Wanted: A Strong and Better G-20 for the Global Economy

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The resurgence of turbulence in international financial markets—with epicenter not in the U.S. banking system as in 2008 but in the European sovereign sector—potentially brings the G-20 closer to the center of policy action after a phase of relative eclipse. Many questions arise. Are the European risks relevant from a global perspective? Is the G-20 the right forum to avert threats to financial stability? And if so on both counts, what concretely can and should the G-20 do?

Since its birth, the G-20 has had two souls—one as policy coordinator in fair weather times and one as crisis manager. As a matter of fact, the G-20 was born twice: a first time in 1999 as a new forum of finance ministers in the wake of the Asian crisis and then again in the fall of 2008, when it was upgraded at the level of heads of state and government in the frantic weeks following the Lehman demise. In both cases, the situation called for a crisis manager, not a fair-weather sailor; the first time, to limit the contagion stemming from emerging but unstable economies; the second, to reassure global financial markets in a moment of grave risk. In both cases, the immediate danger was eventually averted and most would agree that the G-20 contributed to the positive outcome. But in both cases, after the risks receded, the G-20 started to be engaged in the more routine task of crisis prevention, mainly through attempts at economic policy coordination. Here its performance has been at best less convincing and criticism of its effectiveness has mounted.

For these reasons, it is perhaps useful at this juncture to revisit some fundamentals: why should the G-20 exist at all? And how has acted so far and with what success? We argue below that, contrary to what critics say, the G-20 is not unnecessary and has not performed poorly overall since the group's reshaping in 2008. It is true that its effectiveness has diminished and that this has happened particularly when it has tried to play a role as policy coordinator in relatively good times. As we approach the Cannes Summit, the only meeting of G-20 heads of state and government planned in 2011, it seems unlikely that the French presidency will bring substantive deliverables in spite of early ambitions and a substantive agenda. Many observers perceive a slow slide into irrelevance and the G-20 has ceased to be a frequent and topical subject in newspapers, blogs and even scholarly publications. All this is particularly unfortunate at a time when a global economic crisis manager is again needed. Starting from these considerations, the final part of this article elaborates on what contributions the G-20 could provide in ensuring sustainable growth and financial stability in the global economy going forward.

The Case for Global Economic Cooperation

The controversy on the value and the limits of economic policy coordination is among the many unsettled controversies in economics. Decades-old discussions have left behind a number of useful insights, elegant models and plenty of ambivalent empirical evidence, but no clear answers or reliable guiding principles for policymakers.

In principle the basic issues seem easy to settle: in an interdependent world, where national economic performance and policies influence others, there should be benefits from coordinating policy actions—in other words, deciding policies not only on the basis of narrow national interests but also in relation to how they affect others. Moreover, since economic interdependence has increased in recent years due to the surge of international financial inter-linkages, it follows that coordination should also have become more valuable and pursued during time.

In practice, economic analysis has never succeeded in detecting and measuring these benefits precisely for several reasons. First, the counterfactual is lacking; it is not possible to observe what the outcome would have been should coordination in any given circumstance have or have not materialized. Second, many analyses date back to the 1980s —prior to the surge of international capital flows and long before today's emerging powers were starting to emerge. In that world interdependence was limited. Third, standard economic models do not account well for the strength of empirically observed spillovers through asset markets.[1] It is not surprising that older research concluded that the benefits from coordination were negligible.

More recently, economists have revisited the subject using more sophisticated modeling tools, but with no more conclusive results. These models are in general quite restrictive, often assuming constant balance of payments equilibrium and no financial frictions. They do not provide rationale for the degree of interdependence observed empirically. Under these assumptions, these models can hardly provide prescription on policy coordination for a world dominated by persistent global imbalances, very large cross-border financial holdings among advanced countries, and large, highly volatile capital flows between advanced and emerging countries. All in all, since research suggested that the gains from coordination are small either because trade and financial linkages are low when in fact then they have increased markedly, or because they assume away important aspect of financial globalization, it would not seem hazardous to assume that coordination is probably worth pursuing in today's economy.

Recently, the financial crisis has provided additional arguments in this direction, bringing to the fore the existence of substantial international spillovers also in the area of financial regulation. Countries or regions with large developed financial sectors, particularly if their money performs an international role (like the U.S. dollar, or to a lesser extent the euro), typically act also as financial intermediaries for the rest of the world. Their financial structures adapt to this role, collecting abroad large volumes of short-term funds (bank deposits or short-term securities traded in liquid markets) and lending abroad, typically long term. It is clear that, in this situation, the financial regulation and supervision of those countries are likely to have a prominent impact across their borders. Since everywhere in the world financial regulation remains predominantly a national responsibility (within some limits determined by the international harmonization of certain standards), and located in the country where the bank is incorporated (so called "home-country control"), it is clear that the supervisory regulatory frameworks prevailing in the major financial centers exert significant international repercussions, affecting financial stability in other countries and even globally.

