

INTERNATIONAL GOVERNANCE

Is the G20 the right forum?

JEAN PISANI-FERRY

Highlights

- It is telling that one of the very first decisions taken after the crisis erupted in full force in September 2008 was to reform international governance by creating the G20. Yet the relationship between the financial crisis and global governance is not entirely straightforward.
- The G20 is a significantly less suitable forum for discussion of regulatory matters than of macroeconomic issues and their implications for the institutions of global governance.
- Most of the regulatory issues to be solved are the responsibility of the narrow group of countries with sophisticated financial systems. While it is sensible to involve developing and emerging countries in the reform of financial regulation, they are unlikely to play a leading role.
- The macroeconomic dimension of the global agenda was largely overlooked by the November G20 meeting but its main tenets have since then emerged. On these, and on reform of international financial institutions, there can be no meaningful discussion without emerging and developing countries.
- If significant enough, reform of international financial institutions, especially of the International Monetary Fund, could help contain instability. The US and Europe must make the first move.

This policy contribution was prepared for the meeting of the **Club de Madrid** on 26 March 2009.



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Is the G20 the right forum?¹

JEAN PISANI-FERRY, MARCH 2009

IT IS TELLING THAT ONE OF THE VERY FIRST DECISIONS taken after the crisis erupted in full force in September 2008 was to reform international governance by creating the G20. This long overdue decision was in part accidental, but it was nevertheless indicative of the consensus within the international community that designing and implementing an appropriate response implied creating a more legitimate and more effective body than the G7. The upcoming G20 meeting in London is expected to result in further reforms, this time of the international financial institutions.

The relationship between the financial crisis and global governance is not entirely straightforward. The crisis is certainly by now a global one but it has been at root a crisis of the US banking system which immediately contaminated the European banking system. According to the International Monetary Fund (IMF), US banks have suffered 57 percent of the losses on US-originated securitised debt and European banks 39 percent, leaving only 14 percent for the rest of the world. It is only when the crisis took a turn for the worse in September 2008 that the rest of the world really began to be affected by capital flow reversals and the collapse of world trade. More generally, North America and Europe jointly represent 70 percent of the global supply of financial assets and they probably account for an even larger share of financial regulation. This would suggest that managing the financial crisis, and preventing future ones even more so, could essentially have remained a transatlantic affair.

The need for a global economic venue where the leaders of the major industrialised, emerging and developing countries meet and discuss the reshaping of international governance is indisputable, but it is in fact much more pronounced in other fields such as food security (with Europe and North America jointly accounting for less than one-third of world cereals demand), energy and climate (with these two regions accounting for only 40 percent of CO2 emissions), and trade (where, again, Europe and North America only account for somewhat more than 40 percent of the global total).

It was nevertheless the financial crisis that triggered a global governance change. The question now is whether this discrepancy between its substantive agenda and its composition will make it difficult for the G20 to deliver on the expectations it has created.

The idea put forward in this note is that the G20 is a significantly less suitable forum for discussion of regulatory matters than of macroeconomic issues and their implications for the institutions of global governance. While it is sensible to involve developing and emerging countries in the reform of financial regulation, they are unlikely to play a leading role. On macroeconomic matters and as regards institutional reform, however, no meaningful discussion can take place without them.

The first section of this note addresses the regulatory agenda. Macroeconomic dimensions are taken up in section 2. Section 3 draws conclusions.

1. This is a revised version of a note prepared for the meeting of the *Club de Madrid* on 26 March 2009. It also draws on a presentation at the FEEM-Bocconi conference *Back from the Brink: Rethinking Financial Regulation* on 27 March 2009.

1 THE REGULATORY AGENDA

It is widely accepted that the crisis in large part stemmed from shortcomings in financial regulation (shortcomings meaning ‘absence of/insufficient regulation’ but also ‘regulation which is unfit for purpose’). Was this failure of governance primarily a national failure, or a failure of international cooperation which stronger global governance can remedy?

