

THE G20 IS NOT JUST A G7 WITH EXTRA CHAIRS¹

In the wake of the global crisis the G20 has largely substituted the G7 as the key forum for international economic cooperation. However, G7 and non-G7 members of the G20 come to G20 meetings with different priorities. Developed countries have taken a direct hit on their financial systems as a result of the crisis and they accordingly give priority to strengthening financial supervision. Emerging economies have been primarily affected by the collapse of trade and (mostly in emerging Europe) the outflow of capital. Their priority is thus to ward off the reemergence of protectionism. As newcomers, the emerging countries are also focused on the distribution of power in international institutions. So far, the G20 agenda has been dominated by the global turmoil and the rebuilding of financial regulation – a rather G7-like agenda. Meanwhile, it has been silent on the issue of global imbalances, where it could have made a difference. In the future, the G20's agenda will have to evolve and better reflect the variety of concerns of its members.

1

■ The paradox of the G20

The creation of the G20 is recognition that interdependence cannot be managed by developed countries. In recent past the developing world was invited to the top table when development issues were on the agenda. This time it has been given permanent seats and has been asked to participate in the solution of a global problem. This fundamentally changes the nature of the discussion.² The G20 is symbolic in this regard, but the same applies to other bodies, such as the Basel Committee and the Financial Stability Board.

Still, both G7 and non-G7 members of the G20 may not yet have entirely realised that the G20 is not just an extended version of the G7. Its agenda has so far been determined by the urgent responses needed to tackle an unfolding crisis. The discussion are much more specific on financial regulation and remuneration, which mainly concern G7 countries, than on other issues that interest most emerging ones – trade liberalisation and the reform

of Bretton-Woods institutions. But this is to a large extent because emerging countries have not yet produced consistent proposals on how they want to use their new responsibilities in international governance. Consistently, G20 communiqués are rather vague on trade, almost silent on global imbalances, and noticeably unspecific on the surveillance role of the IMF.

Additionally, G20 leaders should acknowledge the fact that, like the G7, the G20 will not be the appropriate configuration forever. Little attention is paid to the fact that Africa is forecast to surpass China, as well as India, in terms of population by 2030. More strikingly, the size of its young population is already almost equal to that of China or India, while Africa also has a large share of land and natural resources available globally.³ The G20, however, includes only one African country: South Africa. It will need to evolve in the future to better represent this region of the world.

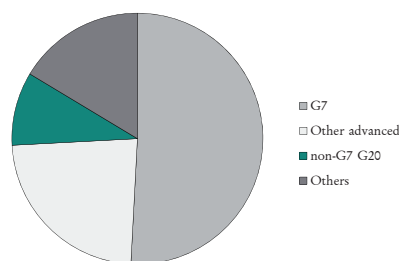
1. This paper draws on the discussion among participants in the Bruegel-ICRIER-CEPII conference on 'International Cooperation in Times of Global Crisis: Views from G20 countries' held in New Delhi on 14-15 September, 2009. We are grateful to Olena Havrylchuk for coordinating a first draft of this document with Dony Alex, Mathew Joseph and H  l  ne Vuillermet. We would also like to thank Manmeet Ahuja, Chantal Bartholin and Arpita Mukherjee for their key roles in the conference. All references without details refer to papers or presentations discussed during the different sessions and can be found on the following link: <http://www.economieinternationale.eu/anglaisgraph/communications/pdf/2009/14150909/14150909.htm>.

2. Montek Singh Ahluwalia (Deputy Chairman of the Indian Planning Commission).

■ The new rules of global finance

The urgency of strengthening the regulation of financial institutions was highlighted in the first two G20 meetings in November 2008 and in April 2009. Over the last few months, a large number of academic papers, official reports and white papers have been published in the US and in Europe, and international organisations have also contributed. Much less, however, has come from the non-G7 G20 countries, not least because their participation in global financial integration is much more limited: the G7 countries and other advanced economies account for the bulk of cross-border holdings of assets and liabilities, and the non-G7 G20 countries for a mere 10% (Figure 1).

Figure 1 – World distribution of external assets and liabilities*, 2007



* Total assets + total liabilities. G20 excluding the Netherlands and Spain.
Source: Authors calculations with Lane and Milesi-Ferretti data.

