BRUEGEL
POLICY
CONTRIBUTION

ISSUE 2011/15
OCTOBER 2011

WANTED: A STRONGER AND BETTER G20 FOR THE GLOBAL ECONOMY

IGNAZIO ANGELONI AND JEAN PISANI-FERRY

Highlights

- The G20 acted as a crisis manager when global financial markets were under threat in 2008 and 2009, and contributed to a positive outcome. However since then, in the more routine work of crisis prevention, its performance has been less convincing at best, and criticism of its effectiveness has increased.
- Nevertheless, a global governance forum such as the G20 is necessary. Allowing the G20 to slide slowly into irrelevance would be unfortunate because a global crisis manager is once again needed, this time to deal with the European sovereign-debt crisis
- The first priority is to promptly finalise the macro-coordination framework still under construction, and strengthen it by bringing intra-regional imbalances explicitly to the fore. These should be treated as global imbalances under G20 responsibility if they have global implications, as the euro crisis certainly does. Second, decisions should be taken on how the emerging country bloc represented in the G20 could contribute to provide financial-market support in conditions of stress. The 3-4 November Cannes G20 summit is an opportunity to strengthen the G20's role.

This paper is a contribution to a *Think Tank 20* volume to be published by The Brookings Institution. Ignazio Angeloni (ignazio.angeloni@bruegel.org) is a Visiting Fellow at Bruegel and an Advisor to the Executive Board of the European Central Bank. Jean Pisani-Ferry (jean.pisani-ferry@bruegel.org) is Director of Bruegel.

Telephone
+32 2 227 4210
info@bruegel.org

www.bruegel.org

WANTED: A STRONG AND BETTER G20 FOR THE GLOBAL ECONOMY

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THE RESURGENCE OF TURBULENCE in international financial markets, with the epicentre not in the US banking system, as in 2008, but in the European sovereign sector, potentially brings the G20 closer to the centre of policy action after a phase of relative eclipse. Many questions arise. Are the European risks relevant from a global perspective? Is the G20 (a large grouping, at top political level but not universally representative and with little own technical expertise) the right forum to prevent threats to financial stability? And if so on both counts, what concretely can and should the G20 do?

Since its birth the G20 has had two souls, one as policy coordinator in times of fair weather and one as crisis manager. In fact, the G20 was born twice: first in 1999, as a new forum for finance ministers in the wake of the Asian crisis, and then again in autumn 2008, when it was upgraded to 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 incarnation aimed 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 G20 contributed to the positive outcome. But in both cases, after the risks receded, the G20 started to engage 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 increased.

For these reasons it is perhaps useful to revisit some fundamentals: why a G20 should exist at all, and how it has acted so far and with what degree of success. We argue that, contrary to what critics say, a global governance forum such as the G20 is neither unnecessary, nor has it performed poorly overall, since its 2008 reshaping. It is true, however, that its effectiveness has diminished and that this has happened particularly when it has tried to be policy coordinator in the (relatively) good times. As we approach the Cannes Summit (3-4 November), the only meeting planned for 2001 of G20 heads of state or government, it seems unlikely that the French presidency, in spite of early ambitions and a substantive agenda, will bring substantive deliverables to the meeting. Many observers perceive a slow slide into irrelevance, and the G20 has ceased to be a frequent and topical subject in newspapers, web bloggings and even scholarly publications. This is particularly unfortunate at a time when a crisis manager is against needed. Starting from these considerations, the final part of this Policy Contribution discusses what contribution the G20 could make in terms of ensuring sustainable growth and financial stability in the global economy.

1 THE CASE FOR GLOBAL ECONOMIC COOPERATION

The controversy over the value and the limits of economic policy coordination is one of 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 policy-makers.

In principle the basic issues seem easy to settle: in an interdependent world, in which national economic performance and policies influence others, there should be benefits from coordinated 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 interlinkages, it follows that coordination

should have become more valuable and thus more pursued in practice.

However, for several reasons, economic analysis has never succeeded in detecting and measuring these benefits precisely. 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 not) materialised. Second, many analyses date back to the 1980s – prior to the surge of international capital flows and before the start of the emergence of today's emerging powers. 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, therefore, that older research concluded that benefits from coordination were negligible.

More recently, economists have revisited the subject using more sophisticated modelling 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 a rationale for the degree of interdependence observed empirically. Under these assumptions, these models can hardly provide a prescription for policy coordination for a world that is dominated instead 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 since then they have increased markedly, or because they assume away important aspect of financial globalisation, it does not seem hazardous to assume, even in absence of solid proof, that coordination is probably worth pursuing in today's economy.

Recently, the financial crisis has provided additional arguments for this view, bringing to the fore the existence of substantial international spillovers in particular in the area of financial regulation. Countries (or regions) with large developed financial sectors, particularly if their money performs an international role (such as the US dollar, or to a lesser extent the euro), typically also act 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 in those countries is likely to have a significant impact beyond their borders. Since financial regulation remains predominantly a national responsibility (within some limits determined by the international harmonisation 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 centres exert significant international influence, affecting financial stability in other countries and even globally.

2 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, often at the times when they are most needed. Representativeness typically conflicts with efficiency of action, which requires a small number of participants.

The composition of the G20 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 favour of emerging economies – this is, after all, the distinguishing trait of the G20 relative to its older 'brother', the G7. At the same time, efficiency of debate and decision making requires that the

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1. See in this respect the Spillover Reports published by the International Monetary Fund in June 2011.

number of seats at the table be limited; the presence of 20 members (19 countries plus the European Union, not counting invited members and international organisations) has proved to be on the high side of manageability.

