G-8 summit has failed to establish its legitimacy as a global steering committee precisely because the G-8 countries are Western industrial rich countries in a world that is predominantly non-Western, non-industrial and poor. The G-8 mirrors a transatlantic bias in the power structure of the IMF and the World Bank where emerging market economies in general and fast industrializing countries in Asia, in particular, are seriously under-represented.

It is fortuitous that the financial crisis forced a summit of the member countries of the G-20 finance ministers' grouping, which has been meeting successfully twice a year since the Asian financial crisis. Many, including particularly Paul Martin, the first chair of the G-20 finance ministers in the early years before becoming Canadian prime minister, have been advocating for some years that a G-20 summit replace the G-8 for global issues. For the past four years at Brookings, we have led a series of seminars, joint with the Centre for International Governance Innovation of Canada, to discuss international institutional and global governance reform issues with Washington-based officials from G-20 countries.

The appropriateness of the group goes beyond financial issues because most of the countries in the G-20 are the major players and have the biggest weight in all the major issues of energy and climate change, global poverty and health, trade and jobs, and security issues as well. The fact that G-20 finance ministers have a track record of effective cooperation and coordination lends credibility to this group of countries as being able to work together on other issues. And finally, and perhaps, most importantly, vaulting from G-8 to G-20 has the advantage of not having to open the Pandora's box on the question of who should be a member of the apex global steering group because the countries in the G-20 finance ministers group is already established.

What Should Be Done

So, the question is: wouldn't it make sense for the G-20 countries to decide on November 15 to constitute themselves as the new apex summit to replace

the G-8 with a more inclusive and broadly representative group of countries both to deal with the current financial crisis and to address the other pressing issues as well, such as climate change? We believe so.

For this to happen, the G-8 would have to be willing to cede space at the tables of decision to Asia and other emerging economies. The value of such a decision by the G-8 is that it would signal a readiness on the part of the transatlantic powers to shift to a global group, the G-20, which includes the major economic and financial powers, major energy exporters and importers, virtually all major polluters, and four Asian countries and three Islamic nations. It would not only become immediately more credible in dealing with global challenges than the G-8 because of the nations involved but would politically shift the tone, context, style and optics of global governance to a dramatically different configuration that is immediately more inclusive, representative and legitimate.

This move should be accompanied by a decision at the G-20 summit on November 15th by the Europeans and the Americans to shift the selection process for managing director of the IMF (hitherto always a European) and the president of the World Bank (hitherto always an American) to an open, merit-based, competitive selection process. This decision would be congruent with the reconstitution of the apex summit grouping. It would signal a willingness to remove the transatlantic biases and prerogatives from these institutions and move toward transforming them into truly global institutions with reconfigured power structures through further reforms in the future. This coordinated step by the U.S. and the Europeans would be the right signal at the right moment to convey the message that the global problems we face cannot be solved unless the mechanisms and institutions meant to address them are themselves global in scope, representation and power structure. Beyond this concrete decision, the G-20 summit should make a credible commitment towards a serious review of the functions and governance of the IMF and the World Bank, including a greater voice and vote for the emerging market economies in their boards, and forge an effective role of these institutions in supporting the agenda of the G-20 summit.

On the basis of these two steps, initiated by the G-8 countries, but hopefully fully shared and supported by the 10 emerging market members of the G-20, the economic and financial reform proposals generated by the G-20 Summit itself should be entrusted and assigned to the G-20 finance ministers and to the IMF and the World Bank. The *glaring biases* manifested by the fact that, under the current system, the G7 finance ministers – a group even more restrictive than the G-8 – were setting the agenda for the G-8 heads of state, who in turn were setting the agendas of the Fund and the Bank, in which the G7/G-8 had dominant control, would be replaced by a *new congruence* of the G-20 heads directing the G-20 finance ministers to make proposals for the Fund and the Bank which would be moving more decisively toward more globally representative power structures under these new arrangements than up to now.

The Bottom Line

Credible actions towards global governance reform of the summit mechanism itself and towards institutional reform of the Fund and the Bank are two necessary, meaningful and feasible components for a successful first-ever G-20 Summit on November 15th. These two reforms are necessary if the other economic and financial proposals generated by the summit are to be received by the world as broadly representative of global interests, with the promise of long-term cooperation among a group of key countries needed to effectively address major global issues in a credible manner. This would be reinforced by the commitment that the leading international institutions will be reformed to reflect the new diversity and power configuration of

the global economy so that they too can more credibly and effectively address the overarching global challenges of today and tomorrow.