Effectiveness and Representativeness

These arguments suggest there are likely benefits from cooperation in global economic governance *if* the institutions and modalities through which such cooperation is enacted are effective. This is a big *if*, however. The incentives to cooperate are weak, particularly when they are most needed. Representativeness typically conflicts with efficiency of action, which requires a small number of participants.

The composition of the G-20 strikes a difficult compromise between representation and efficiency. Political and geographical representation are supposedly provided by the presence at the table of the political leaders from the largest economies, with a correction in favor of emerging economies—this is, after all, the distinguishing trait of the G-20 relative to the G-7. At the same time, efficiency of debate and decision-making requires that the number of seats at the table to be limited; the presence of 20 members (19 countries plus the

European Union, not counting invited members and international organizations) has proved to be on the high side of manageability.

Another delicate aspect is that of the working modalities. This includes the internal organization and the links established with other bodies that, at a more or less technical level, are already active in the areas covered by the G-20. The G-20 has established working arrangements with a number of entities—the International Monetary Fund, the Financial Stability Board, the Basel Committee on Bank Supervision, etc.—and is assisted by two orders of substructures (ministers and deputy ministers). If the lack of its own technical expertise does not seem like a serious limitation—the technical input essentially comes from the bodies just mentioned—a more serious problem has been that of ensuring the continuity of action over time. In absence of a permanent secretarial structure, agenda setting completely relies on the annual rotating presidencies, often with very different priorities from one year to the next.

Some improvements in working arrangements in this area could help. Long-term (multi-year) work streams should be agreed with the aim of providing guidance to the rotating chair. Leaders and ministers should also seek the input from independent experts. More ambitiously, a steering group, similar to that set up in the Financial Stability Board with a mandate extending beyond the annual chair, could be established. A more ambitious possibility in the same direction would be to set up a small permanent secretarial structure at the IMF. Its mandate—ensuring continuity to the process and stronger liaison among the rotating chairs—would not require large staffing and bureaucracy, and red tape should be avoided.

How Has the G-20 Performed?

The few meetings that have taken place since 2008 (summarized in the table) allow only a partial answer to the question of how the G-20 has performed. In this period, the G-20 seems to have gone through a cycle. At first, the "new" G-20 Summit constituted a significant novelty, spurred by a crisis situation. The initial agendas, shaped by the crisis, were pragmatic and action-oriented. The initial period, including the Washington and London meetings, resulted in swift action on financial reform. The Pittsburgh Summit—while still effective in terms of institution building with the establishment of a permanent G-20 and the announcement of a new "framework" for macroeconomic policy coordination—marked the transition to the second stage in which, in the context of economic recovery, renewed a divergence of priorities between advanced and emerging countries, and reduced financial market tension. In this second stage, the G-20 has predominantly focused on macroeconomic coordination and progress has stalled.

From Washington to Cannes

Summit	Date	Headline priorities
Washington	November 2008	• Reform of financial regulation
London	April 2009	• Global stimulus • Reform of financial regulation
Pittsburgh	September 2009	• Rebalancing of world economy • Reform of financial regulation
Toronto	June 2010	• Rebalancing of world economy • Reform of financial regulation
Seoul	November 2010	• Rebalancing of world economy • International financial institutions
Cannes	November 2011	• International monetary system • Commodity prices • Weakening of global growth, euro crisis

This evolving pattern emerges clearly from the wording of the final statements following the meetings. The concluding statement of the Washington meeting was short and fully concentrated on the actions needed to stabilize the financial markets, with a detailed action plan and assignment of specific tasks to the IMF and other bodies. The

Washington Communiqué conveyed a sense of urgency and pragmatism and signaled a community of policymakers that wanted to be on top of events and steer them jointly; this helped the subsequent stabilization of financial markets. The London Summit was dominated by the risks of recession and protectionism; observers at the time were wondering if the world was heading toward another Great Depression. Many seriously feared pervasive restrictions to international trade, as in the 1930s. The London Summit not only maintained the momentum launched in Washington and signaled that protectionist pressures would be resisted, but it also decided on a major and historically unprecedented increase of resources for international financial institutions. Importantly, among the public documents produced at the London meeting was a detailed "Progress Report" showing that in the area of financial reform all actions agreed in the Washington Action Plan were making progress.