The shortcomings were no doubt in many respects entirely national. A few examples will illustrate this. First, the belief that regulators cannot know better than markets and that they can rely on private actors for the assessment of risks had little to do with global developments; also, the competition between public agencies that resulted in an excessively lax supervision of US banks was a purely internal flaw. By the same token, the very uneven exposure to toxic assets of banks within Europe illustrates that it was within the power of national authorities to exercise strict oversight of their banking systems – as Spain did with success. The shortcomings of national authorities cannot blindly be ascribed to international coordination failures.

Weaknesses in international governance have, however, also contributed to regulatory and supervisory shortcomings. Three key channels can be identified:

- *Competition among regulators and supervisors resulting in ‘regulatory shopping’ by transnational players and thus in a loosening of national regulations or a weakening of the effectiveness of supervision.* For example, the off balance-sheet conduits of some German banks were established in Dublin, which in part explains why they were neglected by supervisors. The same applies to the operation of
- weakly regulated and supervised Icelandic banks in the UK and elsewhere.
- *Disagreements among regulators resulting in weak global standards, excessive reliance on self-regulation or the subcontracting of important aspects of standard-setting and implementation to private organisations.* Key examples here are the extensive reliance on rating agencies by the regulators themselves, especially but not only in the rulebook for international banking supervision issued by the Basel Committee for Banking Supervision. The painfully negotiated framework has been largely invalidated by the crisis.
- *Resistance by national authorities to the transfer of significant responsibilities to supranational bodies, resulting in incoherent and/or vulnerable frameworks.* A key problem here has been the supervision of transnational financial institutions. Some global banks have grown too large to be supervised by any single national authority and certainly too large to be bailed out by any single national treasury.

Despite its extensive legislative apparatus, the EU itself has not been immune to these problems. The choice of adopting the accounting standards prepared by the IASB, a private organisation, was largely the result of an inability to find agreement among the national accounting boards through negotiation. Resistance to sovereignty transfer is evident in the debate over supervision. The number of pan-European banks has grown in recent years, while supervision remains essentially national and coordination among national agencies is of limited effect, yet there is no willingness to contemplate radical reforms. The recent Larosière report called for by the European Commission and endorsed by the European Council does not envisage centralising the

‘The crisis in large part stemmed from shortcomings in financial regulation... The shortcomings were in many respects entirely national... but weaknesses in international governance have also contributed.’

supervision of pan-European banks and advocates instead closer cooperation between national authorities.

Crisis management since summer 2007 has confirmed that the tension between the globalisation of finance and the weakness of international governance is a major problem. Cooperation between central banks in the provision of liquidity to distressed banks has been remarkably smooth but international cooperation in dealing with banking crises has been less exemplary. Many problems have emerged, for example as regards the coordination of deposit guarantee schemes, but the most difficult one has no doubt been the rescue of banks with significant cross-border operations. This raises major difficulties for small countries with large, internationalised banking systems, such as Austria or Ireland.

The issue is especially acute within Europe where only partial, ad-hoc solutions have been found (for example, the joint bail-out of the Belgian-Dutch group Fortis by the two governments). The crux of the matter is that the taxpayer remains ultimately national and that for this reason governments reject the notion of a burden-sharing scheme that would commit them to contributing to the budgetary rescue of a non-national bank.

The upshot is that even in the EU, the tension between economic internationalisation and political accountability has not been resolved. As pointed out by the recent report of Lord Turner, chairman of the British Financial Services Authority, 'The current arrangements [...] are not a sound basis for the future regulation and supervision of European cross-border retail banks. Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration'.

From this perspective the G20 agenda provides limited and partial response. The enlargement of standard-setting committees to major emerging countries (in fact, not to all G20 members) is a sensible decision but it is not likely to change the game. The enlargement to 12 new countries and

the European Commission of the Financial Stability Forum, a club of regulators without a decision-making structure, is likely to make its functioning more cumbersome.