Colin Bradford is a Nonresident Senior Fellow with the Brookings Institution, and Johannes Linn is a Senior Fellow and Executive Director of the Wolfensohn Center for Development at Brookings.

6 KEEP THE IMF AT THE CENTER

Lex Rieffel

What's at Stake

A number of unrealistic suggestions have been put forward since President George W. Bush decided to convene a G-20 Summit meeting in Washington on November 15 to discuss the turmoil in financial markets, which is now producing a marked slowdown in global economic growth.

One suggestion was to combine the excess foreign exchange reserves of a few countries to create a huge global pool of money that would be used to reflate economies where growth is lagging. Another was to create a global agency to implement a uniform regulatory regime for financial institutions everywhere. A third was to start a round of global negotiations that will wrap up a bunch of contentious issues in one package, including, in addition to financial sector regulation and supervision, the Doha trade negotiations, the post-Kyoto climate change deal, and financing to achieve the Millennium Development Goals for poor countries.

What Should Be Done

The best feasible outcome for this exceptional Summit meeting could be a consensus to put the IMF back at the center of the system for managing the global economy. It was at the center from its creation in 1945 until a few short years ago when euphoria related to the global financial "bubble" made the IMF look obsolete and irrelevant. Since mid-October, however, the IMF has been re-discovered. For the first time in more than 30 years, a high-income country—Iceland—is getting financing from the IMF.

Nevertheless, three critical issues will have to be resolved to put the IMF back at the center: governance, funding, and mission. The United States is the principal obstacle to making progress in each area, and the November 15 Summit could be helpful in pointing the debate in the right direction.

The governance issue has four elements: the U.S. veto, Europe's over-representation, the role of rising economic powers such as Brazil, China, and India, and the selection of the IMF's Managing Director.

- The United States is the only one of the IMF's 185 member countries that can block decisions on fundamental matters such as amending its charter (Articles of Agreement). While the United States has rarely exercised this power openly, the threat of using it leads other members to defer to U.S. views, and it contributes materially to the image of the IMF as an instrument of U.S. policy rather than a truly global institution.

- Europe's over-representation is an historical artifact that remains because of the reluctance of smaller European countries to give up seats they have held for more than 50 years, and because the option of creating a single European Union seat seems to go too far in the other direction.

- A few steps have been taken recently to increase the voting shares of the rising economic powers, and to coordinate their positions on important matters, but these steps have not reached the point at which the systemically significant emerging market countries feel they have a meaningful ownership stake in the IMF.

- Finally, since the very beginning, the IMF Managing Director has been a European as part of a deal at which the President of the World Bank has always been an American. This deal has developed an overpowering odor, partly as a consequence of several misguided nominations beginning eight years ago.

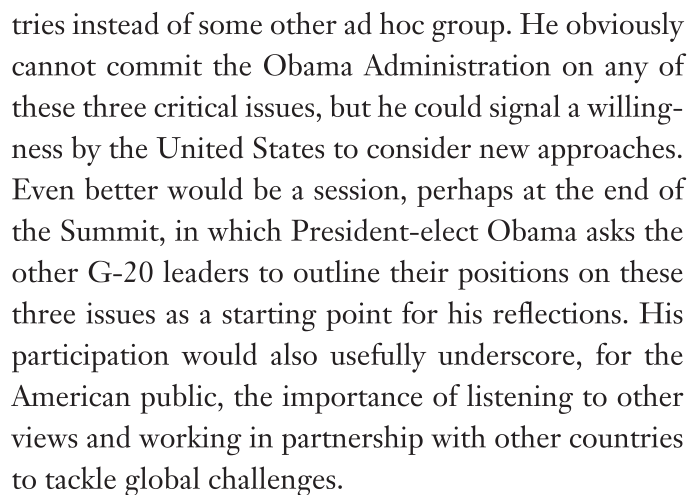
The funding issue is less straightforward. Think of it like a dike to protect a town from flooding. The dike can be built to withstand a 20-year flood, a 50-year flood, or a 100-year flood. The higher and thicker the dike, of course, the more expensive the construction costs. Currently, the IMF's resources are large enough to deal comfortably with the last crisis, the 1997/98 Asian crisis. Clearly they are not large enough to handle the current crisis comfortably, but then there is not a strong technical case for building a war chest that will be sufficient to substitute for private capital flows. A "substantial" increase in funding (quota subscriptions) could command broad support, but the precise amount will ultimately be a judgment call, depending critically on how quota shares are re-allocated.