2

While non-G7 countries are now fully fledged members of the bodies in charge of setting the rules of global finance, they have not yet clarified their own priorities. Some suggest that the global rules should be set 'for Nanos instead of Ferraris'.⁴ But some of the emerging countries' financial institutions are an integral part of globalisation. If a distinction needs to be made, it is not between countries but between global and local players. For the time being, however, rules are being set by the G20 but at the initiative of advanced countries.

The agenda starts with capital requirements and accounting, whose pro-cyclicality has been widely viewed as having considerably deepened the financial crisis. Consistently, the G20 has been considering not only raising capital requirements for 'systemic' financial institutions but also introducing counter-cyclical capital or reserve buffers. As for mark-to-market accounting, a number of politicians, notably in France, have called for reform of accounting standards, insisting that 'market' value is not always 'fair' value. However, the lesson from most previous crises is that non-transparent balance sheets tend to deepen the crisis, due

to late recognition of problems, and to unnecessarily delay the recovery. Consequently, many economists propose to continue relying on fair-value accounting, while applying filters to mitigate the pro-cyclicality of accounting standards, or supplementing them with stress-testing exercises that would provide more long-term views of solvency.⁵

Next comes the scope of financial regulation and supervision, which is widely regarded as having been inadequate. This concerns not only hedge funds but, more importantly, banks! The key point here is that banks escaped capital regulation by using off-balance-sheet special investment vehicles.⁶ Failure to regulate the 'shadow' banking sector is at the root of the crisis.

However, regulatory arbitrage will always exist and banks may find other gaps in order to escape regulation. Fighting such arbitrage will necessitate close coordination between supervisors both within and between countries and an incentive device to make each country resist reaping gains from allowing financial institutions to expand through regulatory gaps – which makes the G20 a much better forum than the G7.

One possibility would be not just to regulate institutions, but rather activities, so that capital can be put aside for credit risk whether it is located on the balance sheet or off. Another option would be to switch from home-country to host-country regulation and supervision. This would require banks to operate through subsidiaries rather than branches, with each subsidiary regulated and supervised by the host country. An additional advantage of such an approach would be to allow each host country to engineer macro-prudential supervision in line with its own credit cycle.

A third micro-prudential issue on the G20 agenda is the dangers that are posed by 'too-big-to-fail' institutions. One way to deal with this issue, proposed by the US Treasury, is to apply stricter and more conservative prudential standards for these institutions in terms of capital and liquidity ratios and risk-management standards. Another possibility, proposed by the Financial Services Authority in the UK (FSA), is to force the biggest banks to pre-plan their own demise by writing 'living wills'. This should not only make banks resolutions easier and faster but, while planning their own resolution, banks would be encouraged to better track their exposures and might eventually simplify their legal structures. Like with the question of supervisory scope, tackling 'too-big-to-fail' institutions is hampered by the willingness of national governments to attract financial activities and to promote national champions.

3. Jean-Joseph Boillot (CEPII's Business Club, Paris and Euro-India Economic Business Group).

4. Andrew Sheng (University of Malaya, Kuala Lumpur).

5. Nicolas Véron (Bruegel, Brussels).

6. Viral Acharya (NYU, USA, with Matthew Richardson).

■ What macroprudential supervision?

The debate on macroprudential supervision is quite different since there was no macroprudential supervision before the crisis (although this is not a new concept). It is increasingly accepted that financial stability cannot be provided by the combination of monetary policy and time-invariant capital requirements. But, now the question is what role macroprudential supervision will play in the policy regime.

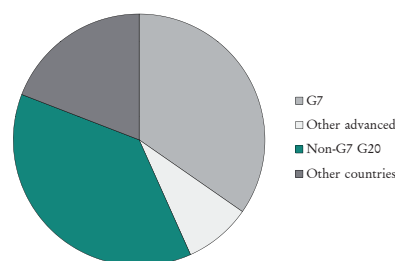
G20 leaders have agreed to consider countercyclical capital requirements, and the Financial Stability Forum, the Basel Committee on Bank Supervision and the Committee on the Global Financial System have been charged with devising a framework for this by the end of 2009. The problem is how to determine when times are 'good' or 'bad', and who is in charge of this task. On the 'how' question, a number of methods have been proposed, such as the use of 'through-the-cycle' internal ratings (already suggested by the FSA and advised by the Committee of European Banking Supervisors), autoregressive adjustment of capital, as well as using a multiplier to adjust capital, which could depend on lending growth, credit spreads, GDP growth, or asset prices⁷ On the 'who' question, there is still no broad consensus either. The best-equipped institution to define 'good' and 'bad' times would be the central banks. However, the interconnection between macrofinancial supervision and bank bail-outs (which have strong fiscal implications) could put central bank independence at risk.