On the whole the fate of global financial regulation will continue to depend on the attitude of the main financial players. So far, these players have not departed from their traditional stance. The G20 November declaration insisted that 'regulation is first and foremost the responsibility of national regulators'². It is significant that on regulatory reform the G20 has emphasised the role of the Financial Stability Forum rather than that of the IMF, a structured institution equipped with decision-making powers. The Obama administration is certainly more sympathetic to global institutions than its predecessor but Congress is unlikely to delegate significant regulatory powers to supranational bodies. It is therefore likely that cooperation will be intensified further and that regulation will be tightened but that the distribution of powers between national and international institutions will remain broadly unchanged.

What is uncertain is the attitude of private institutions. As Mervyn King, the governor of the Bank of England, said, banks have experienced that they are 'global in life but national in death' and the perception that this is a reality is bound to influence their internationalisation strategy. At the time of writing it is unclear whether the trend towards the creation of global financial players will continue or be significantly diminished by the experience of the crisis.

2 THE MACROECONOMIC AGENDA

The macroeconomic roots of the crisis are less unanimously recognised than its regulatory roots, but a growing number of contributions have emphasised the role of global macroeconomic conditions in creating an environment conducive to financial instability.

From the immediate aftermath of the Asian crisis up to the outbreak of the global crisis, an unusual but seemingly stable pattern of savings flows

2. The European insistence on extending oversight to all financial institutions in all countries and on cracking down on regulatory and tax havens can be seen as a stepping stone towards a comprehensive regulatory architecture. The Europeans have learned from experience that it is only in exceptional circumstances that entrenched special interests of this sort can be overcome and they have every reason to push ahead with their agenda. But this should not obscure the fact that tax and regulatory havens are not the core of the issue.

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prevailed in the world economy. For a decade the poor countries, chiefly China, have been financing the rich ones, chiefly the US, whose savings deficit represented some two percent of world GDP. Instead of resulting in capital flows from capital-rich to capital-poor countries as expected, financial globalisation has involved capital flowing in the opposite direction. In 2005 Fed governor (now president) Ben Bernanke famously spoke of a 'global savings glut'.

Several, possibly complementary, explanations have been given to account for this surprising pattern. Emerging countries, especially China, have been accused of keeping their exchange rates artificially low in order to stimulate exports and run a current-account surplus. Following the traumatic experience of the 1997-1998 crisis, the accumulation of foreign-exchange reserves by the same countries has been seen as a form of self-insurance that would avert recourse to the IMF if they were to be confronted with macroeconomic and financial shocks. Finally, it has been argued that households and companies in those countries had little trust in the quality of domestic financial assets and that capital outflows resulted from their preference for US-made assets of reportedly better quality and safety.

Whatever the weight given to these explanations, the massive inflow of foreign savings to the US economy was bound to impact its interest rates, savings behaviour, and market for financial assets. Indeed it contributed to keeping long-term interest rates low, thereby fuelling the real-estate boom, to lowering domestic savings, thereby feeding the consumption boom, and to increasing the demand for US-made safe or seemingly safe assets, thereby contributing to leverage and the manufacturing of assets of dubious quality. It is these conditions that, combined with a lax regulatory environment, provided the perfect incubator for the boom-and-bust cycle.

This type of analysis puts the spotlight on the lack of global macroeconomic surveillance and the role it could have played, had the world economy been equipped with effective global institutions. In particular, exchange-rate surveillance should have prompted policy corrections in light of the massive and protracted current-account surpluses and deficits; trust in the multilateral regime should have made self-insurance unnecessary; and, although less straightforward, alternative assets could have been offered to surplus countries. The global pattern would have been different and arguably less conducive to complacency about the risk of instability.

