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The G20 and the future of market regulation

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›› The global meltdown has politicised the governance of finance to an unprecedented yet healthy degree. At the very least, it has painfully resurrected the need for coordinated action to mitigate its impacts and address the danger of multiplying pro-cyclical measures. Most significantly, the underpinnings of global financial governance have come into question, particularly the hold of leading developed countries as gatekeepers of the global supply of credit and, consequently, their far from amicable relations with borrowing countries.

The current global financial architecture rests on a number of (semi-) institutionalised settings in which policy priorities have so far been decided by G7 countries. It is in these narrow venues where discussions over global financial governance traditionally took place. The eruption of the G20 onto the global scene shows a shift away from the closed club model of regulation. Although this shift is a step in the right direction, the depth, coverage and urgency of the crisis will demand further efforts. So far such an intensification of deliberations is a de facto extension of the kind of informal collegial deliberations prevalent since the breakdown of Bretton Woods in the mid-70s.

The globally coordinated initiatives proposed by the G20 April summit address pro-cyclicality and coordination. Such an approach will inevitably require deeper cooperation and lasting engagement between the erstwhile gatekeepers and borrowers. Viewed in these terms this institutional development has opened the gates to authorities in emerging markets and a prospect of some voice and sense of ownership. But it remains to be seen how issues of truly global reach – competitive subsidisation, debt and commodity trading to name but a few – are included and re-regulated. The principal implication

HIGHLIGHTS

- The G20's widening of club membership is positive but it does not yet provide a point of convergence of policy approaches.
- Rich countries abandoned developing states and emerging markets during their crisis in the 1990s, and are now guilty of employing double standards in their own bail-out packages.
- Industrialised countries are drying up credit markets to finance their own counter-cyclical policies crowding out private investment both domestically and globally as well as capital flows to developing countries.

›››››› of this point is that markets are in practice 'peopled' by agents pursuing specific interests. The relationship of market processes to various forms of political process, what is commonly called 'governance', is a hot issue because it raises difficult questions about whether outcomes are right or fair.

FOREST FIRE IN THE MAKING

The credit crunch spreads like forest fire. Unemployment reached 9.5 percent in the United States by mid-2009 – the highest in the last 26 years – while in Europe 15 million people are suffering the same problem. The United Nations has estimated that in the developing world 100 million people have been pushed into chronic hunger and poverty since the beginning of the crisis. With these additional "new poor" the hunger crisis includes now about one sixth of the world's population.

Despite the erstwhile hold of the United States on the global institutional framework, some circles have cast the blame on developing countries as being the seed of the global imbalances at the root of this debacle. The "global savings glut" perspective posited by Bernard Bernanke considers that the problem arose in the policies of emerging markets that built up a foreign-exchange shield to guard against the repetition of the balance of payment crises that had hit them during the 1990s. In addition, central bank interventions in foreign exchange markets aiming to maintain a competitive exchange-rate to promote export-led growth aggravated the problem of reserve accumulation. These dovetailing goals drove countries actively to preserve current account surpluses at the expense of developed countries' deficits, transforming several emerging-market nations from net borrowers into significant net lenders. In this regard, countries such as the US were dragged to a ballooned deficit that fed the assets bubble and stimulated domestic consumption through endogenous alterations in equity values, house prices, real interest rates and the exchange value of the dollar.

It is true that conventional economic theory considers global imbalances as a threat to global and financial stability. But the reigning policy paradigm prior to the crisis argued that they were the natural consequence of economic and financial globalisation and that the imbalances would be resolved smoothly through the normal functioning of markets. G7 countries embraced such an argument, in a context of revived faith in the stability of the international financial markets upon the arrival of George W. Bush.

The Argentine crisis was a watershed. Despite the large exposure to Argentine debt when Argentina declared default in 2001, the US government refused to support any kind of financial assistance package, arguing that bailing out greedy investors would distort market signals. This policy represented a turning point from the conventional interventionist approach to international financial crises. The fact that the bulk of international lending had shifted from bank credit to securitised finance strengthened the argument against bail-outs: default to thousands of individual bond holders did not pose the same kind of systemic financial risk. Thus, Argentina was a test case of this vanguard hands-off approach to "solve" international financial crises. The fact that the crisis did not have contagion effects beyond Argentina strengthened the conviction of US officials in the merit of this approach.