Another delicate aspect is the G20's working arrangements. This includes the internal organisation and the links established with other bodies that, at a more or less technical level, are already active in the areas covered by the G20. The G20 has established working links with a number of entities that are *de facto* reporting to it (for example, the International Monetary Fund, the Financial Stability Board, the Basel Committee on Bank Supervision) and is assisted by two orders of substructures (ministers and deputy ministers). If the lack of own technical expertise does not seem to be a serious limitation – the technical input comes effectively from the bodies just mentioned – a more serious challenge has been ensuring continuity of action over time. In the absence of a permanent secretariat, agenda setting relies completely on the annual rotating presidencies, often with very different priorities from one year to the next.

Some improvements in working arrangements could help. Long-term (multi-year) work lines should be agreed, with the aim of providing guidance to the rotating chair. Leaders and ministers should also seek 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 along the same lines would be to set up a small permanent secretariat at the IMF. Its mandate – ensuring continuity of the process and stronger liaison between the rotating chairs – would not require large staffing, and bureaucracy and red tape should be avoided.

3 HOW HAS THE G20 PERFORMED?

The limited time elapsed (three years) and the few meetings that have taken place since 2008 (summarised in Table 1) allow only a partial answer to the question of the G20's performance. In this period, the G20 seems to have gone through a cycle. At first, the 'new' G20 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 was still effective in terms of institution building (establishment of a permanent G20, plus the announcement of a new 'Framework' for macro-policy coordination). However, it marked a transition to a second stage, in which, in the context of economic recovery, renewed divergence of priorities between advanced and emerging countries, and reduced financial market tension, the focus was predominantly on macroeconomic coordination, and progress on financial reform stalled.

This evolving pattern emerges clearly from the wording of the final statements following the meetings (documents are available at www.g20.org). The concluding statement of the

Table 1: 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

'The Pittsburgh summit achieved significant results in terms of institution building, but also coincided with a marked slowdown in the productivity of the G20. In subsequent meetings progress slowed considerably, as the pressure of economic and financial emergency abated.'

Washington meeting was short and fully concentrated on the actions needed to stabilise 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 signalled a community of policymakers that wanted to be on top of events and steer them jointly. This helped the subsequent stabilisation of financial markets. The London summit was dominated by the risks of recession and protectionism. Observers at the time wondered if the world was heading towards another Great Depression. There was serious fear of pervasive restrictions to international trade, as in the 1930s. The London summit not only maintained the momentum launched in Washington and signalled that protectionist pressures would be resisted, but also decided on a major (in fact, unprecedented) increase in the resources of international financial institutions. Importantly, also, 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 (September 2009), the summit in Pittsburgh marked a watershed. In a number of ways, Pittsburgh achieved significant results, particularly considering the low expectations on the eve of the summit. A first result concerned institution building. The leaders decided that the G20 summit would become a regular event, replacing the G8 as the forum to which the FSB 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 G20. In subsequent meetings progress slowed considerably, as the pressure of economic and financial emergency abated.

In 2010, the calendar included two summits under joint Canadian-Korean chairmanship: 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 ultimately resolved, after major difficulty, more than a year later at a ministerial meeting in April 2011 under the French G20 presidency. In turn, the 2011 French presidency added new elements to the agenda, including, notably, a new focus on the reform of the international monetary system, and discussions on the volatility of commodity processes and how to deal with them. At the time of writing, however, it is not clear to what extent these novelties announced by the presidency will translate into meaningful decisions at the Cannes summit of 3-4 November.

4 THE G20 AT THE PRESENT JUNCTURE

The G20's agenda remains focused on the priorities dictated by the 2008 US-centred banking crisis and the resulting recession. The two main lines of action – financial regulation and macroeconomic coordination to contain global imbalances – remain important and should be pursued. But the G20 would renege on its responsibility if it did not also focus on today's paramount problem, the risk of financial contagion from the sovereign sectors.

The epicentre of these risks is in Europe. Events have accelerated recently; until June this year, one could still hope that the euro-debt crisis would remain confined to a handful of small countries, financially distressed but manageable by a united Europe. After all, Greece, Portugal and Ireland combined represent a mere six percent of euro-area GDP. 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 in the case that the crisis should spread to Spain. Even the reticence of some policymakers – for example, in deciding on 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 become globally relevant. 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 behaviour will likely extend to more stable countries. In Germany, in spite of the recent export-driven expansion, public opinion is hesitant about endorsing large external transfers and worried by institutional changes in Europe that are perceived as potentially damaging for Germany.

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

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

On 8 August this year, when the euro crisis suddenly aggravated, the G20 issued a statement expressing the "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 finalise the macro-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 G20 responsibility if they have global implications – the euro crisis certainly does. So far there was 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 G20 surveillance mechanism remains organised on a country-by-country basis. For example, the group of 'systemic' countries singled out for in-depth examination in the MAP includes, reportedly, Germany and France and not the euro area 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 if, and how, the emerging bloc represented in the G20 could contribute to financial market support in conditions of stress. This follows from the wording of the August communiqué and would be consistent with the G20's self-assigned mandate. Unilateral approaches have been made very recently, reportedly at least, 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 G20 members, particularly the large debtors and exporters, that global bond markets remain stable. An agreement by the large G20 creditors to support sovereign debt markets, preferably under an IMF facility (as proposed by the former IMF 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 G20 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 the action it takes, the better. Though it looks unlikely at present, Cannes could offer an opportunity.