This suggests that reform of the international financial institutions should contribute to creating the conditions for future financial stability. This dimension of the global agenda was largely overlooked by the G20 meeting in November but its main tenets have since then emerged. Global financial institutions, especially the IMF, should:

- Warn against economic and financial developments that involve a risk of instability and send signals to governments and supervisory institutions so that they can tighten oversight accordingly;
- Provide effective insurance against private capital flow reversals, and for that they must be equipped with sufficient firepower. This implies matching their resources to their potential needs in a context where crises are characterised by massive outflows;
- Exercise even-handed surveillance over the policies of the major countries and blocs and issue warnings when these policies contribute to global instability. This implies making the institutions legitimate through more appropriate representation and say for the participating countries.

This outline suggests that issues of governance and of effectiveness are very closely linked. Keynes used to say that the job of the IMF is 'ruthless truth-telling', but the Fund today lacks effectiveness in dealing with global problems because it does not have the legitimacy that would allow it to tell the truth to China and the independence that would allow it to tell the truth to the US. In fact, it has done neither.

Looking further ahead, the reform of global financial institutions should ultimately be seen as a stepping stone towards a more balanced international system of the sort recently advocated by People's Bank of China governor Zhou. Whatever the questions raised by the proposal for a new global currency, the political significance of the initiative is crystal clear. It is equally clear that a prerequisite for moving towards a more balanced international system is bold institutional reform.

The recent reform of quota and voice in the IMF has evidently not been equal to these needs. It has not even been sufficient to create or recreate the requisite ownership of the institution among emerging and developing countries. The G20 has mandated ministers to prepare proposals to reform international financial institutions, including giving more voice and representation to emerging and developing economies, and G20 ministers have agreed that this should be done by early 2011. This indispensable reform needs to go far beyond the incremental changes agreed upon in 2008. It implies in practical terms a reduction in the number of European votes and seats, possibly leading to consolidation, and abandonment of the US veto. Without such a reform the IMF will continue to be perceived as an instrument of yesterday's powers and will be unable to play the macroeconomic role it needs to play.

If there is a venue where such reforms need to be

discussed, it is the G20 summit. The matter is not a technical but a political one. The question put to the heads of state and government is whether they agree on a major redistribution of powers within the institution and at the same time on a strengthening of its role and effectiveness.

3 CONCLUSIONS

Back in November, global governance reform was the world leaders' chosen response to the outbreak of the crisis. They now have to deliver and they are at risk of disappointing. This would be a very unwelcome development, because it would signal a collective inability to act and could trigger retreat towards national, possibly nationalistic, solutions. History teaches us that failed international conferences in times of deep crisis are to be avoided.

The G20's agenda so far has put the emphasis on regulatory reform. There is no doubt room for sensible initiatives, some of which are loosely related to crisis prevention and some of which could have more effect. Improved standards and more comprehensive regulatory and oversight coverage are among them. But there are limitations to what the G20 can do in this field. First, most of the issues to be solved are the responsibility of the narrow group of countries with sophisticated financial systems. It is appropriate to involve emerging and developing countries in the discussion but their participation is unlikely to change the outcome significantly. Second, regulatory cooperation can be improved but there is little room for radical reform. Problems within the EU are an indication that the supervision of financial institutions remains a fundamentally national responsibility. Third, the reforms are technical in nature and this adds to the risk of disappointing.

Reform of international financial institutions, first

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and foremost of the International Monetary Fund, is a more promising avenue. If significant enough, it could help contain developments conducive to instability. It could embody the transition from a US-dominated world economy to a more balanced, multilateral regime. And it is the condition for rebuilding trust in the system among emerging and developing countries and thereby avoiding the rebellious behaviour observed in recent years.

This is, at its core, a highly political issue where only heads of state and government can take the initiative. The G20 meeting in London offers a rare opportunity for launching a bold reform process. It is up to the United States and Europe to make the first move, because it is their current power and representation in the international financial institutions which is preventing the rest of the world from taking a stake in them..

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