These events diminished demand for more severe public regulation empowering the supporters of market based forms of governance and the delegation of regulatory functions to the private sector, assuming global markets' aptitude for governing themselves. Therefore, the eyes of all money doctors, macroeconomists and governors of Central Banks alike, were almost entirely focused on controlling prices by applying inflation targeting. This policy, however, proved unable to manage asset price bubbles and economic imbalances.

But borrowers, as repeated victims of boom and bust cycles, had also learnt the lesson and so

began their own build up of reserves. A view from these shores reveals that bolstering financial autonomy was a rational (if not efficient) response to the *laissez faire, laissez passer* approach promoted by developed countries both through the G7 as well as through the Bretton Woods institutions. Borrowing countries that had been induced to both open and deregulate their economies during the heyday of the Washington Consensus had been left out in the cold. As either victims or on-lookers to the clearly uncooperative attitude, emerging markets chose individual self-insurance against sudden reversals in capital inflows implementing the reserve accumulation subsequently pointed out by Bernanke as being at the root of the global savings glut. Reserve accumulation was aided by the sharp rise in commodity prices that led to an improvement in the terms of trade for several non-industrialised nations as well as by the domestic political support for "independence" from the IMF.

It remains to be seen how issues of truly global reach are re-regulated

These two independent and uncoordinated policy lines followed by emerging-market nations on one side (working to bolster their financial autonomy) and G7 countries on the other (transferring public authority for financial regulation to market based governance) resulted in the sequence of events that eventually led to the global financial crisis. The evident corollary to this conclusion is that coordination of policies and increased democratic consensus are not only good in and of themselves; they are also necessary for global economic growth and financial stability.

GLOBAL FIRE BRIGADE

If the role of the United States as the gatekeeper of global credit has come under question, the need for coordination of policies is a matter of urgency. The Keynesian policies applied in the Great Depression were designed to boost domestic demand in economies that were largely more self-contained than the globalising world we are living in today. A single country implementing anti-cyclical expansionary monetary, credit, and fiscal policies to boost the national economy will find that much of the expanded demand will be satisfied by imports. Thus, the effectiveness of the policy to mitigate domestic unemployment will be eroded. If short-sightedness prevails governments confront two main alternatives to reap benefits from anti-cyclical policies: an uncooperative stampede, raising protectionist barriers to prevent the leaking of resources assigned for the expansionary policies or the coordination of such policies with other countries so that they are both paid and enjoyed jointly.

Protectionism is a temptation at first glance, especially because it places governments in a comfortable position with their domestic constituencies and special-interest groups. Tempted by short-term political gains most governments respond with an eye to consenting to the desperate claims of sensitive sectors in trouble. Domestic policies go far beyond increased border barriers to trade. They usually include subsidies under several forms, bail out packages, exchange rate devaluations as well as legal privileges for domestic economic agents, among others. In sum, protectionism comes in many guises. Uncooperative policies have a high cost in the medium term since they will most likely trigger a domino effect leaving the global economy worse off by shrinking both domestic and international markets.

The domino effect is everyone's worst nightmare. Fortunately, state agencies face multiple incentives to engage in collective approaches. The first resource at hand was the G20 framework. This group created in the aftermath of the 1998 Russian crisis includes the G7 members and 13 emerging-market nations with potential to both contribute positively or hurt global economic stability. Still, the widening of club membership

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does not yet provide a point of convergence neither on principles nor on the agenda.

To make this point starker: in contrast to financial governance, the governance of international trade has a set of agreed principles and a single (if fuzzy and contested) point of convergence. The Doha round is a sore point in this area but the existence of a single global governance institution such as the World Trade Organisation (WTO) gathering 153 country-members that have accepted a set of principles and procedures as well as a dispute settlement mechanism has proved effective for maintaining a common ground for worldwide trading as well as for preventing a trade-barrier race. Instead, the fiscal and monetary fields lack equivalent converging mechanisms capable of consistently coordinating disperse individual country-policies around common rules. This deficiency has resulted in inconsistency among competing fiscal and monetary counter-cyclical policies and in a very slow rebuilding of the global financial governance.