The need for the above reforms is widely recognised in developed economies, even though opinions differ on the depth and details of implementation. However, the G20 may not have taken into account the views of emerging economies. The introduction of higher and countercyclical capital requirements would probably increase the cost of financial intermediation. While this cost is justifiable in countries with deep financial markets in order to achieve financial stability, emerging economies - with a significant share of the population still excluded from banking markets - would prefer a differential country-by-country approach. Finally, counter-cyclical credit policies may prove tricky in open, emerging countries where credit tightening in a boom may be offset by a rise in capital inflows.

■ Global imbalances

Global imbalances are a G20 topic because unlike gross capital flows, which mostly go North-North, net flows of savings go both North-North and South-North. Significantly, 35% of total current-account surpluses and deficits are accounted for by G7 countries and 38% by non-G7 G20 countries (Figure 2).

Figure 2 – World distribution of absolute current account balances*, 2012 (IMF projections)



* Sum of absolute values of current account balances. G20 excluding the Netherlands and Spain.
Source: Authors' calculations based on IMF April 2009 projections.

There is no consensus among economists on the role played by global imbalances in the crisis. Some claim that the excess of saving over falling investment in East Asia is one important reason why long-term interest rates were so low for so long, encouraging leverage, pushing house prices up and giving incentives to asset managers to seek high-yield products.⁸ Some object that while US macroeconomic conditions were indeed conducive to the crisis, they were fundamentally determined by domestic developments. Furthermore, they observe that the US current-account deficit as a proportion of world GDP actually diminished from 2005 to 2008.⁹

Nevertheless, there is broad consensus that the current situation is not optimal. First, global imbalances have played a role in the transmission of the crisis across borders: emerging economies with large current-account deficits, for example in central and eastern Europe, have been more vulnerable to reversals of capital flows. Second, imbalances reflect domestic problems and distortions, such as a lack of social insurance and poor corporate governance coupled with financial repression (as is the case in China) and low private savings (as is the case of the US). Third, they may constitute an obstacle to a sustained recovery of global growth in a context where failing US consumption needs to be replaced. Finally, to the extent that imbalances are financed through liquid capital flows, they are a potential source of disruptive adjustments.

Although there seems to be some agreement that global imbalances need to be reduced, the 'how' question is much debated, which may explain the reluctance of the G20 to make clear statements on this issue. In particular, it is difficult to imagine how a double-rebalancing of growth, from the public to the private sector and from deficit to surplus countries, could be achieved without significant real exchange-rate adjustments. The US advocates a further appreciation of the renminbi, but Chinese experts are puzzled by the fact that the 2005 decision to move to gradual appreciation was in fact followed by a rise in the country's external

7. Avinash Persaud (Capital Intelligence, London) and comments by Olena Havrylchyk (CEPII, Paris).

8. David Vines (Oxford University and CEPR).

9. Gian-Maria Milesi-Ferretti (IMF, with Olivier Blanchard), and comments by Ted Truman (Peterson Institute for International Economics, Washington).

surplus.¹⁰ Furthermore, China fears that an appreciation of the renminbi could trigger a massive capital loss on its accumulated reserves in US dollars. However, a gradual appreciation of the renminbi may not be advisable either since it could trigger speculative capital inflows into China. All in all, there will be an interconnection in China between, on the one hand, monetary reforms (currency convertibility, making the exchange rate more flexible, liberalising capital flows) and, on the other, structural ones (allowing banks to extend loans according to credit rather than political criteria, accelerating the provision of safety nets, discouraging excess capacity, cutting export subsidies...).

The US has long been blaming China for its undervalued currency, threatening to raise tariffs on Chinese exports if China does not revalue hard. Unfortunately, China has suffered very much from the nose-dive in international trade and has endured rising protectionism, especially from Europe and the US.¹¹ This is not to encourage the Chinese authorities to do a U-turn in their growth and monetary strategies. But, more generally, the way advanced economies deal with domestic protectionist temptation in the face of growing unemployment will be key to encouraging East-Asian countries to remove distortions in favour of their tradable sectors.