The mission issue is the most complicated and most problematical for the United States. Two core elements are "surveillance" of the United States and the other "old economic powers", and global financial sector regulation. The IMF is unique among global organizations in having a formal mandate to "examine" the policies and performance of the advanced industrial countries. However, for most of its 65 years, the IMF's operations have been focused on developing countries. For this and other mainly political reasons, the old powers have been inclined to dismiss the IMF's concerns about their own policy weaknesses and the alternative policies it recommends. The current financial crisis, which originated in the sub-prime mortgage crisis in the United States last year, however, has made it obvious that weaknesses with global implications do exist in the advanced countries. If the old powers now want the rising powers to take the IMF's concerns seriously, then the old powers will have to be more responsive, visibly, to the IMF. This change will require a non-trivial shift in mentality.

Regarding global financial regulation, it is inconceivable that either the old powers or the new powers will agree to grant to the IMF, or any newly created global agency, the authority to regulate and supervise financial institutions operating in their countries. Such a move would involve giving up more sovereignty than their citizens are prepared to accept. The basic choice then is between a regulatory regime that is connected to the IMF and one that is independent of the IMF. The crippling disadvantage of an entirely independent regime is that it would inevitably weaken or undermine the IMF. One attractive alternative is a beefed-up Financial Stability Forum (FSF) that remains "attached" to the Bank for International Settlements in Basel, Switzerland, but has a formal relationship to the IMF as well. In particular, through its ministerial committee, the IMF would have a say in setting the work priorities of the FSF. At the same time, participation in the FSF would be expanded to include the most important emerging market countries.

The Bottom Line

The November 15 Summit in Washington was a European initiative, but President Bush deserves credit for agreeing to host it at an awkward time politically, and for choosing as participants the G-20 coun-



tries instead of some other ad hoc group. He obviously cannot commit the Obama Administration on any of these three critical issues, but he could signal a willingness by the United States to consider new approaches. Even better would be a session, perhaps at the end of the Summit, in which President-elect Obama asks the other G-20 leaders to outline their positions on these three issues as a starting point for his reflections. His participation would also usefully underscore, for the American public, the importance of listening to other views and working in partnership with other countries to tackle global challenges.

Lex Rieffel is a Nonresident Senior Fellow at the Brookings Institution.

7 WHAT THE U.S. AND ASIA SHOULD DO: ESTABLISH A GLOBAL FINANCIAL CRISIS SECRETARIAT AND AN ASIAN FINANCIAL FACILITY

Wing Thye Woo

What's at Stake

It would be a big mistake for the G-20 to squander the November 15 meeting discussing the French-British proposal for a New Bretton Woods. As the still raging global financial crisis was not primarily caused by the flaws in the present international monetary system, Asia and the U.S. should insist that the discussion be narrowly focused on the global coordination of fiscal stimulus and monetary loosening, global avoidance of beggar-thy-neighbor policies of export promotion and import restrictions, global harmonization of regulations governing financial institutions and accounting practices, and the feasibility of the U.S. Federal Reserve broadening its temporary network of bilateral swap lines to other well-managed emerging economies.

What Should be Done

An *ad hoc* Global Financial Crisis Secretariat (GFCS) should be established to undertake global coordination on these matters, and be temporarily housed as an autonomous unit (in the manner of the World Bank) within the office of the UN Secretary-General. Simultaneity in expansionary macroeconomic policies is GFCS's most important objective because it prevents deterioration in the trade balances from rendering each country's expansionary policies unsustainable.