So far, industrialised countries have acted single-handedly applying their own individual recipes according to their own individual needs, injecting liquidity to the money market when judged convenient and capital to large corporations considered "too big to fail". Such "bail out" policies are the exact opposite of what was held for developing countries. Regardless of whether the current state intervention to help firms in trouble is correct or not, it certainly does uncover a double-standard. If symmetrical treatment were a matter of principle, the rhetorical questioner would jump to ask: Why bail out the car industry in Detroit instead of allowing it to redeploy in other jurisdictions?

Fiscal cooperation has been more successful in putting pressure on small countries to eradicate banking secrecy. The G20 has threatened with sanctions non-cooperative jurisdictions – including tax havens – reported in a blacklist that contains 38 countries ranging from Panama to Switzerland. Fighting tax evasion and money laundering should unquestionably be regarded as a positive step. However, the significance of these measures to fight global recession remains unclear.

Genuinely significant fiscal and monetary coordination faces an additional barrier: the goal of coordinating anti-cyclical policies is based on the underlying assumption that each country can actually afford them. Obviously, this assumption is illusory since developing economies face more restrictions than the industrial countries for managing such policies as well as for retaining access to voluntary credit in times of dried up financial markets. Not being issuers of hard currency they lack the resources to pay for their own fiscal pump-priming. The World Bank estimates that as a result of the havoc in financial markets, developing nations can be expected to face a financing gap of between $270 billion and $700 billion. Industrialised countries are drying up credit markets to finance their own counter-cyclical policies crowding out private investment both domestically and globally as well as capital flows to developing countries. The developing world with shrinking borrowing options is locked out of financial flows.

True, many developing countries enjoy in the short-term a relatively comfortable position to deal with simultaneous credit restrictions and capital outflows due to enlarged reserves and lower external and public sector debts in comparison with previous crises. Still, these resources are too limited to afford sustained anti-cyclical policies. Reserves are useful in the short-run but they will dwindle rapidly. In addition, other countries have little room to handle the crisis due to a tight balance of payments. Thus, with different time lags both cases face the same risk: the shortage of funding in the near future for sustaining expansionary policies. There is indeed ample evidence that macroeconomic policies in developing countries are pro-cyclical and that this pro-cyclical behaviour has adverse effects on growth and stability. Illiquid markets will eventually push them to take the protectionist measures the world wants to prevent. In addition, declining foreign reserves may lead a big share of the developing world to a new debt crisis in the medium-term, giving the global economy the final push off the cliff.

This is therefore the perfect opportunity for the developing world to charge on with significant reforms of multilateral financial institutions that seem to be the natural channels for provision of long-term funding for context specific anti-cyclical policies – mainly the IMF and the World Bank as well as the regional development banks. Developing countries claim an enlarged participation in the decision-making of these institutions as well as a realignment of shares in line with their increased relative economic weight in the global economy. They also demand a review of conditionality to gain access to loans.

Meanwhile, as an immediate policy action aiming at both relieving reform pressures from developing countries and contributing to enhance global liquidity the IMF agreed to issue $250 billion in new Special Drawing Rights (SDRs) to reinforce the foreign reserves of IMF members. This liquidity injection will be allocated according to IMF quota shares, which means that the bulk will go to the G7 countries, already enjoying exorbitant monetary privileges. It is evident that developing countries are interested in these multilateral institutions mainly as a source of financial funding whereas industrial economies are aiming at reinforcing IMF role as an auditor of borrowers.

Gatekeepers and money doctors have lost the moral high ground while a number of fire-fighting brigades are out in the fields. If what they hold in hand are centrifugal extinguishers they will only fan the flames onto nearby bushes. Trade protection will turn out to be the mechanism of last resort for a good part of the world – thus lowering aggregate demand and further feeding the fire. This time the developing world has become too big to fail. The politics of market regulation have taken centre stage.

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