Five months later, the Pittsburgh Summit marked a watershed. In a number of ways, Pittsburgh achieved important results, particularly considering the low expectations on the eve. A first result concerned institution building. The leaders decided that the G-20 summit would become a regular event, replacing the G-8 as the entity to which the Financial Stability Board and the IMF would report. This amounted to a significant change in the international financial architecture. A "framework" for macroeconomic policies was announced, in which participating countries would try to coordinate economic policies to reduce global balance of payment imbalances. Leaders instructed their finance ministers to start a mutual surveillance process over macroeconomic policies, the "Mutual Assessment Process" (MAP), with the technical support of the IMF. But Pittsburgh also coincided with a marked slowdown in the productivity of the G-20. In subsequent meetings, the progress slowed down considerably as the pressure of economic and financial emergency abated.

In 2010, the calendar included two summits under a joint Canadian-Korean chair: Toronto and Seoul. For a long time, discussions were trapped in semantics regarding how to express in the final statements sensitive concepts about external imbalances and the exchange rate policies of major countries, notably China. The issue was in the end resolved after major difficulty and over a year later at a ministerial meeting of April 2011 under French presidency. In turn, the 2011 French presidency added new elements in the agenda, including a new focus on the reform of the international monetary system as well as discussions on the volatility of commodity prices and how to deal with them. It is not yet clear to what extent these novelties announced by the French presidency will translate into meaningful decisions at the Cannes Summit.

The G-20 at the Present Juncture

To this day, the G-20's agenda focuses on the priorities dictated by the 2008 U.S.-centered banking crisis and the subsequent recession. The two main lines of action—financial regulation and macroeconomic coordination to contain global imbalances—remain important and should be pursued further. But the G-20 would renege on its responsibility if it did not focus also on today's paramount problem, the risk of financial contagion from the sovereign sectors.

The epicenter of these risks is in Europe. Events have accelerated recently; until June this year, one could still hope that the euro debt crisis could remain confined to a handful of small countries, financially distressed but manageable by a united Europe. After all, Greece, Portugal and Ireland represent a mere 6 percent of GDP for the euro area. The European Financial Stability Facility, the euro rescue fund created in May 2010 in response to the Greek crisis, seemed sufficient to provide a backstop even if the crisis spread to Spain. Even some policymakers' hesitations—for example, in deciding the mix between domestic adjustment, official support and private sector involvement—did not seem excessively threatening given the small amounts involved.

With two large countries (Italy and Spain) under fire, the risks have taken a globally relevant proportion. There are at least three transmission channels: First, distressed sovereigns are implementing harsh and growth-adverse adjustment packages with negative demand as well as supply impacts. Uncertainty and precautionary spending behavior will likely extend to more stable countries. In Germany, in spite of the recent export-driven expansion, the public is concerned and hesitant to endorse large external transfers.

Second, financial institutions are under renewed stress. The euro-area interbank market is again experiencing strains, as during the 2007 liquidity crisis. Banks have suffered from large stock market declines. As a consequence, policymakers are requiring banks to post more capital, which may result in credit restrictions.

Third, confidence in Europe has been severely dented by euro-area developments.

On August 8, when the euro crisis suddenly worsened, the G-20 issued a statement expressing its "commitment to take all necessary initiatives in a coordinated way to support financial stability" and its readiness to "take action to ensure financial stability and liquidity in financial markets". What will this mean in practice?

A first priority is to promptly finalize the macroeconomic coordination framework still under construction and strengthen it by bringing intra-regional imbalances explicitly to the fore. They should be treated as global imbalances under the G-20's responsibility if they have global implications—the euro crisis certainly does. So far, there has been ambiguity in this respect; on the one hand, Europe has insisted that its currency zone be treated as a single entity; on the other, the G-20 surveillance mechanism remains organized on a country-by-country basis. For example, the group of "systemic" countries singled out for in-depth examination in the MAP includes, Germany and France and not the eurozone or the EU. Taken literally, this selection excludes all countries whose sovereign bonds have come under severe pressure in recent times.

A second important issue is whether and how the emerging market countries bloc represented in the G-20 could contribute in providing financial market support in conditions of stress. This follows from the wording of the August communiqué and would be consistent with the G-20 self-assigned mandate. Unilateral approaches have been made very recently by some advanced and emerging countries without success. Even if successful, however, the unilateral approach risks being divisive and ultimately may exacerbate tensions, not resolve them. It is in the interest of all G-20 members, particularly the large debtors and exporters, that global bond markets remain stable. An agreement by the large G-20 creditors to support sovereign debt markets, preferably under an IMF facility, as proposed by the former managing director Johannes Witteveen, would convey a strong and possibly decisive signal to market participants. Support should be accompanied by adequate conditionality, consistent with IMF and EU practices.

The G-20 was created in 1998 and reshaped in 2008 with a crisis management imprint. As global financial instability risks reappear, it will have no choice but to revert to crisis mode after some time of tranquil sailing. The more pre-emptive its action the better. Though at present is looks unlikely that Cannes could offer such an opportunity.

Endnotes

[1] See in this respect the Spillover Reports published by the IMF in June 2011.