If another G-20 summit is set for the future, Asia and US should support the establishment of a GFCS working group on the reform of the IMF: how much to increase its resources to allow it to fight global financial fires, how wide to increase its jurisdiction to authorize it to improve regulation of financial markets, and how radically to restructure its ownership to give it the legitimacy to impose its will on prostrate economies. While an improved IMF is highly desirable, both the US and Asia should recognize that the better first line of Asian defense against financial contagion would be a greatly enhanced swap facility, the Asian Financial Facility (AFF), because Asia collectively now has enough reserves to fend off unwarranted speculative attacks on a subset of its members. It must be emphasized that the core mission of the AFF is to combat financial contagion and not to finance balance of payments adjustment caused by economic mismanagement.

An AFF is necessary because it is simply impossible (certainly, inefficient) to increase the size of the IMF enough to enable it to have in-depth expertise on most of the countries to be able to respond optimally in a timely manner to each national crisis. Furthermore, the IMF policies are decided by Executive Directors who usually take their orders from their national ministries of finance and central banks, and it would be credulous to think that a significant proportion of these national economic agencies would have up-to-date understanding of most of the emerging economies. Even if the improved technical competence of the IMF is not doomed to disappoint the emerging economies, the emerging economies would be disappointed by the long time required for an improved IMF to appear. The negotiations on meaningful IMF reforms would inevitably be cantankerous and hence protracted.

Right now, East Asia has a thin network of swap lines to defend their currencies. It would be desirable to hasten the evolution of the existing swap facility into the AFF by two actions. First, the existing swap facility specifies that a cumulative drawing that exceeds 20 percent of a country's quota would require the country to accept IMF supervision. This "flight-to-IMF" clause should be removed because painful memories of 1997-98 make it politically suicidal for any East Asian leader to do so. Second, because the primary purpose of the AFF is to reduce the cost of bad luck and not of bad economic policies, the removal of the "flight-to-IMF" clause requires that the swap facility establish a surveillance mechanism to pre-qualify its members for emergency loans. Without this surveillance mechanism, the Asian Financial Facility would not attain a meaningful size because no member would be willing to risk committing a large part of its reserves to the facility.

Why should the G-20 support a GFCS? The IMF simply lacks legitimacy and credibility in the eyes of East Asia. The Sarkozy-Brown proposal for a New Bretton Woods is part of the continuing effort by Old Europe to maintain its disproportionate representation in global governance bodies like the UN Security Council, the IMF and the World Bank. The proposal to make the unreformed IMF the super financial policeman of the world is unwise because the concentration of so much power in its hands would magnify the impact of any faulty operational procedure and allow the mistake to be unchecked for a longer time. If need be, the assignment of global financial regulation to an expanded BIS would be a better alternative. The IMF should forgo expansion of its jurisdiction and become instead a more specialized agency that undertakes macroeconomic surveillance for the world, and balance of payments assistance for the emerging economies. The UN is the global organization with the most legitimacy, and its temporary custody of the GFCS would, one, be a good signal by the G-20 of their genuine desire to make multilateralism work; and, two, be a collective statement that it is time for the national allocation of global responsibilities to be reconfigured.

Why should the US support an AFF? The US and other countries would be members of the AFF just as they are now influential members of the Asian Development Bank. In dealing with Asia, the US should rely less on the hard power of a formal dominant role in global leadership, and more on the soft power of leading by example, like helping Asia do what's best for Asia (which is an excellent start to the US re-engagement with Asia). The AFF would expand over time to be an APEC-level institution; and be a good partner to the IMF because "two heads are better than one" in analyzing unexpected quickly-evolving crises and in preventing their contagion.

The Bottom Line

The bottom line for the November 15 meeting is that the focus should be on fighting global recession and not on reforming the international financial architecture; and the bottom line for beyond November 15 is that the better way to improve the supply of global public goods is not to simply increase the size of the existing providers but to increase the number of providers while seeking to improve the performance of existing ones. The GFSC is the change we want to allow simultaneous implementation of macroeconomic stimulus, and harmonized regulation of financial markets. The US support for AFF is the much-needed change toward an inclusive US approach that is diversified in modality to handle each specific multilateral issue. If the G-20 can act decisively on November 15 on these well-defined economic tasks, the world can then have more faith that enlightened self interests will also accomplish the much more arduous task of containing environmental contagion from global climate change (the change we do not want).

Wing Thye Woo is a Senior Fellow at the Brookings Institution, and the New Century Chair in International Trade and Economics.

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1775 Massachusetts Avenue, NW
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