■ Reform of the IMF

The rationale for accumulation of foreign-exchange reserves by some emerging countries, is either foreign-exchange intervention or self-insurance against balance-of-payment crises - a major motivating factor for many small and medium-size countries, especially in Asia where trust in the International Monetary Fund was severely undermined by the experience of the late 1990s. The softer and more flexible conditionality recently adopted by the IMF in central and eastern Europe is widely regarded as resulting from a change in the IMF's approach to crises. But it can also be interpreted - and is indeed interpreted by some - as resulting from Europe having a greater stake than Asia in the governance of the Fund.

Large accumulation of reserves for self-insurance purposes can be considered inefficient both from the point of view of the country that accumulates reserves - it sterilises resources that could be invested more productively - and from a global macroeconomic standpoint - as long as countries aim to accumulate reserves they seek to save more, which dampens global demand. Alternative arrangements, such as the establishment of credit lines, reserve-pooling arrangements, swap lines or other forms of insurance, are therefore preferable. The G20 decision (in April 2009) to increase IMF resources to 750 billion US dollars points to a push to raise the role of the IMF as a lender of last resort. Moreover, the establishment of the Flexible Credit Line can be viewed as giving it the role of 'lender of first resort'. But this is unlikely to convince Asian countries to return to the Fund unless IMF governance undergoes in-depth reform. This is where macroeconomic reform meets reform of the Bretton Woods institutions.

A second reason to reform IMF governance is to improve its ability to carry out effective surveillance. It requires both independence and legitimacy. A way to increase the independence of surveillance could be to relieve the Executive Board of its surveillance duties and to focus it on the overall strategy of the Fund. But to raise the legitimacy of the Fund requires more fundamental change, such a significant shift of voting rights and executive power away from Europe to emerging and developing countries.¹² Furthermore, these changes should go hand in hand with a reduction of the 85 percent-majority threshold, which currently gives the US a power of veto, and with at least partial consolidation of the European chairs.

In this respect the creation of the G20 is likely to have profound implications. Emerging and developing countries cannot continue to accept a minor role in the Bretton-Woods institutions. Neither can they be satisfied with insubstantial changes and a promise that more will happen in the future. Gradualism was a possible reform strategy in the pre-crisis world. It is no longer an option.

*Agnès Bénassy-Quéré, Olena Havrylchyk, Rajiv Kumar
& Jean Pisani-Ferry**
beatrice.postec@cepii.fr

10. He Fan (CASS, Beijing).

11. Min Tang (China Development Research Foundation, Beijing), Natalya Volchkova (New Economic School and Center for Economic and Financial Research, Moscow) and Peter Prayer (South African Institute of International Affairs).

12. Louis Pauly (Toronto University), and comments by Stormy-Annika Mildner (German Institute for International and Security Affairs (SWP)) and Shigeo Kashiwagi (Policy Research Institute, Japanese Ministry of Finance).

* Agnès Bénassy-Quéré, Directeur, CEPII; Rajiv Kumar, Directeur, ICRIER (Dehli) & Jean Pisani-Ferry, Directeur, Bruegel (Bruxelles).

LA LETTRE DU CEPII

© CEPII, PARIS, 2009
EDITORIAL OFFICES
Centre d'études prospectives
et d'informations internationales
9, rue Georges-Pitard
75015 Paris
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

PUBLISHER:
Agnès Bénassy-Quéré
Director of CEPII

CHIEF EDITOR:
Gunther Capelle-Blancard

DTP:
Laure Boivin

DIFFUSION:
La Documentation française

SUBSCRIPTION only to the
original, French version
(11 issues per year)
France 49,50 € VAT
Europe 51,20 € VAT
DOM-TOM (NET, econ. air mail)
50,20 € NET
Other countries (NET, econ. air
mail) 51,20 € HT

Please send your orders to:

La Documentation française
124, rue Henri Barbusse
93308 Aubervilliers Cedex
Tél. : 01 40 15 70 00

WEB site: www.cepii.fr
ISSN 0243-1947

CCP n° 1462 AD
September 21, 2009

Imp. Centre d'analyse stratégique
Imprimé en France

*The CEPII is entirely responsible for
the Lettre du CEPII and its on-line,
English translation. The opinions
expressed are those of the authors.*